WORLD TRADE ORGANIZATION

Dispute Settlement Reports

2002
Volume I

Pages 1-585

THE WTO DISPUTE SETTLEMENT REPORTS

The *Dispute Settlement Reports* of the World Trade Organization (the "WTO") include panel and Appellate Body reports, as well as arbitration awards, in disputes concerning the rights and obligations of WTO Members under the provisions of the *Marrakesh Agreement Establishing the World Trade Organization*. The *Dispute Settlement Reports* are available in English, French and Spanish. Starting with 2002, each volume contains a cumulative index of published disputes.

This volume may be cited as DSR 2002:I

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Arbitration under Article 21.3(c) of the Understanding on Rules and Procedures Governing the Settlement of Disputes

Award of the Arbitrator
James Bacchus
WT/DS114/13

Circulated to Members on 18 August 2000

I. INTRODUCTION

1. On 7 April 2000, the Dispute Settlement Body (the "DSB") adopted the Panel Report in *Canada – Patent Protection of Pharmaceutical Products* ("*Canada – Pharmaceutical Patents*").[1] On 25 April 2000, Canada informed the DSB, pursuant to Article 21.3 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), that it would implement the recommendations and rulings of the DSB in this dispute; however, Canada said that it would require a "reasonable period of time" to do so, under the terms of Article 21.3 of the DSU.

2. Consultations between Canada and the European Communities on the duration of the reasonable period of time for implementation occurred but these did not result in agreement.

3. By joint letter of 20 June 2000, Canada and the European Communities notified the DSB that they had agreed that the duration of the reasonable period of time for implementation should be determined through binding arbitration, under the terms of Article 21.3(c) of the DSU, and that I should act as Arbitrator. The parties also indicated in that letter that they had agreed to extend the time period for the arbitration, fixed at 90 days by Article 21.3(c) of the DSU, until 31 August 2000. Notwithstanding this extension of the time period, the parties stated that the arbitration award would be deemed to be an award made under Article 21.3(c) of the DSU. My acceptance of this designation as Arbitrator was conveyed to the parties by letter of 21 June 2000.

4. Written submissions were received from Canada and the European Communities on 6 July 2000, and an oral hearing was held on 20 July 2000.

II. ARGUMENTS OF THE PARTIES

A. Canada

5. Canada submits that the implementation of the DSB's recommendations and rulings in this case can be accomplished through regulatory change rather than through legislative amendment, which Canada submits is usually more time

[1] WT/DS114/R.

consuming.[2] Given the extent of consultations required in this contentious field, Canada believes that the regulatory process can be carried out and finalized in a maximum of 11 months' time from the date of adoption of the Panel Report.

6. In its submission, Canada explains the process by which changes are made to its regulatory regime. According to Canada, the Government of Canada Regulatory Policy ("Regulatory Policy") states that the use of the government's regulatory powers should result in "the greatest net benefit to Canadian society". Accordingly, authorities who propose the exercise of regulatory power are obliged to demonstrate that the benefits of regulating clearly outweigh the costs, and that an effort has been made to structure the regulatory measures so as to maximize the benefits to Canadians and minimize the costs.

7. Canada explains that, in the normal course, the department with responsibility for the area in which the problem has arisen, in this case, the Department of Industry, should include information about the problem in its Report on Plans and Priorities, a document which is tabled in the Canadian Parliament. Where a potential regulatory initiative has not been so planned and reported, the department must nevertheless explain the rationale for its planned regulatory proposal regarding the problem in its Departmental Regulatory Plan. In the Department of Industry, that information is reviewed by the Department's Senior Policy Committee, which evaluates and categorizes the proposal.

8. The responsible department is then required to draft a proposed regulation. The department must also prepare a Regulatory Impact Analysis Statement (the "RIAS"), which describes the purpose of the draft regulation, the alternatives considered, a cost-benefit analysis, the results of consultations with interested parties, the department's response to the concerns raised, and how the regulation will be enforced.

9. Canada further clarifies that, pursuant to the provisions of the Canadian *Statutory Instruments Act*, the proposed regulation and supporting documentation, including the RIAS, must be produced in both English and French, Canada's two official languages. They must then be approved by the responsible department's legal services and senior management, and sent to the Clerk of the Privy Council and to the Deputy Minister of Justice for review. The Privy Council Office ensures that the proposal is consistent with the government's overall program and that the responsible department has adequately considered the communications aspects of the proposed regulatory action. The Regulations Section of the Department of Justice examines the regulation to ensure that it has a proper legal basis and, in particular, that "it does not trespass unduly on existing rights and freedoms and is not, in any case, inconsistent with the purposes and provisions of the *Canadian Charter of Rights and Freedoms* and the *Canadian Bill of Rights*".[3]

10. Canada explains that the Regulatory Policy also requires that the complete documentation in support of a proposal be sent to the Regulatory Affairs and Orders in Council Secretariat of the Privy Council Office, which is the agency responsible for administering the Policy. The Secretariat reviews the proposal to ensure that it is consistent with the Policy and, in particular, that: the responsible department has considered other alternatives; the benefits of regulation clearly outweigh the costs; adequate consultation with the public has taken place, to allow Canadians to

[2]Canada's submission, para. 9.
[3]Canada's submission, para. 14.

understand the proposed regulation and to participate in the process; and the responsible department has cooperated with Canada's provincial governments to ensure that the proposed regulation does not duplicate or overlap any provincial measure.

11. Once these reviews have been completed, the Minister of the responsible department approves the regulation and supporting documentation and submits them to the Privy Council Office for consideration by the Cabinet's Special Committee of Council (the "SCC"), which is the Cabinet committee that gives Governor in Council approval for the pre-publication of a draft regulation and its accompanying RIAS. The Regulatory Policy requires pre-publication of a regulation in order to provide the Canadian public at large, as opposed to the more limited constituencies initially consulted by the responsible department, with an opportunity to comment. Upon approval by the SCC Ministers, the regulation and its RIAS are published in the Canada Gazette, Part I, and must be open for public comment for at least 30 days.

12. Comments received from the public must be weighed on their merits and changes to the proposed regulation must be considered. If the proposed regulation is changed, the Department of Justice Regulations Section must again examine and approve the revised version before it is sent for final approval by SCC Ministers. If the proposed regulation is amended, the RIAS must also be changed to reflect the amendment.

13. Ministers consider each proposed regulation on its own merits. If they approve the regulation, it is registered under a statutory orders and regulations number within seven days of the Governor General's signature. The regulation will come into force on a date specified by the Governor in Council or, where not so specified, on the day of registration. The approved regulation and its RIAS are then forwarded for publication in the Canada Gazette, Part II, which is published by the Queen's Printer every second Wednesday. Pursuant to subsection 11(1) of the *Statutory Instruments Act*, publication must take place no later than 23 days after registration. Once published, the regulation becomes enforceable as law, as the public is deemed to have notice of the change in the regulatory regime.

14. Canada believes that the process of drafting, consultation, approval, promulgation and registration of the proposed regulation in this case can be accomplished in a maximum of 11 months time from the date of the adoption of the Panel Report by the DSB. Canada breaks this period down as follows:

(a) 2 weeks for identification and assessment, which involves the preparation of an explanation as to why the measure is needed and a reference by the Department of Industry to its Senior Policy Committee for evaluation of the Regulatory Plan and review of the regulatory proposal;

(b) 3 months for the drafting of the proposed regulation and RIAS; review by relevant Department of Industry committees; review and approval by Department of Industry legal services; development of a communications plan; forwarding of the proposed regulation for examination by Department of Justice Regulations Section; informal review by the Privy Council Office; final Department of Industry review and approval for pre-publication and signature of the Minister of Industry;

(c) 2 weeks for the formal submission of the regulatory package to the Privy Council Office for submission to SCC for pre-

publication and approval. The material must be submitted at least one week in advance of a scheduled meeting. Meetings are generally held weekly, but less frequently during Parliamentary recesses. In this respect, Canada notes that its Parliament is currently in recess until the end of September 2000;

(d) 1 month and 1 week for the pre-publication in Canada Gazette, Part I and receipt of questions and comments from the public;

(e) 1-3 months for the response to public comments; amendment of the regulation and RIAS as required; resubmission to Department of Industry legal services and Department of Justice Regulations Section; review and approval for final publication and signature of the Minister of Industry; and

(f) 2 weeks for the formal submission of the regulatory package to the Privy Council Office for submission to SCC for final publication approval; final publication in Canada Gazette, Part II.[4]

15. Canada submits that although the above breakdown totals 8-9 months, it may not be possible to carry out the needed consultations during that time, or to receive the views and advice from all of the relevant constituencies, since critical aspects of the process will occur during the summer vacation period of July and August. Accordingly, in order to ensure that these essential steps are properly carried out, Canada argues that the total period should be increased to approximately 10-11 months.

16. Having explained its regulatory process, Canada turns next to a review of previous arbitrations under Article 21.3(c) of the DSU. Canada submits that, in previous arbitrations, arbitrators have consistently begun their assessments by considering the guideline contained in Article 21.3(c) itself. A guideline for the arbitrator should be that the reasonable period of time to implement DSB recommendations should not exceed 15 months from the date of adoption of a panel or Appellate Body report.

17. Canada submits that the reasonable period of time may be shorter or longer, depending on particular circumstances. Canada recalls that, as the arbitrator in *Australia - Measures Affecting Importation of Salmon* ("*Australia – Salmon*") put it, "what constitutes a 'reasonable period of time' depends upon the action which [the implementing Member] takes under its legal system to implement the recommendations and rulings of the DSB."[5]

18. Canada believes that as it has undertaken to achieve compliance in significantly less time than is contemplated by the Article 21.3(c) guideline, the onus is clearly on the European Communities, as the complaining Member, to establish that there are "particular circumstances" to justify an even shorter period of time. Canada adds that, in determining whether the European Communities has discharged its burden of proof in this case, it will be important to bear in mind that Canada, as the implementing Member, is not obliged to take unusual steps in order to bring its law into compliance with its obligations.

[4]Canada's submission, para. 19.

[5]Award of the Arbitrator under Article 21.3(c) of the DSU, *Australia – Salmon*, WT/DS18/9, 23 February 1999, DSR 1999:I, 267, para. 33.

19. Canada emphasizes the statement of the arbitrator in *Korea - Taxes on Alcoholic Beverages* ("*Korea – Alcoholic Beverages*") that, while the reasonable period of time should be the shortest possible within the legal system of the implementing Member, "this does not require a Member, in my view, to utilize an *extraordinary* legislative procedure, rather than the *normal* legislative procedure, in every case."[6] Canada considers that this approach is in keeping with the discretion that is afforded to WTO Members by Article 1.1 of the *Agreement on Trade-related Aspects of Intellectual Property Rights* (the "*TRIPS Agreement*") "to determine the appropriate method of implementing the provisions of this Agreement within their own legal system and practice".

20. Canada considers that it will achieve compliance with its obligations under the *TRIPS Agreement* by revoking the regulations that are essential to the existence of the stockpiling exception. According to Canada, Subsection 55.2(2) of the *Patent Act* will thereby be rendered of no legal force or effect. Revocation of the Regulations will completely deprive subsection 55.2(2) of the *Patent Act* of any meaning or effect. As a result, no one who has availed themselves of the protection of subsection 55.2(1) -- the "regulatory review" exception -- for the purposes of developing and submitting samples of a competing version of a patented product to regulatory authorities for their review will, on the coming into force of the revoking regulation, be entitled to further manufacture or further stockpile products prior to the expiration of the term of the relevant patent. The protection from infringement liability created by the combination of the theory expressed in subsection 55.2(2) and the practical substance given to that theory by the Regulations will be wholly terminated by the revocation.

21. Canada emphasizes, however, that "the revocation of the *Manufacturing and Storage of Patented Medicines Regulations* will be a very sensitive political matter in Canada", and, thus, that extensive consultations with stakeholders, interest groups and the general public will be required.[7] In Canada's view, a maximum of 11 months' time is, therefore, needed in order to conduct the necessary consultations, as well as to comply with the various procedural requirements of the *Statutory Instruments Act* and the Regulatory Policy.

22. Canada, therefore, requests the arbitrator to rule that 11 months from 7 April 2000, the date of adoption of the Panel Report by the DSB, is the reasonable period of time for the implementation of that ruling in this case. Thus, Canada proposes a "reasonable period of time" for implementation that would end on 7 March 2001.

B. European Communities

23. The European Communities submits that to implement fully the recommendations and rulings of the DSB, Canada must repeal Section 55.2(2) of its *Patent Act*, which the Panel in this dispute found to be inconsistent with the requirements of Article 28(1) of the *TRIPS Agreement*.

24. The European Communities is of the view that implementation of the DSB recommendations in this case requires the repeal of Section 55.2(2) of the *Patent Act*, that is, legislative, and not regulatory action. The European Communities

[6]Award of the Arbitrator under Article 21.3(c) of the DSU, *Korea – Alcoholic Beverages*, WT/DS/75/16, WT/DS84/14, 4 June 1999, DSR 1999:II, 937, para. 42.

[7]Canada's submission, para. 28.

considers that "it is only necessary to repeal a single subparagraph, which is separable from the remainder of the provisions of which it forms part".[8] The European Communities argues that "this can be performed in a period of time significantly shorter than the indicative maximum period" of 15 months provided for in Article 21.3(c) of the DSU.[9] The European Communities argues that, in any event, the "reasonable period of time" in this matter must not be a period longer than 12 months counted from 7 April 2000, the date of the adoption of the Panel Report in this dispute by the DSB.

25. The European Communities submits that the ordinary meaning of the language in Article 21.3(c) of the DSU indicates that 15 months is a guideline for the arbitrator and "sets an outer limit or a maximum in the usual case".[10] Thus, the European Communities contends that when implementation can be effected by administrative means, the reasonable period of time should be considerably shorter than 15 months. In addition, the European Communities asserts that Article 21.3(c) of the DSU must be interpreted in context, and, in particular in the context of Articles 3.3 and 21.1 of the DSU, which place particular emphasis on the prompt compliance of recommendations and rulings of the DSB.

26. The European Communities also highlights the statement of the arbitrator in the *EC Measures Affecting Meat and Meat Products* (*Hormones*) ("*European Communities – Hormones*") arbitration, that the reasonable period of time under Article 21.3(c), "should be the shortest period possible within the legal system of the Member to implement the recommendations and rulings of the DSB."[11]

27. The European Communities acknowledges that it is not within the mandate of the arbitrator under Article 21.3(c) of the DSU to decide on the precise ways and means Canada must use to implement the recommendations and rulings of the DSB. However, in order to be able to assess if implementation can occur immediately, and in case this proves to be impracticable to assess the length of the reasonable period, "it is fundamental for the arbitrator to define the nature of the measure necessary to implement the recommendations and rulings of the DSB".[12]

28. According to the European Communities, it is important to note that "implementation of the recommendations and rulings" in Article 21 of the DSU means full implementation, as opposed to provisional or partial implementation. The European Communities argues that, in accordance with Article 3.7 of the DSU, which stipulates that the first objective of the dispute settlement mechanism is usually to secure the withdrawal of the measures concerned if these are found to be inconsistent with the provisions of any of the covered agreements, Canada has to repeal Section 55.2(2) of its *Patent Act*, which can only be achieved through another legislative act (*actus contrarius*). The abrogation of the regulations, as proposed by Canada, cannot achieve this goal.

29. The European Communities observes that, while law-making procedures differ in the various WTO Members, it is nevertheless instructive to see that the reasonable periods of time for implementation measures of a legislative nature, that

[8]European Communities' submission, para. 4.

[9]European Communities' submission, para. 4.

[10]*Ibid*., para. 14.

[11]Award of the Arbitrator under Article 21.3(c) of the DSU, *European Communities – Hormones*, WT/DS26/15, WT/DS48/13, 29 May 1998, DSR 1998:V, 1833, para. 26.

[12]European Communities' submission, para. 17.

have been granted in the past, cover periods ranging from 11 months and 2 weeks to 15 months and 1 week . The European Communities notes further that this includes cases where the reasonable period had been decided by arbitration under Article 21.3(c) of the DSU as well as cases where the parties agreed by consensus under Article 21.3(b) of the DSU.

30. The European Communities submits that, in *Canada – Certain Measures Concerning Periodicals* ("*Canada – Periodicals*"), Canada agreed to take a number of implementation measures legislatively within 15 months from the adoption of the Appellate Body Report by the DSB. The implementation measures in that dispute covered a wide variety of subject-matter, including the elimination of the entire Part V.1 of Canada's *Excise Tax Act*. Although the European Communities concedes that the agreement between the parties in that dispute is not authoritative for the case at hand, it argues that that agreement "can serve as an indicative yardstick".[13] By comparing the degree of complexity of the measures to be adopted for implementation in the *Canada – Periodicals* case with the measure to be adopted in this case, it becomes apparent that the "reasonable period of time" in the present case must be "significantly shorter than in [that] case."[14].

31. According to the European Communities, in *Canada – Periodicals*, Canada undertook to take a variety of measures, including the repeal of a customs tariff, the elimination of Part V.1 of the *Excise Tax Act*, the restructuring of the administration of the postal subsidy program and the harmonization of the commercial postal rates. In this case, the European Communities argues, all that is needed is the repeal of a single subparagraph of Section 55 of the *Patent Act* without the need for any other action. Furthermore, the fact that tax legislation tends to be subject to special procedural terms, to which general economic legislation such as patent laws are not subject, further militates, in the view of the European Communities, for a reduction of the "reasonable period of time".

32. The European Communities, therefore, requests the arbitrator to rule that 12 months from 7 April 2000, the date of the adoption of the Panel Report by the DSB, is the "reasonable period of time" for the ruling in this dispute. Thus, the European Communities proposes a "reasonable period of time" for implementation that would end on 7 April 2001.

III. DETERMINATION

33. Canada has agreed to implement the recommendations and rulings of the Dispute Settlement Body ("DSB") in *Canada – Pharmaceutical Patents*.[15] Canada has also, however, availed itself of Article 21.3 of the Dispute Settlement Understanding ("DSU"), which states in relevant part:

> If it is impracticable to comply immediately with the recommendations and rulings, the Member concerned shall have a *reasonable period of time* in which to do so. (emphasis added)

[13]European Communities submission, para. 23.
[14]*Ibid*.
[15]DSB Meeting of 25 April 2000, WT/DSB/M/79, para. 13.

34. As the duration of the "reasonable period of time" in this case has not been agreed by either the DSB, under Article 21.3(a), or the parties to the dispute, under Article 21.3(b), the parties have requested that I determine this period of time through binding arbitration under Article 21.3(c). This provision of the DSU refers to the possibility of "binding arbitration within 90 days after the date of adoption of the recommendations and rulings".

35. In this Article 21.3 proceeding, Canada has requested a period of 11 months from the date of adoption of the Panel Report to implement the recommendations and rulings of the DSB, by means of regulations made under Canada's *Patent Act*.[16] The European Communities contests both this form of implementation and also the period of time requested for implementation by Canada. To fulfill my responsibilities as arbitrator, I will look first at the issue of the means of implementation, then at the meaning of a "reasonable period of time" for implementation, and, finally, at Canada's proposed timetable for implementation, before making my determination.

A. *MEANS OF IMPLEMENTATION*

36. The Panel found that "Section 55.2(2) of Canada's *Patent Act* is not consistent with the requirements of Article 28.1 of the TRIPS Agreement."[17] Accordingly, the Panel "recommend[ed] that the Dispute Settlement Body request that Canada bring Section 55.2(2) into conformity with Canada's obligations under the TRIPS Agreement." The DSB adopted the Panel Report on 7 April 2000.[18]

37. Canada proposes to implement the recommendations and rulings of the DSB, not by means of legislation, but by means of administrative action in the form of a regulation. The European Communities responds that, in order to implement the recommendations and rulings of the DSB properly, Canada "has to repeal Section 55.2(2) of its Patent Act, which can only be achieved through another legislative act (actus contrarius)."[19] For this reason, the European Communities states that "it is fundamental for the arbitrator to define the nature of the measure necessary to implement the recommendations and rulings of the DSB."[20] Canada, in turn, maintains that I have no such authority or mandate.

38. In considering the argument by the European Communities on the means of implementation, I note first that the Panel Report in *Canada – Pharmaceutical Patents* does not specify, or even mention, how Canada should implement the recommendations and rulings. The Panel simply recommends that the DSB request Canada to "bring Section 55.2(2) into conformity" with Canada's obligations under the *TRIPS Agreement*. The DSB has done so.

39. Thus, it has been left for Canada to decide what form the implementing action should take. As the arbitrator in *European Communities – Hormones* stated:

> An implementing Member … has a measure of discretion in choosing the *means* of implementation, as long as the means chosen are consistent with the recommendations and

[16]Oral Statement of Canada, para. 18.

[17]Panel Report, *Canada – Pharmaceutical Patents*, WT/DS114/R, adopted 7 April 2000, DSR 2000:V, 2289, para. 8.1(2).

[18]DSB Meeting of 7 April 2000, WT/DSB/M/78, para. 69.

[19]European Communities' submission, para. 19.

[20]*Ibid*., para. 17.

> rulings of the DSB and with the covered agreements.[21]

40. Moreover, I am of the view that whether the means of implementation chosen by a Member is consistent with that Member's obligations under the WTO covered agreements is not a question that falls within the jurisdiction of an arbitrator under Article 21.3(c). As the text of the provision makes clear, the sole task of an arbitrator under Article 21.3(c) is to determine a "reasonable period of time" in which a Member must complete implementation. Thus, I agree with the arbitrator in *Korea – Alcoholic Beverages* that:

> My mandate in this arbitration relates *exclusively* to determining the reasonable period of time for implementation under Article 21.3(c) of the DSU. It is not within my mandate to suggest ways and means to implement the recommendations and rulings of the DSB. Choosing the means of implementation is, and should be, the prerogative of the implementing Member, as long as the means chosen are consistent with the recommendations and rulings of the DSB and the provisions of the covered agreements. I consider it, therefore, inappropriate to determine whether, and to what extent, amendments to various regulatory instruments are required before the new tax legislation comes into effect.[22] (emphasis added)

41. As an arbitrator under Article 21.3(c), certainly my responsibility includes examining closely the relevance and duration of each of the necessary steps leading to implementation to determine when a "reasonable period of time" for implementation will end. My responsibility does not, however, include in any respect a determination of the *consistency* of the proposed implementing measure with the recommendations and rulings of the DSB. The proper concern of an arbitrator under Article 21.3(c) is with *when*, not *what*.

42. *What* a Member must do to comply with the recommendations and rulings of the DSB in any particular case is addressed elsewhere in the DSU. Article 21.5 sets out special procedures for determining "the existence or *consistency* with a covered agreement of measures taken to comply with the recommendations and rulings" resulting from a dispute.[23] If there is any question about whether *what* a Member chooses as a means of implementation is sufficient to comply with the recommendations and rulings of the DSB, as opposed to w*hen* that Member proposes to do it, then Article 21.5 applies, not Article 21.3. The reasons are many and obvious. For example, if the consistency of implementing measures could also be examined during arbitrations under Article 21.3(c), then Article 21.5 would lose much of its effect. Parties would have little to lose in requesting also from an arbitrator under Article 21.3(c) an immediate ruling on the consistency of a proposed

[21] *Supra*, footnote 11, para. 38.
[22] *Supra*, footnote 6, para. 45.
[23] Emphasis added.

measure. Also, the more elaborate Article 21.5 procedures, involving a panel of three or five members and a report adopted by the DSB, seem more suitable than the more constrained legal domain of Article 21.3(c) for assessing the consistency of substantive obligations under WTO covered agreements.

43. For these reasons, I cannot agree with the European Communities' request to examine the "nature" of the implementation proposed by Canada, in the sense of determining whether that proposed implementation is consistent with the recommendations and rulings of the DSB. That would exceed my mandate under the DSU. It is clear to me that any examination of the consistency of a proposed measure with the recommendations and rulings of the DSB must be made, not in an Article 21.3 proceeding, but in an Article 21.5 proceeding. Accordingly, I conclude that the "reasonable period of time" for implementation that must be determined in this Article 21.3 proceeding is the "reasonable period of time" for implementing what has been *proposed by Canada*, and nothing else. Thus, I offer no opinion whatsoever on whether Canada's proposed regulatory change is sufficient, or whether legislative change may be required instead for consistency with the recommendations and rulings of the DSB.

B. *THE MEANING OF A "REASONABLE PERIOD OF TIME"*

44. My task, then, is a limited one: to determine the "reasonable period of time" it should take Canada to make the regulatory change that Canada proposes to make. To accomplish this task, I begin with the text of Article 21.3, which states that:

> … a guideline for the arbitrator should be that the reasonable period of time to implement panel or Appellate Body recommendations *should not exceed 15 months* from the date of adoption of a panel or Appellate Body report. However, that time may be shorter or longer, depending upon the *particular circumstances*. (emphasis added)

45. I note that the 15-month period is a "guideline", and not an average, or usual, period. It is expressed also as a *maximum* period, subject only to any "particular circumstances" mentioned in the second sentence. Further, and significantly, a "reasonable period of time" is not available unconditionally. Article 21.3 makes it clear that a reasonable period of time is available for implementation only "[i]f it is impracticable to comply *immediately* with the recommendations and rulings" of the DSB.[24] Implicit in the wording of Article 21.3 seems to me to be the assumption that, ordinarily, Members will comply with recommendations and rulings of the DSB "immediately". The "reasonable period of time" to which Article 21.3 refers is, thus, a period of time in what is implicitly not the ordinary circumstance, but a circumstance in which "it is impracticable to comply *immediately* … ".[25]

46. Other provisions of the DSU suggest that implementation of recommendations and rulings of the DSB must be achieved, if not "immediately", then promptly. Article 21.1, for example, states that "*prompt* compliance with

[24]Emphasis added.
[25]Emphasis added.

recommendations and rulings of the DSB is *essential* in order to ensure effective resolution of disputes to the benefit of all Members".[26] Similarly, Article 3.3 states:

> The *prompt* settlement of situations in which a Member considers that any benefits accruing to it directly or indirectly under the covered agreements are being impaired by measures taken by another Member is *essential* to the effective functioning of the WTO and the maintenance of a proper balance between the rights and obligations of Members. (emphasis added)

The Concise Oxford Dictionary defines the word, "prompt", as meaning "acting with alacrity; ready", and "made, done, etc. readily or at once".[27]

47. Based on the wording of Articles 21.3, and on the context provided in Articles 3.3, 21.1 and 21.4 of the DSU, I agree with the arbitrator in *European Communities – Hormones* that "the reasonable period of time, as determined under Article 21.3(c), should be the shortest period possible within the legal system of the Member to implement the recommendations and rulings of the DSB."[28] Moreover, as immediate compliance is clearly the preferred option under Article 21.3, it is, in my view, for the implementing Member to bear the burden of proof in showing – "[i]f it is impracticable to comply immediately" – that the duration of any proposed period of implementation, including its supposed component steps, constitutes a "reasonable period of time". And the longer the proposed period of implementation, the greater this burden will be.

48. The "particular circumstances" mentioned in Article 21.3 are, therefore, those that can influence what the shortest period possible for implementation may be within the legal system of the implementing Member. Conceivably, several such "particular circumstances", depending on the facts, could be relevant to a case such as the one before me.

49. For example, if implementation is by *administrative* means, such as through a regulation, then the "reasonable period of time" will normally be shorter than for implementation through *legislative* means. It seems reasonable to assume, unless proven otherwise due to unusual circumstances in a given case, that regulations can be changed more quickly than statutes. To be sure, the administrative process can sometimes be long; but the legislative process can oftentimes be longer.

50. Likewise, the *complexity* of the proposed implementation can be a relevant factor. If implementation is accomplished through extensive new regulations affecting many sectors of activity, then adequate time will be required to draft the changes, consult affected parties, and make any consequent modifications as needed. On the other hand, if the proposed implementation is the simple repeal of a single provision of perhaps a sentence or two, then, obviously, less time will be needed for drafting, consulting, and finalizing the procedure. To be sure, complexity is not merely a matter of the number of pages in a proposed regulation; yet it seems

[26]Emphasis added.

[27]*The Concise Oxford Dictionary*, Della Thompson (ed.) 9th ed. (Clarendon Press, 1995), p. 1096.

[28]*Supra*, footnote 11, para. 26.

reasonable to assume that, in most cases, the shorter a proposed regulation, the less its likely complexity.

51. In addition, the *legally binding*, as opposed to the discretionary, nature of the component steps leading to implementation should be taken into account. If the law of a Member dictates a mandatory period of time for a mandatory part of the process needed to make a regulatory change, then that portion of a proposed period will, unless proven otherwise due to unusual circumstances in a given case, be reasonable. On the other hand, if there is no such mandate, then a Member asserting the need for a certain period of time must bear a much more imposing burden of proof. Something required by law must be done; something not required by law need not necessarily be done, depending on the facts and the circumstances in a particular case.

52. These are but examples. There may well be other "particular circumstances" that may be relevant to a particular case. However, in my view, the "particular circumstances" mentioned in Article 21.3 do *not* include factors unrelated to an assessment of the shortest period possible for implementation within the legal system of a Member. Any such unrelated factors are irrelevant to determining the "reasonable period of time" for implementation. For example, as others have ruled in previous Article 21.3 arbitrations, any proposed period intended to allow for the "structural adjustment" of an affected domestic industry will not be relevant to an assessment of the legal process.[29] The determination of a "reasonable period of time" must be a legal judgement based on an examination of relevant legal requirements.[30]

C. *CANADA'S PROPOSED "REASONABLE PERIOD OF TIME"*

53. In its submission, Canada offers a detailed timetable for implementation of the recommendations and rulings of the DSB. Canada estimates that the regulatory process it has chosen as the means of implementation will take 11 months from the date of adoption of the Panel Report, which was 7 April 2000. Thus, Canada proposes to complete *administrative* implementation by 7 March 2001. In contrast, in its submission, the European Communities stresses that Canada should implement *legislatively*, and argues that Canada should complete *legislative* implementation in a period not exceeding 12 months from the date of adoption of the Panel Report, that

[29]See Award of the Arbitrator under Article 21.3(c), *Indonesia – Certain Measures Affecting the Automobile Industry*, WT/DS54/15, WT/DS55/14, WT/DS59/13, WT/DS64/12, 7 December 1998, DSR 1998:IX, 4029, para. 23; Award of the Arbitrator under Article 21.3(c), *Japan – Taxes on Alcoholic Beverages*, WT/DS8/15, WT/DS10/15, WT/DS11/13, 14 February 1997, DSR 1997:I, 3, paras. 19 and 27.

[30]In paras. 3 and 10 of its submission, the European Communities stated that, during earlier consultations, Canada had offered to implement the recommendations and rulings of the DSB in nine months. Canada argued in the oral hearing in this arbitration that this offer had been made without prejudice during confidential consultations, and that, by submitting this evidence to me, the European Communities was in breach of Article 4.6 of the DSU, which reads: "Consultations shall be confidential, and without prejudice to the rights of any Member in any further proceedings." It is not clear to me that my mandate allows me to rule on whether submission by the European Communities of evidence of an earlier offer by Canada on defining "a reasonable period of time" in this case is inconsistent with Article 4.6 of the DSU. However, it is not necessary to do so, as I am able to arrive at a clear determination in this case without considering this evidence, whatever its legitimacy or merits. And I have not considered it in making my determination. Therefore, I make no ruling on Canada's argument relating to Article 4.6.

is, by 7 April 2001. The European Communities did not address, in its submission, the issue of a "reasonable period of time" for administrative implementation by Canada. However, in the oral hearing, the European Communities said that, if I were to decide that it is not within my mandate to identify the appropriate means of implementation, and if, as a result, my inquiry were to focus on administrative implementation, then a "reasonable period of time", in the view of the European Communities, would be "45 to 60 days from pre-publication", which I take to mean 45 to 60 days following the conclusion of the 30-day period required by Canadian law for pre-publication of the proposed regulatory change in the Canada Gazette.[31]

54. In considering the time period for implementation proposed by Canada, I recall my earlier observation that a "reasonable period of time" under Article 21.3 should be the shortest period possible within the legal system of the Member to implement the recommendations and rulings of the DSB. I note in this respect that most of the specific implementation steps proposed by Canada are either legally required under the *Statutory Instruments Act*[32] or mandated under the Government of Canada Regulatory Policy ("Regulatory Policy").[33] The steps set out in the *Statutory Instruments Act* are required by law. In contrast, the steps mandated under the Regulatory Policy are not formally binding in the sense of a law or regulation. Even so, the steps set out in the Regulatory Policy have been described to me by Canada in the oral hearing as administrative practices which, in practical terms, government officials must ordinarily follow, and this statement by Canada has not been specifically contested by the European Communities. I accept, therefore, for purposes of this arbitration, that these steps, though not legally binding, can nevertheless constitute part of the "reasonable period of time" for implementation. Accordingly, I have taken both the steps legally required under the *Statutory Instruments Act* and the steps and the durations specified under the Regulatory Policy into account in evaluating and calculating as mandatory a "reasonable period of time".

55. However, certain of the time periods specified by Canada for certain steps toward implementation are not fixed by either law or regulation. Rather, they have been estimated by Canada for purposes of this proceeding. As these estimates are not fixed by either law or regulation, but are only estimates, Canada bears a greater burden of proof in demonstrating their accuracy and legitimacy. And here Canada, in my view, has fallen short.

56. In my judgement, some of the administrative steps Canada has identified to me, and has already taken toward implementation, could have been accomplished sooner, simultaneously, or both. That said, and given what has already transpired toward implementation, I point now to one of the additional steps identified by Canada that has not yet been completed. In paragraph 19(2)(e) of Canada's written submission, Canada states with respect to the step following the required pre-publication in the Canada Gazette:

> Response to public comments; amendment of regulation and RIAS as required; resubmission

[31]Statement by the European Communities in answer to a question by the Arbitrator at the oral hearing.

[32]*Statutory Instruments Act*, R.S., 1985, c. S-22 (Exhibit 3 of Canada's submission).

[33]Government of Canada Regulatory Policy, November 1999 (Exhibit 2 of Canada's submission).

> to Department of Industry legal services and Department of Justice Regulations Section; review and approval for final publication and signature of the Minister of Industry. **Time: 1-3 months** (depending on the complexity and contentiousness of the proposal).

57. Canada acknowledges that this period of "1-3 months" is not required by law but is part of the Regulatory Policy, and Canada also acknowledges that the duration of "1-3 months" is an estimate that is not specifically mandated by the Regulatory Policy. Yet Canada maintains that this period of "1-3 months" is necessary nonetheless to allow for the amending of the proposed regulation and RIAS, if needed, as well as for further approvals of the amended text. In explanation, Canada states in part that "comments received from the public must be weighed on their merits and changes to the proposed regulation must be considered."[34] The amount of time it should reasonably take to complete this step that Canada says will take "1-3 months" seems, to me, as Canada has stated, to "depend" in part on the "complexity" of the proposed regulatory change. The more complex the proposed regulatory change, the more "reasonable" a period of "1-3 months" will seem to accomplish this step in the change.

58. With this in mind, I turn to the substantive part of Canada's proposed regulatory change, which reads in its entirety:

> The Manufacturing and Storage of Patented Medicines Regulations are repealed.[35]

I see nothing in this proposed regulatory change that can be described as complex. What is more, in this case, comments from the public could not be expected to result in much alteration of the one substantive sentence of Canada's proposed regulatory change, which merely repeals the existing regulation. After all, how many other ways could this one sentence be written? Likewise, in this case, any consideration of any changes that might conceivably be needed in the solitary substantive sentence of the proposed regulatory change could not be expected to take very long. After the several years of this dispute, once these final public comments have been received, how much more can be left to be said? If this proposed regulatory change were more complex, I might reach a different conclusion. Yet it is not complex at all. And, given the sheer simplicity of the wording, function and purpose of this proposed regulation, I consider it implausible that this particular implementation step in this case should take as much time as claimed by Canada.

59. This is not to say that the dispute between Canada and the European Communities that has given rise to the need for this change is in any way a simple one. Far from it. This dispute is complicated indeed. And the parties, the Panel, and the DSB have all given the many facets of this dispute the sustained attention that has been warranted by the considerable stakes involved. Nor is this to say that only complex laws or regulations have significant results. Again, far from it. Some of the most significant of legal changes can be stated in the simplest of terms, and with the most telling of effects. And, in contrast, some of the most Byzantine by-products of administrative and legislative endeavour sometimes have little real effect once they are enacted. Instead, this is only to say that, in my view, it should not take Canada as

[34] Canada's submission, para. 17.

[35] Text of proposed regulation as notified by Canada in letter of 31 July 2000.

much as three months to finalize this proposed regulatory change once the required 30-day period for pre-publication in the Canada Gazette has ended.

60. As I have noted previously, Canada itself concedes that this proposed "1-3 month" period could vary "depending on the complexity and contentiousness of the proposal."[36] "Complexity", as I have said, is not an issue here. Substantively, at this late point in the resolution of this dispute, we are dealing only with one sentence in one proposed regulation. Nothing more. Nor, I am persuaded, should "contentiousness" ever be an issue. I see nothing in Article 21.3 to indicate that the supposed domestic "contentiousness" of a measure taken to comply with a WTO ruling should in any way be a factor to be considered in determining a "reasonable period of time" for implementation. All WTO disputes are "contentious" domestically at least to some extent; if they were not, there would be no need for recourse by WTO Members to dispute settlement.

61. In looking for additional justification for the time period proposed by Canada, I note that Canada also requests that "the summer vacation period of July and August" should be taken into account in calculating the "reasonable period of time" for implementation, and should, as a consequence, add approximately two months to the period for implementation.[37] I see no reference to "summer vacations" in the DSU. Nor, for that matter, has Canada shown me anything in Canadian law or regulatory policy about such "summer vacations". This argument by Canada is irrelevant. Beyond this, it seems to me that Canada has offered little in the way of additional, persuasive justification for the notion that much more than a few more weeks following the end of the required pre-publication period should be needed to complete implementation. Moreover, I am not aware of, nor has Canada suggested the existence of, any additional step that may be required by Canadian law or in some way mandated as part of the Regulatory Policy before implementation can be completed.

62. Further to an undertaking given by Canada at the oral hearing in this arbitration, I have received notice from Canada that the proposed regulatory change at issue here was to be published by Canada in the edition of the Canada Gazette dated 5 August 2000. I have since confirmed that the proposed regulatory change was indeed published on that date[38], and in the form proposed by Canada in this arbitration. Thus, the required 30-day period for pre-publication will end 4 September 2000. In my view, a "reasonable period of time" for implementation by Canada will end soon thereafter.

63. When they wish to do so, and when they have the lawful discretion to do so, administrative agencies can act, in the language of the DSU, "promptly". There is evidence on record in this proceeding that administrative agencies in Canada have acted quickly in cases where intellectual property rights have been known to be at risk.[39] As I see it, the commitment made by Canada to the DSB to comply fully with the recommendations and rulings of the DSB in this case, and thereby to fulfill Canada's international obligations as a Member of the WTO, should give rise to, if

[36]Canada's submission, para. 19(e).

[37]*Ibid*., para. 19.

[38]Government of Canada Website, Canada Gazette, Saturday, August 5, 2000; Vol. 134, No. 32 (www.canada.gc.ca/gazette/hompar1-2_e.html).

[39]See Oral Statement of the European Communities, para. 16, citing the *Patented Medicines* (*Notice of Compliance*) *Regulations*, SOR/93-133.

not equal, then comparable, urgency in Canada. Whatever their disagreements on a "reasonable period of time" for implementation in this dispute, doubtless Canada and the European Communities will agree on this: the desire of a WTO Member to comply with its treaty obligations under the *WTO Agreement* should occasion, domestically, some modicum of dispatch.

IV. AWARD

64. I determine that the reasonable period of time for Canada to implement the recommendations and rulings of the DSB in this case is *six months* from the date of adoption of the Panel Report by the DSB on 7 April 2000. The reasonable period of time will thus end on *7 October 2000*.

BRAZIL – EXPORTING FINANCING PROGRAMME FOR AIRCRAFT

RECOURSE TO ARBITRATION BY BRAZIL UNDER ARTICLE 22.6 OF THE DSU AND ARTICLE 4.11 OF THE SCM AGREEMENT

Decision by the Arbitrators
WT/DS46/ARB

Circulated to Members on 28 August 2000

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I. INTRODUCTION

A. REQUEST FOR ARBITRATION AND SELECTION OF THE ARBITRATORS

1.1 On 10 May 2000, Canada, pursuant to Article 4.10 of the Agreement on Subsidies and Countervailing Measures (hereinafter the "SCM Agreement") and Article 22.2 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (hereinafter the "DSU"), requested that a special meeting of the Dispute Settlement Body ("DSB") be convened to authorize Canada to take appropriate countermeasures in the amount of Canadian dollars (hereinafter "C$") 700 million per year (WT/DS46/16). At the DSB meeting held on 22 May 2000, Brazil requested, pursuant to Article 22.6 of the DSU, that the matter be referred to arbitration.[1]

[1] See WT/DSB/M/81, para. 10. Brazil later confirmed its request in a communication dated 7 June 2000 (WT/DS46/18). At the meeting of the DSB on 22 May 2000, Brazil also notified the DSB of its decision to appeal to the Appellate Body certain issues of law covered in the panel report under Article 21.5 of the DSU.

1.2 In response to Brazil's request, the DSB decided on 22 May 2000 to submit the matter to arbitration of the original panel in accordance with Article 22.6 of the DSU and Article 4.11 of the SCM Agreement. The arbitrators were to determine whether the countermeasures requested by Canada in document WT/DS46/16 were appropriate; it being understood that no countermeasures would be sought pending the Appellate Body report and until after the arbitrators' report in the present case. [2]

1.3 The arbitration was carried out by the original panel (referred to hereinafter as the "Arbitrators"), namely:

1.4

Chairman:	Dr. Dariusz Rosati
Members:	Professor Akio Shimizu
	Dr. Kajit Sukhum

B. PRESENTATION OF THIS REPORT

1.5 This report is structured as follows: we first address a number of issues which were discussed in the course of these proceedings and which we considered should be properly reported for the information of the Members and the transparency of the proceedings. These issues are the specific timetable applied by the Arbitrators in this case and the request for third party rights submitted by Australia. Included also is a section on the burden of proof in which we describe how we intend to consider the various data supplied by the parties, having regard to the fact that this case deals with the exportations of one single company, the Brazilian aircraft manufacturer *Empresa Brasileira de Aeronáutica S.A.* (hereinafter "Embraer").

1.6 Secondly, we proceed to the determination of the "appropriate countermeasures" in the present case, within the meaning of Article 4.10 and 11 of the SCM Agreement. In that context, we first determine the scope of our task. Thereafter, we proceed to determine whether Canada's proposed suspension of concessions or other obligations[3] fall within the definition of the term "countermeasures". Then, we address the question of whether Canada's proposed countermeasures are "appropriate". In order to do so, we first determine the meaning of the word "appropriate" in terms of the *level* of countermeasures that may be deemed "appropriate". This implies that we address the question of the actual amount of "prohibited subsidy" to be withdrawn pursuant to Article 4.7 of the SCM Agreement and the issue of whether Canada's measures should be based on the amount of nullification or impairment suffered or on the full amount of subsidization under the Brazilian *Programa de Financiamento às Exportaçaões* ("PROEX") interest rate equalisation payments. We then apply the criteria identified and perform our own calculations in order to determine whether the level of countermeasures proposed by Canada is appropriate.

1.7 Thirdly, we state in our conclusion the level of countermeasures which we consider to be appropriate in this case.

II. PRELIMINARY ISSUES

A. TIMETABLE FOR THE ARBITRATION

2.1 The Arbitrators met with the parties on 30 May 2000 to establish their working procedures and timetable. Canada and Brazil objected to the original

[2] See WT/DSB/M/81, para. 31.
[3] See WT/DS46/16.

timetable submitted by the Arbitrators for different reasons. The Arbitrators took into account the comments of the parties. They also considered the complex legal and factual situation which resulted mainly from two elements:

(a) a bilateral agreement between the parties on recourse to Articles 21 and 22 of the DSU and Article 4 of the SCM Agreement (hereinafter the "Bilateral Agreement") which provided for deadlines in relation to the invocation of Article 22;[4] and

(b) the fact that Brazil had appealed certain findings of the panel report issued under Article 21.5 of the DSU before the Appellate Body at the same time as it requested arbitration under Article 22.6 of the DSU and the fact that the report of the Appellate Body in the Article 21.5 proceedings was expected to be issued on 21 July 2000.

The time-periods referred to in the Bilateral Agreement were difficult to reconcile with the situation created by Brazil's appeal.[5] The extent to which the parties' rights and obligations under the DSU might have been affected by the Bilateral Agreement also had to be taken into account. The decision of the Appellate Body could influence the extent to which Brazil may be considered to have brought its legislation into conformity with its WTO obligations. Due process required that parties be in a position to meaningfully comment on the content of the Appellate Body report.[6] Thus, the Arbitrators adopted a timetable which, in their opinion, respected the spirit of Articles 21 and 22 of the DSU and the purpose of arbitration under Article 22.6 of the DSU and Article 4 of the SCM,[7] while not unduly delaying the issuance of the award.

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[4] See document WT/DS46/13. The Arbitrators note in this respect that the Bilateral Agreement did not expressly refer to the fact that a party may appeal the report of the panel under Article 21.5 of the DSU. They also note that Brazil, at the DSB meeting of 9 December 1999, reserved its right to appeal the Article 21.5 panel report issued under Article 21.5 (see WT/DSB/M/72, p. 2).

[5] At the hearing with the Arbitrators, on 14 July 2000, Brazil stated that the recourse by Canada to Article 22.2 of the DSU before the completion of the Article 21.5 proceedings was a material breach of the Bilateral Agreement. Referring to Article 60 of the Vienna Convention on the Law of Treaties (1969) (U.N. Doc. A/CONF. 39/27 (1969), hereinafter the "Vienna Convention"), Brazil declared that it was terminating the Bilateral Agreement. This issue is addressed in section III.A.1. below.

[6] We agree in this respect with the statement of the arbitrators in *European Communities – Regime for the Importation, Sale and Distribution of Bananas - Recourse to Arbitration by the European Communities Under Article 22.6 of the DSU*, 9 April 1999, WT/DS27/ARB (hereinafter "*EC – Bananas (1999)*"), DSR 1999:II, 725, para. 2.12:

> "[…] given that our own decisions cannot be appealed, we consider it imperative to achieve the greatest degree of clarity possible with a view to avoiding future disagreements between the parties. Reaching this objective required the parties to have more time to submit to us the information necessary to complete our tasks." (See also footnote 7 to that paragraph)

[7] The Arbitrators are also aware of the question of "sequencing" recourses to Article 21.5 and Article 22.6 of the DSU. They note that one of the effects of the Bilateral Agreement was to establish such a "sequencing". By issuing their report after the Appellate Body report, the Arbitrators consider that they have respected the intention of the parties. The question of whether such a sequencing is actually required under the DSU is not part of the mandate of the Arbitrators. The

2.2 The Arbitrators designed a timetable providing for two alternative dates of issuance of their report. Should the Appellate Body either decline jurisdiction in proceedings under Article 21.5 of the DSU or fully uphold the conclusions of the panel under Article 21.5, the report would be issued on 26 July 2000. Should any party consider that the conclusions of the Appellate Body would require additional submissions by the parties, a second round of submissions and possibly a second hearing would be organized. The award of the Arbitrators would then be issued on 23 August 2000.[8]

2.3 On the basis of the above-mentioned timetable, Canada was invited to submit a communication by 5 June 2000 explaining the methodology it applied in calculating its proposed level of suspension. Brazil commented on Canada's methodology on 13 June 2000. The parties made their initial written submissions on 26 June 2000. The Arbitrators held a meeting with the parties on 14 July 2000. Questions were asked to both parties by the Arbitrators and by Canada to Brazil on 17 July 2000. Both parties replied on 24 July. On the same date, having reviewed the report of the Appellate Body issued on 21 July, Brazil submitted additional comments to the Arbitrators. Canada commented on 28 July. The Arbitrators, on the basis of the parties' replies to their questions of 24 July, asked additional questions to the parties on 4 August 2000. The parties replied on 14 August 2000. For the reasons mentioned in paragraph 2.14 below, the report was first issued to the parties on 21 August 2000. It was then issued to the Members on 28 August 2000.

B. REQUEST FOR THIRD-PARTY RIGHTS

2.4 On 5 June 2000, Australia requested the Arbitrators to register its participation as a third party given its participation as a third party in the proceedings under Article 21.5 of the DSU and its substantial and continuing interest in the dispute.

2.5 At our request, the parties made their views known on 8 June 2000. On the same day, we informed Australia that we declined its request. Our decision took into account the views expressed by the parties, the fact that there is no provision in the DSU as regards third party status under Article 22, and the fact that we do not believe that Australia's rights would be affected by this proceeding.

2.6 We note in this respect that third party rights were granted in the Article 22.6 arbitrations concerning *European Communities – Measures Concerning Meat*

Arbitrators also took note of the statement of Canada at the DSB meeting of 22 May 2000 not to apply countermeasures before the Appellate Body report had been issued.

[8] The Arbitrators would like to recall that the timetable adopted in this case, which substantially departs from the timetables in previous arbitrations under Article 22.6 of the DSU, was dictated by the particular circumstances of the case. It may be argued that, as a result of the Appellate Body report in this case, the question of whether a panel decision under Article 21.5 can be appealed or not is solved. If this is correct, the legal uncertainty which led the Arbitrators to act cautiously may be unlikely to occur again in similar circumstances and the approach followed is unlikely to set a precedent. However, it is the understanding of the Arbitrators that the issue of the jurisdiction of the Appellate Body in proceedings under Article 21.5 of the DSU was not addressed by the Appellate Body because the parties did not raise it. The Arbitrators have to assume that the Appellate Body considered its jurisdiction to be particularly obvious, because it is generally agreed in public international law that any tribunal is responsible to address the question of its jurisdiction, whether the parties raise it or not.

and Meat Products (Hormones)[9] and rejected in the *EC – Bananas (1999)* Article 22.6 arbitration.[10] We do not consider that Australia in this case is in the same situation as Canada and the United States in the *EC – Hormones* arbitrations, nor even in the same situation as Ecuador in the *EC – Bananas (1999)* arbitration. Indeed, Australia never initiated dispute settlement proceedings against Brazil with respect to the export financing programme at issue. Moreover, Australia did not draw the attention of the Arbitrators to any benefits accruing to it or any rights under the WTO Agreement which might be affected by their decision.[11]

C. BURDEN OF PROOF

2.7 Parties have addressed the question of the burden of proof in their submissions. The need for the Arbitrators to rely on data available only to one party also justifies that we recall at this stage how we deal with these aspects in this case.

2.8 In application of the well-established WTO practice on the burden of proof in dispute resolution, it is for the Member claiming that another has acted inconsistently with the WTO rules to prove that inconsistency.[12] In the present case, the action at issue is the Canadian proposal to suspend concessions and other obligations in the amount of C$700 million as "appropriate countermeasures" within the meaning of Article 4.10 of the SCM Agreement.[13] Brazil challenges the conformity of this proposal with Article 22 of the DSU and Article 4.10 of the SCM Agreement. It is therefore up to Brazil to submit evidence sufficient to establish a *prima facie* case or "presumption" that the countermeasures that Canada proposes to take are not "appropriate". Once Brazil has done so, it is for Canada to submit evidence sufficient to rebut that "presumption". Should the evidence remain in equipoise on a particular claim, the Arbitrators would conclude that the claim has not been established. Should all evidence remain in equipoise, Brazil, as the party bearing the original burden of proof, would lose the case.

2.9 An issue to be distinguished from the question of who bears the burden of proof is that of the duty that rests on both parties to produce evidence and to collaborate in presenting evidence to the Arbitrators. This is why, even though Brazil bears the original burden of proof, we expected Canada to come forward with evidence explaining why its proposal constitutes appropriate countermeasures and we requested it to submit a "methodology paper" describing how it arrived at the level of countermeasures it proposes.[14]

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[9] See *European Communities – Measures Concerning Meat and Meat Products (Hormones), Original Complaint by Canada, Recourse to Arbitration by the European Communities under Article 22.6 of the DSU*, 12 July 1999, WT/DS48/ARB, DSR 1999:III, 1135, para. 7; *European Communities – Measures Concerning Meat and Meat Products (Hormones), Original Complaint by the United States, Recourse to Arbitration by the European Communities under Article 22.6 of the DSU*, 12 July 1999, WT/DS26/ARB, DSR 1999:III, 1105, para. 7. These decisions are hereinafter referred to as "*EC – Hormones*".

[10] *Op. Cit*., para. 2.8.

[11] Our decision may have been different if Australia had demonstrated that the countermeasures which Canada plans to adopt may affect Australia's rights or benefits under the WTO Agreement.

[12] See also how this issue is addressed in the decisions by the arbitrators in *EC – Hormones, Op. Cit.,* paras. 8 to 11.

[13] See WT/DS/46/16.

[14] This approach is similar to those followed in the arbitrators' decisions in *EC - Bananas (1999)* and *EC - Hormones, Op. Cit*.

2.10 A related problem faced by the Arbitrators in this case was that, in many instances, the original data necessary for the calculations or assessments was solely in the hands of Brazil. When this information originated in the Brazilian government, we assumed good faith and accepted the information and the supporting evidence provided by Brazil to the extent Canada also accepted it or did not provide sufficient evidence to put in doubt the accuracy of Brazil's statements and/or evidence.

2.11 However, since this case relates to subsidies granted for the purchase of aircraft produced by the Brazilian aircraft manufacturer, Embraer, a large number of data essential for the resolution of our task is only available to that company. We assumed that Embraer was independent from the Brazilian government and, for that reason, we could not treat statements from that company as we would have if they had originated from a subject of international law.[15] When Brazil only provided statements regarding information available solely to Embraer, we requested that Brazil support those statements with materials usually regarded as evidence, such as articles or statements reproduced in the specialized press, company annual reports or any other certified information originating in Embraer or other reliable sources. When Brazil was not in a position to provide documentary evidence, we requested a detailed explanation of the reasons why such evidence was not available and expressed our willingness to consider written declarations from authorized Embraer officials, if duly certified. We then weighed this evidence against the evidence submitted by Canada.

2.12 In some instances, such as for the unit price of each model of Embraer's regional jets, Brazil declared that it was not in a position to provide the information or evidence supporting it, but stated that it accepted the data provided by Canada. In these circumstances, we accepted the information and evidence supplied by Canada.

2.13 Finally, Brazil insisted in the course of the proceedings on the confidentiality of certain documents it provided to the Arbitrators. We were mindful of the serious problems that could be caused by the disclosure of certain commercial or financial information. We were also aware of the fact that the full cooperation of Members and private persons to the WTO dispute settlement mechanism, which is essential for an objective assessment of the facts, often depends on the appropriate protection of confidential information.

2.14 This is the reason why we decided to prepare two versions of this report. The first version, including the details of our calculations and all the information relied upon, was issued exclusively to the parties on a confidential basis. The second version, in which the most commercially sensitive information has been removed, is circulated to the Members.[16] While some data is not included in this version, it is nevertheless sufficiently detailed for all Members to understand the reasoning of the

[15] See preceding paragraph, where we apply a presumption of good faith to statements and evidence originating in subjects of international law (on production and appraisal of evidence, see, *inter alia*, International Court of Justice ("ICJ") judgement of 9 April 1949 *Corfu Channel Case*, ICJ Reports 1949, p. 32; ICJ judgement of 11 September 1992 *Land, Island and Maritime Frontier Dispute (El Salvador v. Honduras, Nicaragua intervening)*, ICJ Reports 1992, p. 399, para. 63; ICJ judgement on merits *Military and Paramilitary Activities in and Against Nicaragua (Nicaragua v. United States of America)*, ICJ Reports 1986, p. 40, para. 60.

[16] The text of the version circulated to Members is identical to the text of the confidential version issued to the parties, with the exception of the information which the Arbitrators, having regard to the comments of the parties, considered to be confidential. This information was replaced by "xxx".

Arbitrators and the methodology applied in determining whether the countermeasures proposed by Canada are appropriate. By doing so, the Arbitrators are of the view that they have respected their obligations under the DSU while appropriately protecting the confidentiality of certain information, for which the parties had requested confidentiality.

III. DETERMINATION OF THE "APPROPRIATE COUNTERMEASURES"

A. EXTENT OF THE MANDATE OF THE ARBITRATORS

1. Applicable provisions

(a) WTO provisions

3.1 The Arbitrators note that the provisions which establish their mandate are also discussed in several of the following sections. Therefore, rather than quoting them each time they are referred to, the Arbitrators reproduce them here and will refer to this subsection as necessary.

3.2 Article 4.11 of the SCM Agreement reads as follows:

> "In the event a party to the dispute requests arbitration under paragraph 6 of Article 22 of the Dispute Settlement Understanding ("DSU"), the arbitrator shall determine whether the countermeasures are appropriate."[footnote 10]

Footnote 10 reads as follows:

> "This expression is not meant to allow countermeasures that are disproportionate in light of the fact that the subsidies dealt with under these provisions are prohibited."

3.3 Article 4.11 of the SCM Agreement refers to an arbitration requested under paragraph 6 of Article 22 of the DSU. Article 22.6 reads in relevant parts as follows:

> "[…] However, if the Member concerned objects to the level of suspension proposed, or claims that the principles and procedures set forth in paragraph 3 have not been followed where a complaining party has requested authorization to suspend concessions or other obligations pursuant to paragraph 3(b) or (c), the matter shall be referred to arbitration. […]"

3.4 The role of the arbitrator under Article 22.6 is described in Article 22.7, which reads in relevant parts as follows:

> "The arbitrator […] shall determine whether the level of such suspension is equivalent to the level of nullification or impairment. The arbitrator may also determine if the proposed suspension of concessions or other obligations is allowed under the covered agreement. However, if the matter referred to arbitration includes a claim that the principles and procedures set forth in paragraph 3 have not been followed, the arbitrator shall examine that claim. In the event the arbitrator determines that those principles and procedures have not been followed, the complaining party shall apply them consistent with paragraph 3. […]"

3.5 The Arbitrators are aware that Article 4.10 and 11 has the status of "special or additional rules and procedures", within the meaning of Article 1.2 of the DSU. Having considered the views expressed by the parties, we follow the practice of the Appellate Body as defined more specifically in its report *on Guatemala – Anti-Dumping Investigation Regarding Portland Cement from Mexico.*[17]

(b) Status of the Bilateral Agreement

3.6 Both Canada and Brazil have referred to the Bilateral Agreement, which was concluded on 23 November 1999 and notified to the DSB in an annex to a communication from Canada.[18] At the hearing with the Arbitrators on 14 July 2000, Brazil declared that it had terminated the Bilateral Agreement because of a material breach by Canada. Brazil referred to Article 60 of the Vienna Convention. Brazil thus stated that, pursuant to Article 22.7 of the DSU, the Arbitrators should determine that the proposed countermeasures are not allowed under the SCM Agreement on the grounds that the time within which they may be authorized has expired. Canada considered that the Arbitrators do not have authority to interpret the Bilateral Agreement. Canada added that there is nothing in the SCM Agreement that provides that a Member must request or receive authorization to take countermeasures within a particular period of time. Furthermore, Article 22.6 of the DSU does not provide that a Member is required to take action within a particular period of time.

3.7 With respect to the Bilateral Agreement, the Arbitrators consider that the first question to address is whether it relates to the tasks of the Arbitrators. Without interpreting the Bilateral Agreement, the Arbitrators note that the only provision which could be taken to relate to their work is paragraph 5,[19] which provides for time periods for DSB action under the first sentence of Article 22.6 of the DSU and for a 30 day deadline for the completion of the arbitration.

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[17] Adopted on 25 November 1998, WT/DS60/AB/R, DSR 1998:IX, 3767 (hereinafter "*Guatemala – Cement*"). See, in particular, paras. 65 and 66, where the Appellate Body stated that special or additional rules and procedures referred to in Article 1.2 of the DSU fit together with the generally applicable rules and procedures of the DSU to form a comprehensive, integrated dispute settlement system (para. 66). Special or additional rules and procedures shall prevail over the provisions of the DSU to the extent there is a difference between the two sets of provisions. If there is no "difference", the rules and procedures of the DSU apply together with the special or additional provisions of the covered agreement. A special or additional rule or procedure should only be found to prevail over a provision of the DSU in a situation where adherence to one provision will lead to a violation of the other provision, that is, in case of conflict between them (para. 65); see also Appellate Body Report in *Brazil – Measures Affecting Desiccated Coconut*, adopted on 20 March 1997, WT/DS22/AB/R, p. 14, DSR 1997:I, 167, at 178-179. We therefore read these provisions as a whole and give a useful meaning to all, in application of the principle of effective interpretation (*ut res magis valeat quam pereat*).

[18] WT/DS46/13.

[19] Paragraph 5 of the Bilateral Agreement reads as follows:

> "Pursuant to footnote 6 to Article 4 of the SCM Agreement, Brazil and Canada agree that the deadline for DSB action under the first sentence of Article 22.6 of the DSU shall be 15 days after the circulation of the report under Article 21.5of the DSU, and that the deadline specified in the third sentence of Article 22.6 of the DSU for completion of arbitration shall be 30 days after the matter is referred for arbitration."

3.8 The Arbitrators note that the parties disagree as to the meaning of the term "report under Article 21.5 of the DSU" in paragraph 5 of the Bilateral Agreement. However, we recall that, at the DSB meeting of 22 May 2000, it was agreed not to seek countermeasures "pending the Appellate Body report and until after the arbitration report in the present case."[20] We consider that, by doing so, the parties have amended the terms of paragraph 5 of the Bilateral Agreement. Since the date of issuance of the report proposed by the Arbitrators has not led to objections by the parties, we consider that we acted in conformity with our obligations under the norms applicable to our task. We therefore do not need to discuss the question of whether we could interpret the Bilateral Agreement or whether it ceased to apply to the Arbitrators' tasks after Brazil's alleged application of Article 60 of the Vienna Convention[21]on 14 July 2000.

3.9 Brazil also claimed that, as a result of the termination of the Bilateral Agreement, the Arbitrators should, pursuant to Article 22.7 of the DSU, determine that the proposed countermeasures are not allowed under the SCM Agreement on the grounds that the time within which they may be authorized has expired.

3.10 We note that Article 60 of the Vienna Convention provides for the "termination" of a treaty by one party in response to a "material breach" by the other party. Article 70 of the Vienna Convention nevertheless provides that the termination of a treaty does not affect any right, obligation or legal situation of the parties created through the execution of the treaty prior to its termination. We conclude that, even assuming that the Bilateral Agreement has been terminated by Brazil on 14 July 2000, the request by Canada under Article 4.10 of the SCM Agreement, to the extent it was made in accordance with the terms of the Bilateral Agreement, remains unaffected by the termination.[22] We therefore do not find it necessary to address further this question.

2. Specific claims and arguments raised by Brazil

3.11 The parties agree that the Arbitrators are called upon to determine whether the *level* of countermeasures is appropriate. Having regard to the terms of Article 4.11 of the SCM Agreement and Article 22.7 of the DSU, we agree with them that we have, pursuant to those provisions, jurisdiction to determine whether the *level* or the *amount* of countermeasures proposed by Canada is appropriate.

3.12 More particularly, we note that Brazil, at the DSB meeting of 22 May 2000, where it requested arbitration under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement, objected to the level of suspension of concessions or other obligations proposed by Canada. We note, however, that Brazil has, in the course of the proceedings, presented certain claims or arguments the admissibility of which needs to be addressed at this stage.

[20] WT/DSB/M/81, para.31.

[21] See above, para. 3.6.

[22] Furthermore, we note that the interpretation of the first sentence of Article 22.6 of the DSU suggested by Brazil has not been followed by the DSB so far. For instance, the request by Ecuador to suspend concessions or other obligations under Article 22.6 of the DSU in the case on *European Communities – Regime for the Importation, Sale and Distribution of Bananas* (hereinafter "*EC – Bananas*"), adopted on 25 September 1997, WT/DS27/AB/R, DSR 1997:II, 591, was made on 8 November 1999, several months after the adoption of the panel report under Article 21.5 (at the DSB meeting of 6 May 1999).

3.13 First, in a communication circulated as document WT/DS46/18, Brazil argued that the principles and the procedures set out in Article 22.3 of the DSU had not been followed by Canada. Canada has objected that this claim is not within the mandate of the Arbitrators. At the hearing of the Arbitrators, Brazil stated that "Since Canada's current retaliation proposal appears to fall within the provisions of Article 22.3(a), Brazil is not today raising any issue under Article 22.3. Brazil reserves its right to do so in the event that Canada modifies or expands its requested countermeasures."

3.14 It is within our jurisdiction to determine the scope of our mandate. We consider that if Brazil's claim were part of our mandate, Brazil would be entitled to develop it at any stage of the proceedings.[23] However, we would like to specify first that we are doubtful that Canada may "modify or expand its requested countermeasures" in the course of the present proceedings. We note that, at the time of issuance of this report, Canada has actually not notified anything of that sort.

3.15 Furthermore, we reviewed the minutes of the DSB meeting of 22 May 2000, where our mandate was adopted by the DSB. We note that, during that meeting, Brazil stated that:

> "[it] ha[d] to object to the level of suspension proposed by Canada, which was entirely arbitrary"[24]

However, we did not find any clear evidence that, at that meeting, Brazil actually raised the claim that the principles and the procedures set out in Article 22.3 of the DSU had not been followed. Consequently, the statement of Brazil regarding that claim in document WT/DS/46/18 does not refer to a claim which is part of our terms of reference, as established at the DSB meeting of 22 May 2000. Therefore, we do not find it necessary to address this point any further.

3.16 Second, Brazil also argued in its oral presentation that certain measures which Canada planned to adopt in relation to certain obligations under Article VI:6(a) of the GATT 1994 and in relation to certain obligations under the Agreement on Textiles and Clothing and the Agreement on Import Licensing Procedures were not appropriate.[25]

3.17 While the claim raised by Brazil might seem to relate to the nature of the measures at issue, we consider that it is closely linked to the *level* of the countermeasures. Indeed, according to Brazil, it is not clear how the impact of these measures will be assessed in terms of the value of the Brazilian trade to be affected. Since, as mentioned above, the parties agree that we have jurisdiction to determine whether the level of countermeasures is appropriate, we consider that, if necessary, we may decide on the relevance of the application of such measures by Canada.

3. Task of the Arbitrators

3.18 As to our task, we follow the approach adopted by previous arbitrators under Article 22.6 of the DSU.[26] We will have not only to determine whether Canada's proposal constitutes "appropriate countermeasures", but also to determine the level of countermeasures we consider to be appropriate in case we find that

[23] See Appellate Body report in *EC – Bananas, Op. Cit,* paras. 145-147.
[24] WT/DSB/M/81, para. 10.
[25] Brazil's oral presentation, 14 July 2000, para. 3.
[26] See Article 22.6 arbitrations in *EC – Hormones, Op. Cit.*, para. 12.

Canada's level of countermeasures is not appropriate, if necessary by applying our own methodology.

B. ARE CANADA'S PROPOSED COUNTERMEASURES "APPROPRIATE COUNTERMEASURES"?

1. Summary of Canada's methodology and Brazil's counter approach

(a) Canada's methodology

3.19 Hereafter is a summary of Canada's methodology, as understood by the Arbitrators.[27] In Canada's calculation, the level of countermeasures is directly proportionate on both an annual and total basis to the size of the prohibited subsidies Brazil pays out in support of its regional aircraft exports. Canada estimates the subsidy by multiplying the average subsidy per exported aircraft by Brazil's announced annual rate of production for these aircraft. The cumulative total of Brazil's subsidies, based on Embraer's order book, is C$4.1 billion with a present value of C$3.2 billion based on the annual profile of regional aircraft deliveries. In this calculation, Canada has taken into account:

(a) The average level of prohibited subsidy found to apply to Brazil's regional aircraft exports pursuant to contracts concluded prior to 18 November 1999 for aircraft delivered after that date under the PROEX regime that applies to those contracts;

(b) the average level of prohibited subsidy on regional aircraft to be delivered pursuant to contracts concluded after 18 November 1999 under the modified PROEX regime; and

(c) Brazil's announced production rates for ERJ-135/140/145 and ERJ 170/190.

3.20 Canada's calculation results in annual prohibited subsidies equal to United States dollar (hereinafter "US$") 480 million. At an exchange rate of C$1.47 to US$, this is equivalent to C$705.6 million per year.

3.21 In the alternative, Canada also provided a calculation based on the value of the harm caused by the subsidy to the Canadian industry. In that calculation, Canada estimates that the present value of the harm to Canada's regional aircraft industry is C$ 4.7 billion.

3.22 However, Canada specified that its preference was to use the option based on the amount of the subsidy granted by Brazil.

(b) Brazil's counter approach

3.23 As the Arbitrators understand it, Brazil's position can be summarized as follows. Brazil considers that the Arbitrators must determine what annual prospective Canadian exports of regional aircraft would be if Brazil had withdrawn PROEX from undelivered aircraft as of 18 November 1999 and for transactions entered into after 18 November 1999.[28]

[27] See Canada's explanation of its methodology in the paper submitted to the Arbitrators on 5 June 2000. This methodology was developed in Annex I to its written submission of 26 June 2000.

[28] Brazil's approach and the figures referred to hereafter are contained essentially in paragraphs 66 to 72 of its written submission of 26 June 2000 and in its reply of 24 July to question No. 21 of the Arbitrators.

3.24 Brazil differentiates between sales of aircraft made before 18 November 1999 – the date by which it was supposed to have complied with the recommendations of the DSB – and sales made after that date. Brazil provides separate calculations of the level of impairment of Canada's trade with respect to sales of aircraft which took place before 18 November 1999 but for which delivery had not taken place at that date and sales made after 18 November 1999. For sales made after 18 November 1999, Brazil bases the appropriate countermeasures by reference to three elements: Brazil's number of deliveries of aircraft each year, the number of those sales that might have been won by Canada if PROEX had been cancelled as of 18 November 1999, and the likely amount of the subsidy on each aircraft.

3.25 First, Brazil took the projected number of deliveries of aircraft per year as 168. Brazil then considered how many of these sales might have been won by Canada if PROEX had been cancelled as of 18 November 1999. In discussing the situation of undelivered aircraft, Brazil explained that Canada would not compete for sales of several categories of aircraft. Thus, because Canada does not produce a 37-seat regional jet (and has no apparent plans to do so), sales of the ERJ-135 do not compete with Canada's industry and should be excluded from the calculation. Similarly, there are a number of contracts for which, for various technical/operational reasons, Canada's aircraft did not compete. Brazil found that, out of the total of 942 undelivered aircraft, Canada may only have competed for and won sales of 44 of these aircraft had PROEX been cancelled as of 18 November 1999. Brazil assumed that the same competitive and technical conditions would apply for future sales after 18 November 1999. Brazil therefore multiplied the annual production level of 168 aircraft by the ratio of undelivered sales that Canada might win to the total number of undelivered sales (44/942). The result was 8 aircraft per year that Canada might possibly win were PROEX cancelled as of 18 November 1999.

3.26 Second, this number of aircraft must be multiplied by the average amount of the prohibited portion of the subsidy per aircraft. Brazil calculated this amount as US$xxx per aircraft. Multiplying this amount by 8 (the number of aircraft explained above) gives a determination of US$xxx as the annual level of impairment of Canada's trade with respect to sales made by Brazil after 18 November 1999.

(c) Preliminary remarks regarding the consequences of these approaches on the Arbitrators' task

3.27 The Arbitrators note that Canada is not requesting countermeasures corresponding to the level of nullification or impairment it suffers. The Arbitrators also note that both parties, even though they disagree on the subsequent steps, suggested that the calculation of the level of appropriate countermeasures could be based on the amount of subsidy. As a result, we take Canada's approach as a starting point and proceed to determine whether, and to what extent, this approach results in "appropriate countermeasures", having regard to Brazil's arguments.

2. Does the term "countermeasures" in Article 4.10 and 11 of the SCM Agreement apply to the type of countermeasures which Canada plans to take?

3.28 In a communication dated 10 May 2000, Canada informed the DSB that it would request the authorization from the DSB to take countermeasures in the form of suspension of concessions and other obligations under GATT 1994 and other Annex

1A agreements. Canada also notified a list of products for which concessions could be suspended.[29] Except for the claims referred to in the previous section, Brazil did not comment in the course of the proceedings on the measures planned by Canada.

3.29 We do not consider that we need to elaborate further on this issue. In particular, we do not need to identify a generally applicable definition of "countermeasures". We, therefore, note that both parties agree that the term "countermeasures", as used in Article 4 of the SCM Agreement, may include suspension of concessions or other obligations. We have found no reason why we should disagree with the parties.

3. Meaning of "appropriate"

(a) Issues before the Arbitrators

3.30 The core of the arguments exchanged by the parties relates to what should be considered an *appropriate level* of countermeasures. Canada considers that countermeasures are appropriate if they correspond to the amount of the prohibited export subsidy granted. Brazil agrees that the starting-point for the calculation of the appropriate level of countermeasure should be the subsidy granted. However, Brazil considers that this amount does not correspond to the full payment under the PROEX interest rate equalization programme. Brazil considers that only the part of the payments used to "secure a material advantage in the field of export credit terms" within the meaning given to those terms in item (k) of the Illustrative List of Export Subsidies[30] constitutes a prohibited subsidy. Brazil also considers that, since Canada chose to take countermeasures in the form of suspension of concessions or other obligations, the countermeasures adopted by Canada must be equivalent to the level of nullification or impairment pursuant to Article 22.4 of the DSU.

3.31 The Arbitrators are of the view that two main issues have to be addressed with respect to this question in the present case:

(a) since both parties agree that the determination of an appropriate level of countermeasures can be based on the amount of the subsidy granted, we must first determine what constitutes the subsidy, the withdrawal of which has been recommended;

(b) the second issue is to determine whether the level of countermeasures should correspond to the amount of the subsidy to be withdrawn or be equivalent to the level of nullification or impairment caused to Canada, with a consequence on the number of aircraft sales which should be taken into account.

We proceed to address these two main issues and the questions related to them successively hereafter.

(b) Is the "subsidy", to be used as the basis for the calculation of the level of appropriate countermeasures, the portion of the PROEX payments that reduces the net interest rate below the appropriate benchmark rate, or the full amount of the PROEX payments?

3.32 We note that Brazil has argued in its written submission of 26 June 2000 that the determination of the appropriate countermeasures based on the amount of the

[29] WT/DS46/16.

[30] Annex I to the SCM Agreement (hereinafter the "Illustrative List").

prohibited subsidy in this case should be limited to the difference between the amount of the PROEX support provided in each transaction and the appropriate benchmark, be it the rate of the US Treasury 10-year bond plus 20 basis points ("T-bill plus 20") used in the revised PROEX programme or the Commercial Interest Reference Rate ("CIRR") established under the OECD Arrangement on Guidelines for Officially Supported Export Credits. Brazil recalled at the hearing with the Arbitrators that this issue was pending before the Appellate Body as part of its appeal of the findings of the panel under Article 21.5 of the DSU. On 24 July, after the circulation of the Appellate Body report in the proceedings under Article 21.5 of the DSU,[31] Brazil submitted comments in which it claimed that the Appellate Body had concluded that only the portion of the PROEX payments that reduces the net interest rate below an appropriate benchmark constitutes a prohibited subsidy. Canada contested Brazil's interpretation in remarks filed on 28 July 2000.

3.33 We recall that the first panel established in this case (hereinafter the "Original Panel") concluded that *PROEX payments* on exports of Brazilian regional aircraft are subsidies within the meaning of Article 1 of the SCM Agreement which are contingent upon export performance within the meaning of Article 3.1(a) of the SCM Agreement.[32] This conclusion was not modified by the original Appellate Body report. We also recall that the Original Panel did not differentiate in its findings between the portion of the "payments" which is not "used to secure a material advantage within the field of export credit terms", within the meaning of item (k) of the Illustrative List, and the portion which is or may be used for that purpose. The original Appellate Body report did not rule on the issue either. One of the reasons was that the issue of whether such "payments" would be *a contrario* "permitted" under the SCM Agreement led to no findings by the Original Panel and the lack of findings was not appealed.[33]

3.34 However, the panel in the proceedings initiated under Article 21.5 of the DSU (hereinafter the "Article 21.5 Panel") was confronted with a specific allegation of Brazil that, as a result of Brazil's Resolution 2667 of 19 November 1999, PROEX payments are no longer used to secure a material advantage in the field of export credit terms and are hence "permitted" by the first paragraph of item (k) of the Illustrative List.[34] The Article 21.5 Panel considered that:

> "[…] Brazil's defence in this dispute depends upon the proposition that the first paragraph of item (k) may be used to establish that an export subsidy within the meaning of item (k) is "permitted" by the *SCM Agreement*. It further depends upon Brazil establishing that (a) PROEX payments are 'payments' within the meaning of

[31] Report of the Appellate Body on *Brazil – Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU*, adopted on 4 August 2000, WT/DS46/AB/RW, DSR 2000:VIII, 4067.

[32] Panel Report on *Brazil – Export Financing Programme for Aircraft*, adopted on 20 August 1999, WT/DS46/R, DSR 1999:III, 1221, para. 7.14.

[33] *Ibid.* paras. 7.18 and 7.37; Appellate Body Report on *Brazil – Export Financing Programme for Aircraft*, adopted on 20 August 1999, WT/DS46/AB/R, DSR 1999:III, 1161, para. 187.

[34] Panel Report on *Brazil – Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU,* adopted on 4 August 2000, WT/DS46/RW, DSR 2000:IX, 4093, para. 6.20.

> item (k); and (b) PROEX payments are not 'used to secure a material advantage in the field of export credit terms'."[35]

3.35 On appeal, the Appellate Body stated:

> "[…] we agree with the Article 21.5 Panel that in order for Brazil to establish its alleged "affirmative defence", Brazil must succeed in its legal and factual arguments on *each* of the three issues examined by the Article 21.5 Panel."[36]

3.36 The Appellate Body then proceeded with the examination of the last issue dealt with by the Article 21.5 Panel, i.e. whether subsidies under the revised PROEX are "used to secure a material advantage in the field of export credit terms." Having found that Brazil had failed to demonstrate that PROEX payments are not "used to secure a material advantage in the field of export credit terms" within the meaning of the first paragraph of item (k) of the Illustrative List,[37] the Appellate Body did not believe it was necessary to examine the other two issues identified by the Article 21.5 Panel. The Appellate Body declared the findings of the panel on these two issues "moot, and, thus, of no legal effect".[38]

3.37 We consider that, in order to reach a conclusion consistent with the various decisions adopted in the course of this case, we have to start from the findings and conclusions of the Appellate Body report in the Article 21.5 proceedings. We note that, in paragraph 82(b) of its report, the Appellate Body "[upheld] the Article 21.5 Panel findings that payments made under the revised PROEX are prohibited by Article 3 of the *SCM Agreement* and are not justified under item (k) of the Illustrative List."[39] The Original Panel and the Article 21.5 Panel always made it clear that, when they referred to "PROEX payments", they referred to the PROEX interest rate equalization payments as a whole, not to a portion of such payments under PROEX.[40]

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[35] Panel Report on *Brazil – Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU,* adopted on 4 August 2000, WT/DS46/RW, DSR 2000:IX, 4093, para. 6.22.

[36] Appellate Body Report on *Brazil – Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU, Op. Cit.,* para. 58.

[37] *Ibid*., para. 77.

[38] *Ibid*., paras. 78 and 81. Moreover, we note that the Appellate Body stated in para. 80 of its report that:

> "If Brazil had demonstrated that the payments made under the revised PROEX were not 'used to secure a material advantage in the field of export credit terms', and that such payments were 'payments' by Brazil of 'all or part of the costs incurred by exporters or financial institutions in obtaining credit', then we would have been prepared to find that the payments made under the revised PROEX are *justified* under item (k) of the Illustrative List." (Emphasis added)

This seems to imply that, in spite of its statement at paragraph 58 that "in order for Brazil to establish its alleged "affirmative defence", Brazil must succeed in its legal and factual arguments on *each* of the three issues examined by the Article 21.5 Panel", the Appellate Body would have been ready to find that the payments made under the revised PROEX are justified under item (k) of the Illustrative List if Brazil had proven two of the three issues. The Appellate Body also stated that it did not interpret footnote 5 of the SCM Agreement and did not opine on the scope of footnote 5 or on the meaning of any other items in the Illustrative List.

[39] Emphasis added. Italics in the original.

[40] See, e.g., Original Panel Report, *Op. Cit*., paras. 7.14; 7.74; 8.1 and 8.2; Article 21.5 Panel Report, *Op. Cit*. , section VI.C.2.(c) "Conclusions and closing remarks".

3.38 If, as Brazil suggested, the Appellate Body had meant in its report in the Article 21.5 proceedings that the prohibited subsidy was only the portion beyond the appropriate benchmark under item (k) of the Illustrative List, it would have had to specify it, since the Appellate Body did not contest in the original proceedings the fact that "PROEX payments", as meaning the full interest rate equalization payments, were considered to be a prohibited subsidy. It could be argued that the Appellate Body did not have to specify whether the prohibition applied to the full PROEX payment or only to part of it. Since it found that Brazil had not provided evidence that the subsidy was not used to secure a "material advantage", even the portion of the PROEX payments going beyond the CIRR was a prohibited subsidy. However, as mentioned above, the meaning given to the term "PROEX payments" by the Original Panel and by the Article 21.5 Panel was clear. If the Appellate body had disagreed with that meaning, an explanation would have been essential in its report under Article 21.5 of the DSU. In the absence of such a clarification, we can only conclude that, by "[upholding] the Article 21.5 Panel findings that payments made under the revised PROEX are prohibited by Article 3 of the SCM Agreement and are not justified under item (k) of the Illustrative List", the Appellate Body understood the term "payments" as meaning the full equalization payment under PROEX.

3.39 Moreover, Brazil's argumentation in its additional comments of 24 July 2000 seems to be based on a confusion between the notion of "benefit" under Article 1 of the SCM Agreement and the notion of "material advantage" in item (k) of the Illustrative List, a confusion against which the Appellate Body carefully cautioned in its original report.[41] Even if an export subsidy is "justified" under item (k) because it is not used to secure a material advantage in the field of export credit terms, it still confers a benefit and it is still an export subsidy.[42] A possible *justification* under item (k), like a justification under Article XX of the GATT 1994, does not change the legal nature of a measure. If the justification did not exist, it would be that same amount of subsidy for which justification was sought which would be prohibited, because the fact that a subsidy is justified does not mean that it is no longer a subsidy. It simply means that it is not a *prohibited* subsidy.

3.40 We also note that Article 4.7 of the SCM Agreement provides that "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." We are therefore of the view that the subsidy to be withdrawn within the meaning of Article 4 of the SCM Agreement, and consequently the one on which we must base our calculations, is the full amount of the PROEX interest rate equalisation payments on exports of Brazilian regional aircraft, not the portion of those payments which goes beyond the CIRR rate or any other appropriate benchmark rate under item (k) of the Illustrative List.

[41] *Op. Cit*., para. 179.
[42] *Ibid.* See also para. 180.

(c) Should the level of countermeasures correspond to the amount of the subsidy granted by Brazil or be equivalent to the level of nullification or impairment suffered by Canada?

(i) Analysis of the relevant provisions

3.41 Canada considered that, since it could have proposed countermeasures based on the level of nullification or impairment suffered, its proposal based on the amount of subsidy per aircraft is *a fortiori* "appropriate", because it is much less.[43] Brazil claimed in substance that nullification or impairment has always been the yardstick in GATT 1947 and it has been carried into the WTO Agreement. Brazil agreed that Canada could have requested the authorization to grant a counter-subsidy. However, since Canada has chosen to impose countermeasures in the form of suspension of concessions or other obligations, it must comply with the requirements of Article 22.4 of the DSU.

3.42 In accordance with Article 3.2 of the DSU, we proceed with an analysis of the meaning of the term "appropriate" based on Article 31 of the Vienna Convention.

3.43 Examining only the ordinary meaning of the term "appropriate" does not allow us to reply to the question before us, since dictionary definitions are insufficiently specific. Indeed, the relevant dictionary definitions of the word "appropriate" are "specially suitable; proper".[44] However, they point in the direction of meeting a particular objective.

3.44 The first context of the term "appropriate" is the word "countermeasures", of which it is an adjective. While the parties have referred to dictionary definitions for the term "countermeasures", we find it more appropriate to refer to its meaning in general international law[45] and to the work of the International Law Commission (ILC) on state responsibility, which addresses the notion of countermeasures.[46] We note that the ILC work is based on relevant state practice as well as on judicial decisions and doctrinal writings, which constitute recognized sources of international law.[47] When considering the definition of "countermeasures" in Article 47 of the Draft Articles,[48] we note that countermeasures are meant to "induce [the State which

[43] See para. 3.21 above.

[44] *The New Shorter Oxford English Dictionary* (1993), p. 103; *Webster's New Encyclopedic Dictionary* (1994), p. 48.

[45] See, e.g., the *Naulilaa* arbitral award (1928), UN Reports of International Arbitral Awards, Vol. II, p. 1028 and *Case Concerning the Air Services Agreement of 27 March 1946 (France v. United States of America)* (1978) International Law Reports, Vol. 54 (1979), p. 338. See also, *inter alia*, the *Draft Articles on State Responsibility With Commentaries Thereto Adopted by the International Law Commission on First Reading* (January 1997), hereinafter the "Draft Articles" and the draft articles provisionally adopted by the Drafting Committee on second reading, A/CN.4/L 600, 11 August 2000. Even though the latter modify a number of provisions of the Draft Articles, they do not affect the terms to which we refer in this report.

[46] We also note that, on the basis of the definition of "countermeasures" in the Draft Articles, the notion of "appropriate countermeasures" would be more general than the term "equivalent to the level of nullification or impairment". It would basically include it. Limiting its meaning to that given to the term "equivalent to the level of nullification or impairment" would be contrary to the principle of effectiveness in interpretation of treaties.

[47] See Article 38 of the Statute of the ICJ.

[48] We note that Canada objects to us using the Draft Articles in this interpretation process. Canada argues that the Draft Articles are not "relevant rules of international law applicable to the relations between the parties" within the meaning of Article 31.3(c) of the Vienna Convention. As

has committed an internationally wrongful act] to comply with its obligations under articles 41 to 46". We note in this respect that the Article 22.6 arbitrators in the *EC – Bananas (1999)* arbitration made a similar statement.[49] We conclude that a countermeasure is "appropriate" *inter alia* if it *effectively* induces compliance.

3.45 In this respect, we recall that the measure in respect of which the right to take countermeasures has been requested is a prohibited export subsidy falling under Article 3.1(a) of the SCM Agreement. Article 4.7 of the SCM Agreement provides in this respect that if a measure is found to be a prohibited subsidy, it shall be withdrawn without delay. In such a case, effectively "inducing compliance" means inducing the withdrawal of the prohibited subsidy.

3.46 In contrast, other illegal measures do not have to be withdrawn without delay. As specified in Article 3.8 of the DSU, if a measure violates a provision of a covered agreement, the measure is considered *prima facie* to cause nullification or impairment. However, if the defendant succeeds in rebutting the charge, no nullification or impairment will be found in spite of the violation. Such a rebuttal may be impossible to make in a number of cases. Yet, this does not change the fact that the concept of nullification or impairment is not found in Articles 3 and 4 of the SCM Agreement. The Arbitrators are of the view that meaning must be given to the fact that the negotiators did not include the concept of nullification or impairment in those articles, whilst it is expressly mentioned in Article 5 of the SCM Agreement, which deals with the adverse effects of actionable subsidies.

3.47 A first approach would be to consider that the concept of nullification or impairment does not apply to Article 4 of the SCM Agreement. We note in this respect that, in relation to actionable subsidies, Article 5 refers to nullification or impairment as only one of the three categories of adverse effects. This could mean that another test than nullification or impairment could also apply in the context of Article 4 of the SCM Agreement.

3.48 That said, we note that the Original Panel concluded that, since a violation had been found, a *prima facie* case of nullification or impairment had been made within the meaning of Article 3.8 of the DSU, which Brazil had not rebutted. In that context, we are more inclined to consider that no reference was expressly made to nullification or impairment in Article 4 of the SCM Agreement for the following reasons:

(a) a violation of Article 3 of the SCM Agreement entails an irrebuttable presumption of nullification or impairment. It is therefore not necessary to refer to it;

(b) the purpose of Article 4 is to achieve the *withdrawal* of the prohibited subsidy. In this respect, we consider that the requirement to withdraw a prohibited subsidy is of a different nature than removal of the specific nullification or impairment

already mentioned, we use the Draft Articles as an indication of the agreed meaning of certain terms in general international law.

[49] *Op. Cit.*, para. 6.3. In that case, the arbitrators had to determine the level of nullification or impairment. Since the Article 22.6 arbitrators in the *EC – Bananas* case considered that measures equivalent to the level of nullification or impairment can induce compliance, it could be argued that in the present case too, countermeasures equivalent to the level of nullification or impairment should be sufficient to induce compliance. However, the arbitrators in *EC – Bananas* were instructed by Article 22.7 to determine whether the proposed measures were equivalent to the level of nullification or impairment.

caused to a Member by the measure.[50] The former aims at removing a measure which is presumed under the WTO Agreement to cause negative trade effects, irrespective of who suffers those trade effects and to what extent. The latter aims at eliminating the effects of a measure on the trade of a given Member;

(c) the fact that nullification or impairment is established with respect to a measure does not necessarily mean that, in the presence of an obligation to withdraw that measure, the level of appropriate countermeasures should be based only on the level of nullification or impairment suffered by the Member requesting the authorization to take countermeasures.

3.49 We also note that, when the negotiators have intended to limit countermeasures to the effect caused by the subsidy on a Member's trade, they have used different terms than "appropriate countermeasures". Article 7.9 and 10, which is the provision equivalent for actionable subsidies to Article 4.9 and 10 for prohibited subsidies, uses the terms "commensurate with the degree and nature of the adverse effects determined to exist". In that context, we do not consider the arguments made by Brazil in its oral presentation and based on the central position of the notion of nullification in the GATT to be compelling. As we have seen above, the term "appropriate countermeasures" does not impose similar constraints.

3.50 The parties have also discussed the meaning of footnotes 9 and 10 to, respectively, paragraphs 10 and 11 of Article 4 of the SCM Agreement. The content of those footnotes is identical; they both read as follows:

> " This expression is not meant to allow countermeasures that are disproportionate in light of the fact that the subsidies dealt with under these provisions are prohibited."

3.51 We agree that, as those footnotes are drafted, it seems difficult to clearly identify how the second part of the sentence ("in light of the fact that the subsidies dealt with under these provisions are prohibited") relates to the first part of the sentence ("This expression is not meant to allow countermeasures that are disproportionate"). This is probably due to the use of the words "in light of the fact that". However, since the text of the treaty is supposed to be the most achieved expression of the intent of the parties, we should refrain from second guessing the negotiators at this point. We can nonetheless note that the reference to the fact that the subsidies dealt with are prohibited can most probably be considered more as an aggravating factor than as a mitigating factor. We also find the use of the word "disproportionate" to be interesting in light of the term "out of proportion" used in Article 49 of the Draft Articles. We do not draw any firm conclusions as to the meaning of footnotes 9 and 10. However, we note that footnotes 9 and 10 at least confirm that the term "appropriate" in Articles 4.10 and 4.11 of the SCM Agreement

[50] We note that Article 3.7 of the DSU refers to the "withdrawal of the measures concerned" as a first objective. However, we also note that, contrary to Article 3.7 of the DSU, Article 4.7 of the SCM Agreement does not provide for any alternative than the withdrawal of the measure once it has been found to be a prohibited subsidy.

should not be given the same meaning as the term "equivalent" in Article 22 of the DSU.[51]

3.52 Brazil raised a number of non-textual arguments in support of its position. We consider our analysis based on the text of the SCM Agreement sufficiently compelling. We will nevertheless discuss these other arguments for the sake of completeness.

3.53 Brazil agreed with Canada that the countermeasures should relate to the amount of the subsidy.[52] Brazil nonetheless claimed that countermeasures based on the full amount of the PROEX interest rate equalization payment and not taking into account solely the number of sales of aircraft with respect to which Canada suffers nullification or impairment would be disproportionate.

3.54 Our interpretation of the scope of the term "appropriate countermeasures" in Article 4 of the SCM Agreement above shows that this would not be the case. Indeed, the level of countermeasures simply corresponds to the amount of subsidy which has to be withdrawn. Actually, given that export subsidies usually operate with a multiplying effect (a given amount allows a company to make a number of sales, thus gaining a foothold in a given market with the possibility to expand and gain market shares), we are of the view that a calculation based on the level of nullification or impairment would, as suggested by the calculation of Canada based on the harm caused to its industry, produce higher figures than one based exclusively on the amount of the subsidy. On the other hand, if the actual level of nullification or impairment is substantially lower than the subsidy, a countermeasure based on the actual level of nullification or impairment will have less or no inducement effect and the subsidizing country may not withdraw the measure at issue.[53]

3.55 Brazil also claimed that countermeasures based on the full amount of the subsidy would be highly punitive. We understand the term "punitive" within the meaning given to it in the Draft Articles.[54] A countermeasure becomes punitive when it is not only intended to ensure that the State in breach of its obligations bring its conduct into conformity with its international obligations, but contains an additional dimension meant to sanction the action of that State. Since we do not find a calculation of the appropriate countermeasures based on the amount of the subsidy granted to be disproportionate, we conclude that, *a fortiori*, it cannot be punitive.[55]

3.56 We note that Brazil also claimed that Canada could not request the right to take countermeasures in the amount of the subsidy because it chose to take countermeasures in the form of suspension of concessions or other obligations and,

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[51] We are mindful of the fact that, from the point of view of a textual interpretation, "equivalent" and "appropriate" should not be given the same meaning. Interpreters are not permitted to assume such a thing. What we mean is that the term "appropriate", read in the light of footnotes 9 and 10, may allow for more leeway than the word "equivalent" in terms of assessing the appropriate level of countermeasures. A countermeasure remains "appropriate" as long as it is not *disproportionate*, having also regard to the fact that the measure at issue is a prohibited subsidy.

[52] Brazil's comments on Canada's methodology paper, 13 June 2000, para. 2.

[53] Moreover, Brazil's approach seems to be contradictory in so far as it combines the level of the subsidy with its trade effect. By using the level of subsidy as the starting-point of its analysis, Brazil disregards the fact that trade effects may have no direct relation with the amount of the subsidy itself.

[54] See Draft Articles, p. 307.

[55] In this respect we recall our comment in footnote 43 above that "appropriate" should not be given the same meaning as "equivalent", but should be understood as giving more discretion in the appraisal of the level of countermeasures against prohibited subsidies.

pursuant to Article 22.4 of the DSU, such measures must be equivalent to the level of nullification or impairment.

3.57 We read the provisions of Article 4.11 of the SCM Agreement as special or additional rules. In accordance with the reasoning of the Appellate Body in *Guatemala – Cement*,[56] we must read the provisions of the DSU and the special or additional rules in the SCM Agreement so as to give meaning to all of them, except if there is a conflict or a difference. While we agree that in practice there may be situations where countermeasures equivalent to the level of nullification of impairment will be appropriate, we recall that the concept of nullification or impairment is absent from Articles 3 and 4 of the SCM Agreement. In that framework, there is no legal obligation that countermeasures in the form of suspension of concessions or other obligations be equivalent to the level of nullification or impairment.

3.58 On the contrary, requiring that countermeasures in the form of suspension of concessions or other obligations be equivalent to the level of nullification or impairment would be contrary to the principle of effectiveness by significantly limiting the efficacy of countermeasures in the case of prohibited subsidies. Indeed, as shown in the present case,[57] other countermeasures than suspension of concessions or obligations may not always be feasible because of their potential effects on other Members. This would be the case of a counter-subsidy granted in a sector where other Members than the parties compete with the products of the parties. In such a case, the Member taking the countermeasure may not be in a position to induce compliance.

3.59 We are mindful that our interpretation may, at a first glance, seem to cause some risk of disproportionality in case of multiple complainants. However, in such a case, the arbitrator could allocate the amount of appropriate countermeasures among the complainants in proportion to their trade in the product concerned. The "inducing" effect would most probably be very similar.

3.60 For the reasons set out above, we conclude that, when dealing with a prohibited export subsidy, an amount of countermeasures which corresponds to the total amount of the subsidy is "appropriate".[58]

(ii) Implications with respect to the number of aircraft sales to be taken into account in the calculation of the appropriate countermeasures

Treatment of sales of certain models of aircraft

3.61 In its submissions, Brazil excluded a number of sales on the grounds that they did not give rise to PROEX payments. This is the case for the sales of the xxx xxxxxxx to xxxxxxxx and xx xxxxxxx. Brazil also excluded certain sales in which

[56] *Op. Cit.,* para. 65.

[57] Canada mentioned that it could have applied a counter-subsidy but refrained from doing so for a number of reasons.

[58] The Arbitrators also reviewed the arguments and evidence submitted by the parties concerning the approach based on the level of nullification or impairment suffered by Canada. They note that this approach implied – as any counterfactual - many more assumptions than the approach based on the amount of the subsidy. The Arbitrators were of the view that, if the calculation of appropriate countermeasures based on the amount of the subsidy were compatible with Article 4.10 of the SCM Agreement, it would be preferable to follow this approach since it could lead to a more objective result.

competition was based on other factors than price (such as weight or maintenance costs of the aircraft, passengers and freight capacity and airport certifications). Finally, Brazil excluded the sales of ERJ-135 on the grounds that they do not compete with the turboprop aircraft produced by Bombardier.

3.62 Since we selected the amount of the subsidy as the basis for the countermeasures and not the level of nullification or impairment suffered by Canada, it is appropriate and logical to include in our calculation all the sales of subsidized aircraft, whether they compete or not with Bombardier's production. However, consistent with our approach on the burden of proof, we excluded all the sales where Brazil demonstrated that no PROEX interest rate equalization payments had been made and we assumed that future sales of the xxx xxxxxxx and xxx would not benefit from the PROEX interest rate equalization payments.

Treatment of the contracts pre-dating 18 November 1999

3.63 Brazil has claimed that the deliveries of aircraft for which PROEX letters of commitment had been issued before 18 November 1999 should be excluded from the calculation of the appropriate countermeasures, and that only sales subsequent to the 90 day implementation period should be considered.

3.64 We note that, in its report within the framework of the proceedings under Article 21.5 of the DSU, the Appellate Body made the following findings:

> "[the Appellate Body] upholds the conclusion of the Article 21.5 Panel that as a result of the continued issuance by Brazil of NTN-I bonds, after 18 November 1999, pursuant to letters of commitment issued before 18 November 1999, Brazil has failed to implement the recommendation of the DSB that it withdraw the prohibited export subsidies under PROEX within 90 days"[59]

3.65 We, therefore, consider that we have to include in the calculation of the appropriate countermeasures the firm sales for which PROEX letters of commitment were issued before 18 November 1999 and which had not yet been delivered (since the NTN-I bonds are issued at the time of the delivery of the aircraft).[60] We do not consider the arguments based on Brazil's contractual obligations to be compelling. Obligations under internal law are no justification for not performing international obligations.[61]

4. Methodology applied by the Arbitrators

3.66 We first note that the parties agree to distinguish between pre and post 18 November 1999 aircraft sales in relation to the percentage of PROEX interest rate

[59] *Op. Cit*. para. 82(a).

[60] This clarification is made in relation to the use by the Arbitrators of the delivery data provided by Brazil rather than on information relating specifically to the issuance of the NTN-I bonds. Our choice is consistent with the factual finding of the Original Panel (*Op. Cit*., para. 7.71) and the Appellate Body report in the original proceedings (*Op. Cit*. para. 154).

[61] See Article 27 of the Vienna Convention:

> "A party may not invoke the provisions of its internal law as justification for the failure to perform a treaty. […]"

equalization applied. On the basis of the above considerations, we have decided to calculate the appropriate amount of countermeasures on the following basis:

(a) We start with the identification of the average sale price of the models of aircraft for which sales are subsidized. We also take into account the fact that sales of spare parts have also been subject to payments under PROEX. We consider that PROEX financing for spare parts should be included in our calculation of the subsidy.

(b) We then make a projection of the annual production of aircraft per model for the period 2000-2005 (six years). We chose this period essentially because it corresponds to the period in which Embraer's production capacity assessments can be assumed to be reasonably accurate. We also note, on the basis of the information available, that it will take until 2005 for Embraer to exhaust its backlog relating to sales pre-dating 18 November 1999 for which deliveries had not taken place on that date and for sales between 19 November 1999 and 30 June 2000 for ERJ-135.[62]

(c) The next stage consists of the calculation of the present value of the subsidy per aircraft model using the sale price for each model, a financing rate of xxx% (for a financing corresponding to xxx% of the price), the applicable PROEX interest rate equalization (3.8% or 2.5% of the financing depending on the sale or the time at which it was made), the agent fee which we considered to be representative of these types of transactions for Brazil and a discount rate equal to LIBOR.[63]

(d) Finally, for each model we multiply the total amount of aircraft sold with a PROEX interest rate equalization of 3.8% by the present value of the subsidy per model and the total amount of aircraft sold with a PROEX interest rate equalization of 2.5% by the present value of the subsidy per model. The total is spread over 6 years to give the annual average present value of the subsidy for each of the subsidized models (ERJ-135 and ERJ-145). The total corresponds to the appropriate level of countermeasures based on the premises developed above.

C. CALCULATION OF THE APPROPRIATE LEVEL OF COUNTERMEASURES

1. Average unit price per model

(a) Basic elements

(i) Sale price

3.67 We used the average sale price for the ERJ-135 and ERJ-145 models. For the reasons mentioned above, sales of ERJ-170 and 190 have been excluded. There were no sales of ERJ-140 among the transactions considered. Brazil was not in a position to provide the Arbitrators with detailed price information regarding each

[62] See Table 1 and the related explanations below.
[63] LIBOR stands for "London Interbank Offer Rate".

sale. Therefore, having considered the arguments of the parties, we use the average sale prices supplied by Canada for each of the models concerned. Canada gives the price of the ERJ-135 as US$xxx million and of the ERJ-145 as US$xxx million.[64]

(ii) Spare parts

3.68 Canada's net price for each aircraft has been adjusted to take into account financing of spare parts under PROEX. Brazil estimates the total value of spare parts covered by PROEX that remained undelivered as of 18 November 1999 to be US$xxx.[65] According to evidence provided by Brazil,[66] there is no financing for spare parts under PROEX for the ERJ-135. Canada did not provide specific information contradicting this statement. Therefore, we accept Brazil's evidence that PROEX only includes financing of spare parts for the ERJ-145 model. We also accept that the average expected PROEX financing for spare parts on the total number of ERJ-145 aircraft to be delivered after 18 November 1999 is US$xxx. After 18 November 1999, there were no new requests for spare part financing under PROEX.

3.69 We noted that not all of the ERJ-145 aircrafts will likely benefit from PROEX financing for spare parts, but the evidence submitted does not allow a determination of which sales will and which will not benefit. Therefore, in order to take into account the subsidization which resulted from undelivered spare parts as of 18 November 1999, we chose to divide the amount of US$xxx by the total number of ERJ-145 aircraft to be delivered between 2000 and 2005 (i.e. 780 aircraft). We reach an approximate average figure of US$xxx for spare parts per ERJ-145.

(b) Results

3.70 We thus use Canada's sale price for ERJ-135/145 aircraft and allocate the total value of undelivered spare parts provisioning that benefited from PROEX support to the total amount of ERJ-145 aircraft to be delivered between 2000 and 2005. As mentioned above, there is no financing for spare parts for ERJ-135. Therefore, for ERJ-145 only, we add US$xxx per aircraft for spare parts benefiting from PROEX.

3.71 Thus, the average unit price per aircraft model for the purpose of our calculation is as follows:

(a) the average price for an ERJ-135 is US$xxx million;

(b) the average price for an ERJ-145 is US$xxx million (US$xxx million plus US$xxx for spare part financing under PROEX);

3.72 Having regard to the arguments of the parties, we considered that it was appropriate, for the purpose of calculating appropriate countermeasures, to consider that the external or bank financing on the basis of which PROEX interest rate equalization payments are calculated covers xxx% of the price of each model of

[64] Information on the average sale price for ERJ-135 and ERJ-145 models as provided in Table 8 of Annex I to Canada's 26 June 2000 written submission. In its reply at p. 23 to question No. 9 of the questions of the Arbitrators dated 17 July 2000, Brazil "xxxxxxxxx xxxx xxxxx xxxxxx xxxxxxxxx xxxxxxxxx xxx xxxxxx xxxxxxxxxx, and Brazil accepts the use of Canada's figures xxx xxx xxxxxxx xxxxxx xxxx xxxxx xx xxxxx x for the purpose of calculating the amount of the PROEX subsidy".

[65] Brazil's written response of 24 July 2000 to question No. 18 of the Arbitrators, pp. 32-33.

[66] Statement from the Banco do Brasil contained in Brazil's Exhibit Br-A-33.

aircraft. Thus, we consider that the financing for the ERJ-135 is xxx% of the US$xxx million price of the aircraft, which amounts to US$xxx. PROEX financing for the ERJ-145 is xxx% of the US$xxx million price of the aircraft, which amounts to US$xxx.

2. Projection of annual aircraft production per model

3.73 Pursuant to the methodology described above, we have established a projection of annual aircraft production per model of aircraft for the period 2000-2005. This projection is contained in Table 1. The parameters used in this table and the sources on which we relied to prepare this table are explained hereafter.

3.74 Table 1 sets out the comparison between the projected production capacity and projected deliveries of ERJ-135 and ERJ-145 aircraft for the period 2000-2005. As highlighted above, we consider a time-period of six years, i.e. 2000-2005, for our analysis of the structure of production per model of aircraft. In selecting this period, we took into account the fact that the production capacity figures given by Brazil only extend to 2004. However, this six-year period corresponds to the period of time which, under the production capacity figures provided to the Arbitrators, will be necessary to exhaust the backlog for existing orders of ERJ-135/145 aircraft. This should occur, according to our projection, by 2004 for the ERJ-145 and by 2005 for ERJ-135. We therefore considered that we should use a period of time which covers the foreseeable production based on existing firm orders and conversions of existing options as of 30 June 2000.[67] We did not find it reasonable to apply a longer period since it would be too speculative in this rapidly evolving sector of commercial aviation.

3.75 Table 1 contains three categories. Category A features the total production capacity figure per year for ERJ-135 and ERJ-145 aircraft for the period 2000 to 2005. Category B gives the production structure for the ERJ-135 model. Category C sets out the production structure for the ERJ-145 model. Under each of these categories, the total deliveries are given.[68]

3.76 In Category A of Table 1, we chose Brazil's projection of annual aircraft production per model for 2000-2002[69] and Canada's assessment for 2003-2005.[70] Otherwise, if one follows Brazil's production figures after 2002, the backlog of aircraft would be impossible to deliver in any reasonable time period. Given full production, we expect the backlog for ERJ-135 to be exhausted by 2005 and for ERJ-145 to be exhausted by 2004. Therefore, the total production figure at full capacity for ERJ-135 and ERJ-145 aircraft for the period 2000 to 2005 is 1,118 aircrafts.

3.77 For the breakdown of production between ERJ-135 and ERJ-145, we note that Brazil was not in a position to provide a detailed breakdown.[71] Canada assumed

[67] We note that, in its reply to question No. 16 of the Arbitrators, dated 24 July 2000, Brazil mentions that production of ERJ-135 and 145 should be gradually phased out. In Exhibit Br-A-30, Embraer states that its current backlog should be reduced substantially by 2002 xxx xxxx xxxx cxxxxxxxx xxxxxxx xxxxx xxxxx xx xxxxxx xxxxxx xxxx xxx xxxxx xx xxx xxxxx. We considered this information and that provided by Canada and concluded that it was preferable to rely on current orders and options xxxx xx xxxxxx xxxxxxxxx xxxxxxx xx xxxxxx xx xxxxxxx xx xxx xxxxxx.

[68] The Arbitrators relied on Brazil's Exhibit Br-A-21.

[69] Brazil's written submission of 24 July 2000, p. 32.

[70] Annex I of Canada's 26 June 2000 written submission.

[71] Brazil's Exhibit Br-A-30, para. 7.

weights of 20% for ERJ-135, 10% for ERJ-140 and 70% for ERJ-145.[72] We did not find convincing evidence to support this breakdown of production. Therefore, we decided to apply the ration of 30/70 derived from the structure of the existing backlog for ERJ-135 and ERJ-145 aircraft respectively, based on data supplied by Brazil.[73]

3.78 The amount of aircraft benefiting from the 3.8% or the 2.5% equalization rate applied under PROEX is given per model in Categories B and C. This structure is based on Brazil's submission.[74] Furthermore, in projecting deliveries of aircrafts, we assumed that the deliveries of aircraft benefiting from the PROEX interest rate equalization of 3.8% will likely be executed first. Therefore, for the ERJ-135, the total number of aircraft to be delivered between 2000 and 2005 at 3.8% is xxx, and the total number to be delivered at the equalization rate of 2.5% is xxx. For the ERJ-145, the total number of aircraft to be delivered between 2000 and 2005 at 3.8% is xxx and the total number at 2.5% is xxx.

3.79 For Categories B and C, Table 1 sets out the conversion of options into firm orders for ERJ-135 and ERJ-145. For pre-18 November 1999 and 18 November 1999-30 June 2000 orders, the existing options are assumed to be converted into firm orders at the rate of 85%. Canada suggested a conversion rate of 100% due to high demand. Canada also suggested a conversion rate of 80% as the market for regional jets matures.[75] Brazil provided evidence of cancellations of options and states that the rate of conversion will be no more than 84%.[76] Having considered the evidence provided by the parties, we assumed a conversion of options into firm orders at a rate of 85% for the period 2000-2005. However, this assumption is only relevant to determine the proportion of aircraft transactions benefiting from PROEX at 3.8% and of those benefiting from PROEX at 2.5% because, in the assumed context of production at full capacity, the conversion rate of options does not affect the amount of deliveries.

Table 1: Projection of Annual Aircraft Production per Model, 2000-2005

Model	Jan-June 2000	July Dec 2000	2001	2002	2003	2004	2005	Total
A. ERJ-135/145 total production capacity (Brazil's figures) (Canada's figures)	151 (151) (168)		188 (188) (192)	203 (203) (192)	192 (148) (192)	192 (122) (192)	192 (122) (192)	**1118** (934) (1128)
B. ERJ-135 total deliveries	25	22	56	61	58	58	58	**338**
Pre 18.11.99 orders (85 % conversion rate)	25	22	56	61	58	31	-	253

[72] Table 9 of Canada's 26 June 2000 written submission.

[73] Brazil's Exhibit Br-A-21.

[74] Brazil's Exhibit Br-A-15. The Arbitrators assumed that the PROEX rate applied after 18 November 1999 is 2.5%.

[75] Annex I, paras. 18 to 20 of Canada's written submission.

[76] Brazil's oral statement, 14 July 2000, para. 60.

Model	Jan-June 2000	July Dec 2000	2001	2002	2003	2004	2005	Total
18.11.99–30.6.00 orders (85% conversion rate)	-	-	-	-	-	27	6	33
New orders	-	-	-	-	-	-	52	52
Total ERJ-135 at 3.8%	xxx	xxx	xxx	xxx	xxx	xxx	xxx	**xxx**
Total ERJ-135 at 2.5%	xxx	xxx	xxx	xxx	xxx	xxx	xxx	**xxx**
C. ERJ-145 total deliveries	54	50	132	142	134	134	134	**780**
Pre 18.11.99 orders (85% conversion rate)	54	50	132	81	-	-	-	317
18.11.99–30.6.00 orders (85% conversion rate)	-	-	-	61	134	129	-	324
New orders	-	-	-	-	-	5	134	139
Total ERJ-145 at 3.8%	xxx	xxx	xxx	xxx	xxx	xxx	xxx	**xxx**
Total ERJ-145 at 2.5%	xxx	xxx	xxx	xxx	xxx	xxx	xxx	**xxx**

3. Calculation of the present value of the subsidy

(a) Calculation of the present value of the subsidy

(i) Relevant tables

3.80 The Annex to this report contains, for each model of aircraft (ERJ-135 and ERJ-145), the calculation of the present value of the subsidy per aircraft and per equalization rate. The results are reported in Table 2 below. This calculation assumes the following parameters.

(ii) Financing method

3.81 We note that the parties have based their calculations on different forms of repayment of the loan. We assumed that interest was paid on the outstanding balance. We agreed that there could be, in theory, a possibility to apply an annuity method of repayment (i.e., equal instalments including payments and interest, as used by Canada). However, we assumed that the method suggested by Brazil corresponded to the form of repayment actually used when PROEX interest rate equalization payment is provided. Accordingly, we applied constant instalments for capital reimbursement in our calculations.

3.82 Moreover, we assume semi-annual constant instalments for capital reimbursement. Thus, 30 payments are made over a period of 15 years, in accordance with the maturation period of NTN-I bonds used by Brazil to finance

PROEX interest rate equalization payments.[77] These instalments are based on PROEX financing of xxx% of the price of the aircraft (see section C.1 above on aircraft prices).

(iii) Financing rate

3.83 We have taken note that Canada's proposed methodology used a financing rate of 7.79%. However, we do not need to take a position on the accuracy of this rate. Indeed, the financing rate does not affect the level of the subsidy as it is expressed as a percentage of the financed portion of the price of the aircraft, which does not depend on the level of the interest rate. We therefore refrain from addressing this aspect of the financing.

(iv) Agent fee

3.84 Canada assumed that commercial banks involved in financing aircraft sales in the context of PROEX payments levy an agent fee inferior to one percent. In contrast, Brazil alleged that the commercial banks involved in PROEX payments take xxxx xxxx agent fees. In support of its claims, Brazil submitted evidence setting out the terms of financing for PROEX over a 15-year period for specific transactions.[78]

3.85 Even though the evidence presented by Brazil related to a limited number of aircraft, we assumed it to be sufficiently representative, because it refered to actual transactions. Therefore, we accept Brazil's claim. We understand that the agent fee of xxx% of the value of the NTN-I bonds mentioned in the evidence submitted by Brazil is supposed to reflect the "Brazil risk" inherent in the payment of PROEX over a 15-year period. Even though this is a high agent fee, we accept to use it for the following reasons:

(a) the liquidity of the NTN-1 bonds is more limited than other government bonds that are denominated in convertible currencies. This is demonstrated by the fact that, according to Brazil, only three banks are involved in PROEX payments;

(b) NTN-1 bonds are paid in domestic currency and face a convertibility risk; and

(c) Brazil submitted two concrete examples involving the xxx banks which handle xxx% of the bonds used for PROEX financing and demonstrating that these banks have in the recent past charged an agent fee or commission of xxx% of the value of the NTN-I bonds or higher.[79]

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[77] For a description of the operation of the PROEX programme, see Original Panel Report, *Op. Cit*., section II.

[78] Brazil's Exhibits Br-A-14, Br-A-22 and Br-A-30.

[79] On p. 18 of Brazil's written submission of 26 June 2000, Brazil refers to a letter from a bank, which proposes an agent fee of xxx%. Brazil states that:

> "this discount fee represents xx xxxxxxx xxxxxxxxxx xx xxx xxxxxxx xxxxx xxxxxxxx xx xxx xxxxxxxx xxxxxxx xx xxxxx xxxx x xxxxxxx xxxxxx, and is in line with normal commercial operations in Brazil. xxxx xxxxx xx xxx xxxxxx xxxx xxxxxxx xx xx xxxxxxxxx xxxxxxxx xxxx xx xxxxxx. The calculation of this rate is shown in the worksheets attached as Exhibit Br-A-13."

3.86 We therefore use the figures contained in the evidence submitted by Brazil that stipulates an agent fee or commission of xxx% of the interest rate equalization payment (PROEX) for the first ten years and xxx% for the remaining five years over a total 15-year financing period. At the PROEX rate of 3.8%, a xxx% agent fee is equivalent to xxx percentage points of 3.8% of the financing for the first ten years, and a xxx% agent fee is equivalent to xxx percentage points for the remaining five years (i.e. 3.8% x xxx% = xxx percentage points; 3.8% x xxx% = xxx percentage points). At the PROEX rate of 2.5%, a xxx% agent fee is equivalent to xxx percentage points for the first ten years, and a xxx% agent fee is equivalent to xxx percentage points for the remaining five years.

(v) Discount rate

3.87 We note that Canada's methodology used a discount rate of 12% and an agent fee of 0.15%. We understand that Brazil has included the xxx% agent fee in its calculation of the discount rate, as part of its claim that the total amount levied by the bank is equivalent to a discount rate of xxx%. Thus, Brazil adds the xxx% agent fee to the xxxxx rate of xxx% in order to reach what it claims to be equivalent to a discount rate of xxx%.[80] As outlined above, we prefer to calculate the specific risk factor entirely as part of the agent fee, since it appears to be the practice followed by the main banks involved in PROEX financing.

3.88 Therefore, for the discount rate, we considered it appropriate to use a xxxxx rate for US dollars of xxx%, as suggested by Brazil. We used a xxxxx rate for US dollars because the transactions are in US dollars. We did not use a higher discount rate, such as the rate suggested by Canada, because we assumed that all risk factors are reflected entirely in the agent fee, as explained above.

(vi) Present value of the subsidy per aircraft model

3.89 As set out in Table 2, we define the net PROEX subsidy per aircraft as a figure that is net of the agent fee (i.e. total PROEX financing minus the agent fee). This is in our view consistent with the definition of subsidy in Article 1 of the SCM Agreement.[81]

3.90 We have calculated the present value of the subsidy for an ERJ-135 and an ERJ-145 with financing at the PROEX interest rate equalization of 3.8% and with financing at the PROEX interest rate equalization of 2.5%. Therefore, the present value of a PROEX interest rate equalization payment of 3.8% of xxx% of the sale price of an ERJ-135 (US$xxx million) is US$xxx; and with a PROEX interest rate equalization payment of 2.5% is US$xxx. The present value of a PROEX interest rate equalization payment of 3.8% of xxx% of the sale price of an ERJ-145 (US$xxx million) is US$xxx; and with a PROEX interest rate equalization payment of 2.5% is US$xxx.

[80] Our calculations show that this implied discount rate is slightly lower than the xxx% rate used by Brazil. Our calculations show that the rate is between xxx and xxx%, depending on the assumptions used.

[81] See also the Illustrative List of Export Subsidies, Annex I to the SCM Agreement.

3.91 The above elements are set out in Table 2 below:

Table 2: Calculation of the Present Value of the Subsidy: Repayment according to constant instalments (method used by Brazil)

	Sale Price (US$)	PROEX rate (percentage points)	Agent fee (%)	Net PROEX subsidy rate (after deducting the agent fee) (percentage points)	Present value of the subsidy per aircraft model (US$)
ERJ-135	xxx	3.8	xxx/xxx	3.8-xxx = xxx	**xxx**
	xxx	2.5	xxx/xxx	2.5-xxx = xxx	**xxx**
ERJ 145	xxx	3.8	xxx/xxx	3.8-xxx = xxx	**xxx**
	xxx	2.5	xxx/xxx	2.5-xxx = xxx	**xxx**

(b) Calculation of the total present value of the subsidy

3.92 Based on the information set out in Tables 1 and 2 above, the average present value of the subsidy per aircraft is estimated by multiplying the total number of aircraft by model at 3.8% PROEX and 2.5% PROEX produced during the period 2000-2005 (see Table 1) by the average annual subsidy per model (see Table 2). The calculation is as follows:

ERJ-135: xxx aircraft @ 3.8% x US$xxx = US$xxx
PLUS:
xxx aircraft @ 2.5% x US$xxx = US$xxx
EQUALS:

US$405,046,838

ERJ-145: xxx aircraft @ 3.8% x US$xxx = US$xxx
PLUS:
xxx aircraft @ 2.5% x US$xxx = US$xxx
EQUALS

US$996,266,316

3.93 The total amount of the subsidy per year is then calculated by adding the above figures for the total number of ERJ-135 and ERJ-145 aircraft, i.e. US$405,046,838 plus US$996,266,316, to reach a total of US$1,401,313,154 over the time-period 2000-2005. This figure is then divided by six (for the time-period of six years) to determine the average present value of the subsidy per year. This average in US dollars is then converted into Canadian dollars. In this process, we use

the most recent exchange rate between the Canadian and the US dollar.[82] We therefore apply a rate of C$1.474 to US$1. The result is therefore as follows: US$233,552,192.3 multiplied by 1.474 equals C$344,255,931.4502. This figure can be rounded to *C$344.2 million*.

IV. AWARD OF THE ARBITRATORS

4.1 For the reasons set out above, the Arbitrators decide that, in the matter *Brazil – Export Financing Programme for Aircraft*, the suspension by Canada of the application to Brazil of tariff concessions or other obligations under GATT 1994, the Agreement on Textiles and Clothing and the Agreement on Import Licensing Procedures covering trade in a maximum amount of C$344.2 million per year would constitute appropriate countermeasures within the meaning of Article 4.10 of the SCM Agreement.

4.2 In this respect, the Arbitrators urge Canada to make sure that, if it decides to proceed with the suspension of certain of its obligations *vis-à-vis* Brazil referred to in document WT/DS46/16 other than the 100 per cent surtax, this will be done in such a way that the maximum amount of countermeasures referred to in the preceding paragraph will be respected.

4.3 Finally, the Arbitrators would like to emphasize that Article 22.8 of the DSU provides that:

> "The suspension of concessions or other obligations shall be temporary and shall only be applied until such time as the measure found to be inconsistent with a covered agreement has been removed, or the Member that must implement recommendations or rulings provides a solution to the nullification or impairment of benefits, or a mutually satisfactory solution is reached. […]"

[82] Exchange Cross Rates, 18 August 2000, *Financial Times*, Monday, 21 August 2000, p. 22.

ANNEX

ERJ-135, 2.5% PROEX financing

Aircraft price		
Down payment portion	PROEX equalization rate	2.50%
Equalization applicable portion	Agent fee year	
Down payment value	Agent fee year	
Total financing	Financing period – years	15
Discount rate	Semi-annual payments	30

Year	Capital Portion	Principal Balance	Equal. Total	Agent fee	Net EQ	EQ/Year	NPV
1							
2							
3							
4				XXX			
6							
7							
8							
9							
10							
11							
12							
13				XXX			
14							
15							
		Agent fee Nominal value of EQ NPV of EQ					

ERJ-135, 3.8% PROEX financing

Aircraft price		
Down payment portion	PROEX equalization rate	3.80%
Equalization applicable portion	Agent fee year	
Down payment value	Agent fee year	
Total financing	Financing period – years	15
Discount rate	Semi-annual payments	30

Year	Capital Portion	Principal Balance	Equal. Total	Agent fee	Net EQ	EQ/Year	NPV
1							
2							
3							
4				XXX			
5							
6							
7							
8							
9							
10							
11							
12							
13				XXX			
14							
15							
		Agent fee Nominal value of EQ NPV of EQ					

ERJ-145, 2.5% PROEX financing

Aircraft price		
Down payment portion	PROEX equalization rate	2.50%
Equalization applicable portion	Agent fee year	
Down payment value	Agent fee year	
Total financing	Financing period – years	15
Discount rate	Semi-annual payments	30

Year	Capital Portion	Principal Balance	Equal. Total	Agent fee	Net EQ	EQ/Year	NPV
1							
2							
3							
4				XXX			
5							
6							
7							
8							
9							
10							
11							
12							
13				XXX			
14							
15							
		Agent fee Nominal value of EQ NPV of EQ					

ERJ-145, 3.8% PROEX financing

Aircraft price		
Down payment portion	PROEX equalization rate	3.80%
Equalization applicable portion	Agent fee year	
Down payment value	Agent fee year	
Total financing	Financing period – years	15
Discount rate	Semi-annual payments	30

Year	Capital Portion	Principal Balance	Equal. Total	Agent fee	Net EQ	EQ/Year	NPV
1							
2							
3							
4				XXX			
5							
6							
7							
8							
9							
10							
11							
12							
13				XXX			
14							
15							
		Agent fee Nominal value of EQ NPV of EQ					

UNITED STATES – TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS"

RECOURSE TO ARTICLE 21.5 OF THE DSU BY THE EUROPEAN COMMUNITIES

Report of the Appellate Body
WT/DS108/AB/RW

Adopted by the Dispute Settlement Body on 29 January 2002

United States, *Appellant/Appellee*
European Communities, *Appellant/Appellee*
Australia, *Third Participant*
Canada, *Third Participant*
India, *Third Participant*
Japan, *Third Participant*

Present:
Feliciano, Presiding Member
Ganesan, Member
Taniguchi, Member

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I. INTRODUCTION

1. The United States appeals certain issues of law and legal interpretations in the Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations" – Recourse to Article 21.5. of the DSU by the European Communities* (the "Panel Report").[1] The Panel was established to consider a complaint by the European Communities concerning the consistency of the United States FSC Replacement and Extra-territorial Income Exclusion Act (the "ETI Act") [2] with the *Agreement on Subsidies and Countervailing Measures* (the "*SCM Agreement*"), the *Agreement on Agricul-*

[1] WT/DS108/RW, 20 August 2001.
[2] United States Public Law 106-519, 114 Stat. 2423 (2000).

ture, and the *General Agreement on Tariffs and Trade 1994* (the "GATT 1994"). The ETI Act is a measure taken by the United States with a view to complying with the recommendations and rulings of the Dispute Settlement Body (the "DSB") in *United States – Tax Treatment for "Foreign Sales Corporations"* ("*US – FSC*").[3] Pertinent aspects of the ETI Act are described in Section II below, as well as in paragraphs 2.1-2.8 of the Panel Report.

2. In *US – FSC*, the original panel concluded that the "FSC measure", consisting of Sections 921-927 of the United States Internal Revenue Code (the "IRC") and related measures establishing special tax treatment for foreign sales corporations, was inconsistent with the United States' obligations under the *SCM Agreement* and under the *Agreement on Agriculture*.[4] The Appellate Body upheld the original panel's finding that the FSC measure was inconsistent with United States' obligations under the *SCM Agreement* and modified the Panel's findings under the *Agreement on Agriculture*.

3. On 20 March 2000, the DSB adopted the reports of the original panel and the Appellate Body. The DSB recommended that the United States bring the FSC measure into conformity with its obligations under the covered agreements and that the FSC subsidies found to be prohibited export subsidies within the meaning of the *SCM Agreement* be withdrawn without delay, namely, "at the latest with effect from 1 October 2000."[5] At its meeting on 12 October 2000, the DSB acceded to a request made by the United States to modify the time-period for complying with the DSB's recommendations and rulings in this dispute so as to expire on 1 November 2000.[6] On 15 November 2000, with a view to such compliance, the United States promulgated the ETI Act.[7] The background of this dispute is set out in further detail in the Panel Report.[8]

4. The European Communities considered that the ETI Act did not comply with the recommendations and rulings of the DSB and that it was not consistent with the United States' obligations under the *SCM Agreement*, the *Agreement on Agriculture*, and the GATT 1994. The European Communities therefore requested that the matter be referred to the original panel pursuant to Article 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU").[9] On 20 December 2000, in accordance with Article 21.5 of the DSU, the DSB referred the matter to the original panel.[10] The Panel Report was circulated to the Members of the World Trade Organization (the "WTO") on 20 August 2001.

5. The Panel concluded that:

(a) the [ETI] Act is inconsistent with Article 3.1(a) of the *SCM Agreement* as it involves subsidies "contingent… upon

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[3] The recommendations and rulings of the DSB resulted from the adoption, by the DSB, of the Appellate Body Report in *US – FSC*, WT/DS108/AB/R, adopted 20 March 2000, DSR 2000:III, 1619 (the "original Appellate Body Report"). In this Report, we refer to the panel that considered the original complaint brought by the European Communities as the "original panel" and to its report as the "original panel report".

[4] Original Panel Report, *US – FSC*, WT/DS108/R, adopted 20 March 2000, as modified by the Appellate Body Report, WT/DS108/AB/R, DSR 2000:III, 1677, para. 8.1.

[5] *Ibid*., para. 8.8.

[6] WT/DSB/M/90, paras. 6-7. See also Panel Report, para. 1.3.

[7] Panel Report, para. 1.5.

[8] *Ibid*., paras. 1.1-1.13.

[9] WT/DS108/16, 8 December 2000.

[10] WT/DS108/19, 5 January 2001.

export performance" within the meaning of 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 [ETI] 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* by applying the export subsidies, with respect to both scheduled and unscheduled agricultural products, in a manner that, at the very least, threatens to circumvent its export subsidy commitments under Article 3.3 of the *Agreement on Agriculture* and, by acting inconsistently with Article 10.1, the United States has acted inconsistently with its obligation under Article 8 of the *Agreement on Agriculture*;

(d) the [ETI] Act is inconsistent with Article III:4 of the *GATT 1994* by reason of the foreign articles/labour limitation as it accords less favourable treatment within the meaning of that provision to imported products than to like products of US origin; and

(e) the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies inconsistent with Article 3.1(a) of the *SCM Agreement* and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 *SCM Agreement.*[11]

6. The Panel also concluded that 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.[12]

7. 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, pursuant to paragraph 4 of Article 16 of the DSU, and filed a Notice of Appeal pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*").[13]

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[11] Panel Report, para. 9.1.
[12] *Ibid.*, para. 9.2.
[13] WT/DS108/21, 15 October 2001.

8. By letter of 22 October 2001, the United States requested the Appellate Body pursuant to Rule 16(2) of the *Working Procedures* to modify the timetable set out in the Working Schedule for Appeal for the filing of the appellant's submissions by the United States. The United States stated that suspected bioterrorist attacks had compromised the ability of the United States to conduct the necessary consultations with the United States Congress with regard to this appeal.[14] According to the United States, the effect of these circumstances was such that adhering to the original timetable would result in manifest unfairness to the United States. In its letter of 23 October 2001, the European Communities did not object to the request made by the United States, but requested that, in order to preserve the balance of procedural rights afforded to the participants in this appeal, the Appellate Body extend the deadline for the filing of the European Communities' appellee's submission by 14 days. In a letter dated 23 October 2001, the Division of the Appellate Body hearing the appeal accepted that the circumstances identified by the United States constituted "exceptional circumstances" within the meaning of Rule 16(2) of the *Working Procedures* and that maintaining the deadline for submission of the appellants' submission would result in "manifest unfairness" to the United States. Accordingly, the Division agreed to modify the Working Schedule for this appeal to allow the United States an additional seven days for the filing of its appellant's submission. In the same letter, the Division also extended by seven days the deadlines for the filing of the other appellant's submissions, the appellee's submission, and the third participants' submissions.

9. On 1 November 2001, the United States filed its appellant's submission.[15] On 6 November 2001, the European Communities filed its other appellant's submission.[16] On 16 November 2001, the European Communities and the United States each filed an appellee's submission.[17] On the same day, Australia, Canada, India and Japan each filed a third participant's submission.[18]

10. The oral hearing in this appeal was held on 26 and 27 November 2001. The participants and third participants presented oral arguments and responded to questions put to them by the Members of the Division hearing the appeal.

11. At the oral hearing, the Division requested the United States to reduce to writing, by 28 November 2001, certain of its responses to questioning.[19] The Division also authorized the European Communities and the third participants, if they wished, to respond in writing by 30 November 2001.[20] In response to this request, the United States filed an additional written memorandum on 28 November 2001. The European Communities filed a response to this additional written memorandum on 30 November 2001.

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[14] In its letter, the United States explained that, due to the delivery of the bacterium anthrax to the United States Congress, several buildings had been temporarily closed, including buildings housing the offices of United States Senate officials with jurisdiction over the issues arising in this appeal.

[15] Pursuant to Rule 21(1) of the *Working Procedures*.

[16] Pursuant to Rule 23(1) of the *Working Procedures*.

[17] Pursuant to Rules 22 and 23(3) of the *Working Procedures*.

[18] Pursuant to Rule 24 of the *Working Procedures*.

[19] Pursuant to Rule 28(1) of the *Working Procedures*.

[20] Pursuant to Rule 28(2) of the *Working Procedures*.

II. BACKGROUND

A. Overview of United States Rules of Taxation

12. In our Report in *US – FSC*, we provided certain general background information relating to United States rules of taxation. We said:

> For United States citizens and residents, the tax laws of the United States generally operate "on a worldwide basis". This means that, generally, the United States asserts the right to tax all income earned "worldwide" by its citizens and residents. A corporation organized under the laws of one of the fifty American states or the District of Columbia is a "domestic", or United States, corporation, and is "resident" in the United States for purposes of this "worldwide" taxation system. …
>
> The United States generally taxes any income earned by foreign corporations within the territory of the United States. The United States generally does not tax income that is earned by foreign corporations outside the United States. However, [under Section 882(a) IRC], such "foreign-source" income of a foreign corporation generally will be subject to United States taxation when such income is "effectively connected with the conduct of a trade or business within the United States". …[21] (footnotes omitted)

13. This statement continues to describe the United States tax system and is relevant for the purposes of this appeal also. In addition, we note that, under Sections 1 and 11 IRC, the United States imposes a tax on the "taxable income" of its citizens and residents. According to Section 63(a) IRC, taxable income is equal to "gross income minus the deductions allowed" under the IRC. Section 61(a) IRC provides that gross income is "all income from whatever source derived". When a United States citizen or resident is subject to tax, in the United States, on income which is also subject to tax in a foreign State, the United States grants the taxpayer tax credits, subject to certain limitations, in respect of the amount of foreign taxes paid.[22]

14. The provisions of the IRC relating to these rules of taxation have not been modified by the ETI Act, although the application of these rules has been altered by the adoption of the ETI Act.

B. ETI Act

15. A detailed description of the measure at issue in this appeal is contained in paragraphs 2.2 to 2.8 of the Panel Report. Nevertheless, we consider it useful, at this stage, to provide an overview of the fundamental aspects and key provisions of the ETI Act.

16. The ETI Act consists of five sections. At issue in this dispute are, first, certain elements of Sections 2 and 5, which relate to foreign sales corporations and, second, certain elements of Section 3. Section 3, entitled "Treatment of Extraterritorial Income", amends the IRC by inserting into it a new Section 114, as well as a new Sub-

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[21] Appellate Body Report, *supra*, footnote 3, paras. 6-7.

[22] Section 901(a) IRC.

part E, which is in turn composed of new Sections 941, 942 and 943. The remaining sections of the ETI Act are not relevant for purposes of this dispute.[23]

17. As we have said, the ETI Act was promulgated by the United States with a view to complying with the recommendations and rulings of the DSB in *US – FSC*. Section 2 of the ETI Act repeals the provisions of the IRC relating to FSCs.[24] Section 5(b) prohibits foreign corporations from electing to be treated as FSCs after 30 September 2000 and provides for the termination of inactive FSCs. Nevertheless, Section 5(c) creates a "transition period" for certain transactions of existing FSCs. Specifically, under Section 5(c)(1) of the ETI Act, the repeal of the provisions of the IRC relating to FSCs "shall not apply" to transactions of existing FSCs which occur before 1 January 2002 or to any other transactions of such FSCs which occur after 31 December 2001, pursuant to a binding contract between the FSC and an unrelated person which is in effect on 30 September 2000. These provisions are the subject of the European Communities' claim that the United States has not fully withdrawn the FSC subsidies, in accordance with Article 4.7 of the *SCM Agreement*.

18. Sections 114, 941, 942 and 943 IRC were inserted into the IRC by virtue of Section 3 of the ETI Act, and create new rules under which certain income is excluded from United States taxation. We refer to these new rules as the "ETI measure" (or sometimes simply as the "measure"), which we outline below. In these proceedings, the claims brought by the European Communities under Article 3.1 of the *SCM Agreement*, Articles 3.3, 8 and 10.1 of the *Agreement on Agriculture* and Article III:4 of the GATT 1994 contest various elements of this measure.

19. The tax treatment provided by the ETI measure is available to United States' citizens and residents, including natural persons, corporations and partnerships. In addition, the provisions of the ETI measure also apply to foreign corporations which elect to be treated, for tax purposes, as United States corporations.[25] The ETI measure permits all these taxpayers to elect to have qualifying income taxed in accordance with the provisions of that measure. This election may be made by taxpayers on a transaction-by-transaction basis.

20. Generally, income from specific transactions will qualify for treatment in accordance with the provisions of the ETI measure if it is income attributable to gross receipts: (i) from specific types of transaction; (ii) involving "qualifying foreign trade property" ("QFTP"); and (iii) if the "foreign economic process requirement" is fulfilled with respect to each such transaction.[26] Turning to the first of these conditions, the rules contained in the ETI measure apply, in particular, to income arising from sale, lease or rental transactions. The ETI measure also applies to income earned from the performance of services "related or subsidiary to" qualifying sales or lease transactions, as well as to income earned from the performance of certain other services.[27]

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[23] Section 1 relates to the short title of the ETI Act, while Section 4 sets forth a number of "technical and conforming" amendments.

[24] Subpart C of part III of Subchapter N of chapter 1, consisting of Sections 921-927 IRC.

[25] Section 3 of the ETI Act, Section 943(e) IRC.

[26] Under the ETI Act, the need to satisfy these three conditions is subject to a number of exceptions. We examine certain of these exceptions below, to the extent that they are pertinent to our analysis of the issues on appeal.

[27] The detailed rules of the ETI measure provide that foreign trading gross receipts may be earned through (i) any sale, exchange, or other disposition of qualifying foreign trade property; (ii) any lease or rental of qualifying foreign trade property; (iii) any services which are related and subsidiary to (i)

21. The second condition is that these transactions involve QFTP. Section 943(a)(1) IRC defines QFTP as property which is: (A) manufactured, produced, grown or extracted within or outside the United States; (B) held primarily for sale, lease or rental, in the ordinary course of business, for direct use, consumption, or disposition outside the United States; and (C) not more than 50 percent of the fair market value of which is attributable to: (i) articles manufactured, produced, grown, or extracted outside the United States; and (ii) direct costs for labour performed outside the United States.[28]

22. The third condition is that the "foreign economic process requirement" must be fulfilled with respect to each individual transaction.[29] This requirement is fulfilled if the taxpayer (or any person acting under contract with the taxpayer) participated outside the United States in the solicitation, negotiation, or making of the contract relating to the transaction. Furthermore, a specified portion of the "direct costs" of the transaction must be attributable to activities performed outside the United States.[30]

23. Section 942(a) IRC designates as "foreign trading gross receipts" the receipts generated in transactions satisfying all three of these conditions. Under Section 114(e) IRC, "extraterritorial income" is the gross income attributable to foreign trading gross receipts and, under Section 941(b) IRC, "foreign trade income" is the taxable income attributable to foreign trading gross receipts.

24. Section 114(a) IRC provides that a taxpayer's gross income "does not include extraterritorial income". Section 114(b) IRC adds that this exclusion of extraterritorial income from gross income "shall not apply" to that portion of extraterritorial income which is not "qualifying foreign trade income" ("QFTI"). Accordingly, the *only* portion of extraterritorial income which is excluded from gross income – and, thereby, from United States taxation – is QFTI.

25. QFTI is an amount which, if excluded from the taxpayer's gross income, will result in a reduction of the taxable income of the taxpayer from the qualifying transaction. Pursuant to Section 941(a)(1) and (2) IRC, QFTI is calculated as the greatest of, or the taxpayer's choice of, the following three options: (i) 30 percent of the foreign sale and leasing income derived by the taxpayer from such transaction[31]; (ii) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transac-

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and (ii); (iv) for engineering or architectural services for construction projects located (or proposed for location) outside the United States; and (v) for the performance of managerial services for a person other than a related person in furtherance of activities under (i), (ii) or (iii). (Section 3 of the ETI Act, Section 942(a) IRC) We will generally refer to sale and lease transactions as a shorthand reference to the transactions described in (i) and (ii) of this footnote.

[28] Section 3 of the ETI Act, Section 943(a)(1) IRC. Section 943(a)(3) and (4) IRC set forth specific exclusions from this general definition.

[29] Section 3 of the ETI Act, Section 942(b) IRC.

[30] The relevant activities are: (i) advertising and sales promotion; (ii) processing of customer orders and arranging for delivery; (iii) transportation outside the United States in connection with delivery to the customer; (iv) determination and transmittal of final invoice or statement of account or the receipt of payment; and (v) assumption of credit risk. A taxpayer will be treated as having satisfied the foreign economic process requirement when at least 50 percent of the total costs attributable to such activities is attributable to activities performed outside the United States, or, for at least two of these five categories of activity, when at least 85 percent of the total costs attributable to such category of activity is attributable to activities performed outside the United States. (Section 3 of the ETI Act, Section 942(b)(2)(A)(ii), (b)(2)(B) and (b)(3) IRC)

[31] Foreign sales and leasing income is defined in Section 941(c)(1) IRC.

tion[32]; or (iii) 15 percent of the foreign trade income derived by the taxpayer from the transaction.[33]

III. ARGUMENTS OF THE PARTICIPANTS AND THIRD PARTICIPANTS

A. Claims of Error by the United States – Appellant

1. Subsidies Contingent Upon Export under the SCM Agreement

(a) Article 1.1(a)(1)(ii) of the *SCM Agreement*: Revenue Foregone that is "Otherwise Due"

26. The United States requests us to reverse the Panel's finding that the ETI Act confers a subsidy within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*. More specifically, the United States contends that the Panel "misapplied" the comparison test established in the original Appellate Body Report.[34]

27. The United States argues, first, that the Panel ignored the fact that the definition of "gross income" is not contained in Section 61 of the IRC alone, but depends also on other sections of the IRC and, more particularly, on Section 114(a) and (b) IRC. Second, the Panel erroneously created a distinction between a "specific" and a "general" tax exclusion. The Panel stated that a Member may exclude a category of income from taxation only if it excludes "all of the income" in that category. The United States contends that such an analysis improperly incorporates the concept of specificity, found in Article 2 of the *SCM Agreement*, into the definition of "subsidy" in Article 1. Third, the Panel created another erroneous standard by stating that a tax exclusion must have "some kind of overall rationale and coherence" if it is to avoid foregoing revenue that is otherwise due. Such a proposition is inconsistent with the Appellate Body's prior statement that a Member is free to tax or not tax the categories of revenues that it chooses. Fourth, the United States appeals what it considers to be a failure by the Panel to apply the original panel's "but for" test, a test which the Appellate Body had upheld. The United States submits that "but for" the exclusion of qualifying foreign trade income, *all* extraterritorial income would be excluded from "gross income". Finally, the Panel erred in finding that extraterritorial income excluded by the ETI Act necessarily would be taxed if the ETI Act did not exist. The United States submits that merely classifying income as "gross income" does not *per se* mean that it would necessarily be taxed, since "gross income" may also be subject to deferral, deductions or foreign tax credits.

28. In its additional written memorandum, the United States emphasizes that, in determining the relevant benchmark rules of taxation in this case, the "basic issue ... is the allocation of income earned in an international transaction between the domestic and foreign portions of such income."[35] The longstanding "normative" principles of the United States permit taxpayers "to structure their affairs in a manner that separates the foreign-allocated portion of foreign sales income from the domestic

[32] Foreign trading gross receipts are defined in Section 942(a) IRC.
[33] Foreign trade income is defined in Section 941(b) IRC.
[34] United States' appellant's submission, para. 107.
[35] United States' additional written memorandum, p. 1.

portion and subjects only the domestic portion to domestic taxation."[36] Traditionally, the United States has permitted the foreign portion of such income to be allocated outside its taxing jurisdiction through the use of a foreign-incorporated subsidiary of a United States taxpayer. The foreign portion of the income earned by such subsidiaries is not subject to United States taxation.[37] The direct allocation, under the ETI Act, of income earned in an international transaction between the domestic and foreign portions of such income simplifies the method for allocating such income outside United States' taxing jurisdiction. The ETI Act allows such allocation to be made in respect of transactions carried out directly by a United States taxpayer – without the use of a foreign subsidiary. Thus, while the ETI Act reformulates, through a fundamental revision of Sections 61 and 114 of the IRC, the method by which the United States implements its normative benchmark principles, it is consistent with such principles.

(b) Article 3.1(a) of the *SCM Agreement*: Export Contingency

29. The United States also asks us to reverse the Panel's finding that the ETI Act involves a subsidy contingent upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*. The United States argues that the Panel incorrectly transformed Article 3.1(a) into a "reverse national treatment" requirement under which domestic sales must be afforded no less favourable treatment than exports or other foreign sales.[38] However, no such requirement is present in the text of Article 3.1(a) and the availability of a subsidy to purely domestic transactions is irrelevant under Article 3.1(a).

30. According to the United States, the Panel artificially bifurcated and improperly examined the ETI Act as if it had one category of treatment for United States-produced goods and a different one for foreign-produced goods. In so doing, the Panel created a distinction not found in the ETI Act, which was purposefully drafted to provide tax relief based on export-neutral criteria.

31. The United States maintains that the ETI Act is export-neutral in that it permits income to be earned without exporting. Article 3.1(a) does not prohibit subsidies that benefit exporters if conferred through export-neutral principles. In finding the ETI Act to be export-contingent, the Panel improperly held that a measure violates Article 3.1(a) if exportation is *one* way of obtaining a subsidy. However, exportation constitutes a prohibited contingency only where exportation is a *mandatory* condition. Finally, according to the United States, the Panel erroneously found that an export-contingent subsidy cannot be cured by expanding the universe of eligible recipients.

(c) Footnote 59 to the *SCM Agreement*: Double Taxation of Foreign-Source Income

32. The United States further requests us to set aside the Panel's findings that the ETI Act is not a measure to avoid double taxation under the fifth sentence of footnote 59 to the *SCM Agreement*. The Panel erroneously created detailed criteria for a

[36] United States' additional written memorandum., p. 3.

[37] Subject to the anti-abuse rules contained in Subpart F of the IRC. (United States' additional written memorandum, p. 2)

[38] United States' appellant's submission, para. 142.

measure to qualify under the fifth sentence of footnote 59 and, in so doing, improperly established "a new double taxation avoidance code".[39]

33. At the outset, the United States submits that the Panel incorrectly imposed on the United States the burden of proving that the ETI Act is a measure to avoid double taxation. The Panel ignored the Appellate Body's finding in *EC Measures Concerning Meat and Meat Products (Hormones)* ("*EC – Hormones*")[40] that related provisions which define key elements of the violations alleged form part of the elements of the *prima facie* case that a complainant must make.

34. The United States alleges that in finding that the ETI Act is not a measure to avoid double taxation, the Panel articulated four new principles that cannot be found in the fifth sentence of footnote 59. First, the Panel incorrectly stated that such a measure must apply to *all* income that is potentially subject to double taxation. Second, the Panel found that such a measure cannot encompass income that might *not* be treated as taxable in other jurisdictions. Third, the Panel held that a *bona fide* measure to avoid double taxation must contain a "permanent establishment" requirement. Fourth, the Panel erred in stating that a country which has an extensive system of bilateral tax treaties could not adopt a measure to avoid double taxation.

35. The United States claims that in addition, the Panel wrongly created a new standard for reviewing conformity with the fifth sentence of footnote 59: the "reasonable legislator" standard. The United States sees this as a substitution by the Panel of its judgment for that of a national legislature as to whether a measure is intended to avoid double taxation.

36. In the view of the United States, the fifth sentence of footnote 59 does not define "double taxation" or indicate the types of measure that are permissible to "avoid" double taxation. The sentence also does not define "foreign-source income". Two general categories of measures are nevertheless well-accepted and used throughout the world for the avoidance of double taxation: the exemption (or non-taxation) method and the tax credit method. The United States emphasizes that international tax conventions recognize that countries are free to use one or the other or both methods, and that the methods used vary from country to country.

37. The United States submits that the ETI Act achieves avoidance of double taxation through the exclusion of extraterritorial income from gross income. The ETI Act's legislative history expressly identifies double taxation avoidance as a primary objective of the ETI Act, and the ETI Act was designed to parallel certain aspects of the territorial systems of many member States of the European Communities. "Extraterritorial income" under the ETI Act is income derived from foreign transactions, and, as such, it falls within the ordinary meaning of the phrase "foreign-source income" under footnote 59 to the *SCM Agreement*.

38. Should we reverse the Panel's finding and hold that the ETI Act is a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59, the United States requests us to complete the analysis and find that, by virtue of footnote 5 to the *SCM Agreement*, the ETI Act is not a prohibited export subsidy.

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[39] United States' appellant's submission, para. 173.

[40] Appellate Body Report, WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, DSR 1998:I, 135.

2. *Export Subsidies under the Agreement on Agriculture*

39. The United States also asks us to reverse the Panel's finding that the ETI Act is inconsistent with the United States' obligations under Articles 8 and 10.1 of the *Agreement on Agriculture*. The Panel's finding that the ETI Act constitutes an export subsidy under Article 1(e) of the *Agreement on Agriculture* is based entirely on its finding under the *SCM Agreement*. Because the Panel's finding of an export subsidy under the *SCM Agreement* is in error, the United States submits that the Panel's finding of an export subsidy under the *Agreement on Agriculture* is also in error.

3. *Article III:4 of the GATT 1994*

40. The United States appeals the Panel's finding that, by reason of its "fair market value rule," the ETI Act accords less favourable treatment to imported products than to like United States' products and is, therefore, inconsistent with Article III:4 of the GATT 1994.

41. The United States recalls that the "no less favourable treatment" standard under Article III:4 has been interpreted by panels and the Appellate Body to require effective equality of opportunities between imported products and domestic products. Since it applied an exclusively *de jure* test in its analysis, the Panel could have found an inconsistency with Article III:4 only if it demonstrated, in the text of the measure itself, an "incontrovertible linkage between the text and the imported products whose internal use allegedly is affected by the measure".[41] The United States considers that the Panel did not establish such a linkage.

42. The United States contends that an analysis under Article III:4 should focus upon whether the measure in question is directed, on the one hand, toward particular categories of imports or imports in general, or, on the other hand, whether it is a measure of "general application". Unlike measures in past cases involving Article III:4, the ETI Act focuses entirely on income derived from property for use outside the United States; within this general framework, the ETI Act establishes various parameters and limitations on its application, one of which is the fair market value rule.

43. The United States submits that in its analysis of the fair market value rule, the Panel erroneously equated this rule with a domestic content or domestic value-added requirement. This characterization is "plainly incorrect"[42] because the ETI Act does not refer to United States' content nor does it predicate eligibility for the tax exclusion upon manufacture in the United States. The United States emphasizes that, in fact, the fair market value rule can be satisfied without any portion of the fair market value of a product being derived from United States' sources.

44. The United States argues that, in finding the fair market value rule to be inconsistent with Article III:4 of the GATT 1994, the Panel failed to establish a meaningful causal link between that rule and the alleged discrimination against imports and improperly extended the findings of the panel report in *Canada – Certain Measures Affecting the Automotive Industry* ("*Canada – Autos*")[43] to a very different situation. Moreover, the Panel ignored the findings of the Appellate Body in *Korea –*

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[41] United States' appellant's submission, para. 253.

[42] *Ibid*., para. 256.

[43] Panel Report, WT/DS139/R, WT/DS142/R, adopted 19 June 2000, as modified by the Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R, DSR 2000:VII, 3043.

Measures Affecting Imports of Fresh, Chilled and Frozen Beef ("*Korea – Various Measures on Beef*").[44] Whereas in *Korea – Various Measures on Beef*, the Appellate Body rejected speculative conclusions by the panel as to possible competitive effects that might result from the differential treatment established under the relevant measure and focused, instead, on the actual effects of the measure, the Panel in this case employed similar speculation in finding that the fair market value rule necessarily places imported products at a comparative disadvantage *vis-à-vis* like domestic products in the United States' market. The Panel unreasonably assumed that despite the variety of ways in which qualifying foreign trade property could be produced, producers would necessarily source their production in the United States. The Panel compounded this flawed analysis by further incorrectly assuming that, having decided to produce goods in the United States, producers would inherently prefer using United States components to imported components as a means of meeting the fair market value requirement.

4. Withdrawal of the FSC Subsidies

45. The United States, finally, requests us to set aside the Panel's finding that the ETI Act's transition rules are inconsistent with the full withdrawal of the FSC subsidies. Providing transitional relief is customary in the United States (and in other countries) when tax laws upon which taxpayers have relied in structuring transactions are changed. The United States contends that failure to maintain a consistent practice of transition relief would impose significant and unjustified additional transaction costs on taxpayers.

B. Arguments of the European Communities – Appellee

1. Subsidies Contingent Upon Export under the SCM Agreement

(a) Article 1.1(a)(1)(ii): Revenue Foregone that is "Otherwise Due"

46. The European Communities considers that the United States' appeal does not focus on the Panel's reasoning on the existence of a financial contribution within the meaning of Article 1 of the *SCM Agreement*, but rather criticizes certain isolated elements of the Panel's findings and responds to arguments which the Panel did not even make.

47. According to the European Communities, the Panel did *not* base its conclusion on the notion that Section 61 of the IRC was the normative benchmark, or say that any exception to it would be a subsidy. Rather, in analyzing the ETI Act, the Panel looked at the "overall situation as an integrated whole."[45] In the view of the European Communities, the United States is also wrong to criticize the Panel for distinguishing between broad and specific exclusions, and for observing that even if income attributable to foreign transactions might be a "category," the United States is not in fact excluding *all* of that "category". The European Communities similarly rejects the criticism by the United States that the Panel wrongly created an "overall

[44] Appellate Body Report, WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001, DSR 2001:I, 5.

[45] Panel Report, para. 8.23.

rationale and coherence corollary" to the *SCM Agreement*. Rather, the Panel examined the "overall rationale and coherence" of the ETI Act only after concluding that the ETI Act resulted in the foregoing of revenue otherwise due.

48. In its response to the United States' additional written memorandum, the European Communities considers that the United States is arguing that the domestic tax rules against which the ETI Act must be assessed are the rules that apportion income between domestic and foreign sources so that each part can be taxed differently, and that the ETI Act operates as a "rule of thumb" to achieve a result similar to that which would be achieved under the normal United States' source rules. The European Communities submits that the ETI Act benefits are nevertheless subsidies when regarded as derogations from the source rules. The European Communities also points out that the ETI Act source rules differ from other source rules of the United States tax code and that taxpayers can elect to their advantage which system to use on a case-by-case basis.

49. As to the alleged failure of the Panel to apply the "but for" test, the European Communities recalls that, as the Appellate Body pointed out in paragraph 91 of its original Report, the "but for" test is not treaty language and could be easily circumvented by a Member through manipulation of its tax system. In any case, the Panel did in fact apply the "but for" test when it stated that, in the absence of the ETI Act, extraterritorial income would be "gross income" and thus would be taxed.[46] The European Communities adds that even if there may be some cases where a taxpayer could avoid paying some tax in the absence of the ETI Act, it is nonetheless clear that the ETI Act shelters income from tax that would otherwise (at least in many cases) be taxed.

(b) Article 3.1(a) of the SCM Agreement: Export Contingency

50. The European Communities submits that a subsidy contingent upon export performance *necessarily* treats export sales better than domestic sales. Such "better treatment" is the very rationale for prohibiting export-contingent subsidies. The European Communities disputes the United States' argument that the criteria set out in the ETI Act are "export neutral" simply because there is an alternative to exporting for qualifying for the tax exemption. The ETI Act embodies a bundle of two *sole* contingencies for two categories of beneficiaries, each of which stipulates a *sole* means to obtain the tax subsidy. For one of these categories of beneficiaries, namely those producing goods within the United States, it is necessary to export if they are to obtain the subsidy. For a measure to be inconsistent with Article 3.1(a) of the *SCM Agreement*, it is sufficient to demonstrate that in one, or in some cases, the receipt of the subsidy is contingent upon export performance. The European Communities insists that the prohibition of export-contingent subsidies under Article 3.1(a) of the *SCM Agreement* is absolute and must be respected in all cases.

51. The European Communities adds that the alleged "alternative" for obtaining the ETI benefit, that is, the relocation of production abroad by United States producers, is not one that realistically will be used. This confirms that, in analyzing the Act, it is proper to focus on the alternatives available for goods which *have already been*

[46] Panel Report, para. 8.25.

produced, or continue to be produced, in the United States. In this context, the only means for such producers to obtain the ETI tax benefit is to export such goods.

52. The European Communities also agrees with the Panel's reasoning that the former FSC measure cannot be cured merely by extending it to non-export transactions. The Panel correctly found that, as regards the measure at issue – the ETI Act – the only way to eliminate the export contingency would be to extend the availability of the subsidy to include *domestic* sales as well.

(c) Footnote 59 to the *SCM Agreement*: Double Taxation of Foreign-Source Income

53. According to the European Communities, the Panel made clear that the issue of burden of proof was academic and had no impact on the other findings of the Panel, and that even if the European Communities bore the burden of proving that the ETI Act did not fall within the scope of the fifth sentence of footnote 59, it had discharged that burden. In any event, the European Communities also agrees with the Panel's finding on the burden of proof relating to this issue.

54. The European Communities supports the view of the Panel that, although it may not be possible to design a measure that "entirely, exclusively or precisely" avoids double taxation and, therefore, such precision is not required by the fifth sentence of footnote 59, a Member has nevertheless an obligation to identify the type of income that may be subject to double taxation and to approximate the boundaries of its measure to it. The United States has made no attempt to do this. Rather, the United States includes in the exempted category under the ETI Act income that could not legitimately be taxed in another jurisdiction.

55. The European Communities contests the United States' claim that the Panel has imposed a "permanent establishment" requirement as a necessary feature of a double taxation measure. The Panel did not articulate any such principle; indeed, it stated the opposite. The United States further alleges that the Panel held that a country could not institute a measure to avoid double taxation if it has an extensive system of bilateral tax treaties. However, in the view of the European Communities, the Panel merely considered relevant the fact that the ETI Act does not target those situations where such bilateral agreements were not in place.

56. The European Communities also contends that the United States' objection relating to the application of an alleged "reasonable legislator" standard is without merit. The Panel did not apply any such standard. Rather, the Panel considered whether the character of the ETI Act as a measure to avoid the double taxation of foreign-source income was "reasonably discernible". In the view of the European Communities, the Panel's test was legally correct and its assessment of the facts is beyond the scope of appellate review.

57. With respect to the meaning of "foreign-source" income in the fifth sentence of footnote 59, the European Communities observes that income derives from economic activities. Therefore, foreign-source income means income derived from foreign economic activities. "Income" is not the same as "payment". The fact that a payment comes from abroad does not mean that the income is generated abroad. The ETI Act, however, does not require that the economic activities giving rise to the excluded income take place abroad. Therefore, the definition of extraterritorial income in the ETI Act bears no relation to the determination of foreign-source income, and the ETI Act is not a measure falling within the scope of footnote 59. Furthermore, the European Communities notes, the ETI Act is optional for United States

taxpayers, as they can choose between the ETI Act and the other source rules of the IRC.

58. For all these reasons, the European Communities considers that the Panel correctly found that the ETI Act is not a measure to avoid the double taxation of foreign-source income and is therefore not covered by the fifth sentence of footnote 59 to the *SCM Agreement*. It follows that the Appellate Body need not reach the issue of footnote 5 to the *SCM Agreement*. In any event, the European Communities does not consider that the phrase "measures referred to in Annex I as not constituting export subsidies" in footnote 5 includes measures falling within the scope of the fifth sentence of footnote 59. Thus, footnote 5 to the *SCM Agreement* does not assist the United States.

2. *Export Subsidies under the Agreement on Agriculture*

59. The European Communities notes that the United States' arguments under the *Agreement on Agriculture* depend entirely on its arguments under the *SCM Agreement*. Accordingly, the European Communities requests us to uphold the Panel's finding under the *Agreement on Agriculture* for the same reasons it has asked the Appellate Body to uphold the Panel's finding under the *SCM Agreement*.

3. *Article III:4 of the GATT 1994*

60. The European Communities observes that the United States' appeal with regard to Article III:4 of the GATT 1994 is limited to the Panel's interpretation of the terms "affecting" and "less favourable treatment" within this provision. The word "affecting" has, since the inception of GATT 1947, consistently been interpreted broadly, and was interpreted by the Appellate Body in *European Communities – Regime for the Importation, Sale and Distribution of Bananas* ("*EC – Bananas III*")[47] as meaning to "have an effect on" the conditions of competition. The Panel applied the same interpretation and correctly concluded that the fair market value rule "affects" the use of imported products because it modifies the conditions of competition between domestic and imported goods. Whereas use of domestic "articles" will contribute to qualifying for the tax exemption, the use of foreign "articles" will never do so.

61. Thus, the European Communities considers that the Panel correctly found that less favourable treatment is accorded by reason of the fair market value rule. All other conditions being equal, United States producers will always have an *incentive* to use inputs of domestic origin. In certain cases, due to the cost structure of their production, use of domestic inputs will be necessary in order to obtain the tax benefit. The European Communities agrees with the Panel that such an incentive is sufficient to establish inconsistency with Article III:4 of the GATT 1994.

4. *Withdrawal of the FSC Subsidies*

62. The European Communities contends that the United States does not address any of the Panel's reasons or rely upon any provision of the covered agreements in support of its appeal on this issue. The United States' sole argument seems to be that transition rules are essential to the orderly shift from one set of tax rules to another.

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[47] Appellate Body Report, WT/DS27/AB/R, adopted 25 September 1997, DSR 1997:II, 591.

The European Communities responds that the findings in the original proceeding took this fact into account and, in stipulating that the FSC subsidies must be withdrawn at the latest with effect from 1 October 2000, allowed the United States a grace period to introduce the required changes.

C. Claims of Error by the European Communities – Appellant

1. Article 10.3 of the DSU: Third Party Rights

63. The European Communities requests us to reverse the Panel's finding that third parties are not entitled to receive *all* of the parties' written submissions to the meeting of the Panel, but only the *first* written submissions. The European Communities submits that Rule 9 of the Working Procedures adopted by the Panel, and the Panel's subsequent denial of the European Communities' request to change this rule, conflict with Article 10.3 of the DSU and the rights of third parties set out therein.

64. The European Communities recognizes that panels have a certain discretion to establish their own working procedures. However, panels may not derogate from binding provisions of the DSU. Article 10.3 provides that third parties shall receive "the submissions"; it does not draw any distinction between different types of submissions. Rule 9 of the Panel's Working Procedures, and the practice in Article 21.5 proceedings of requiring that only the first written submissions be provided to the third parties, are also inconsistent with Article 10.1 of the DSU, which requires panels "fully" to take into account the interests of Members, including third parties.

65. Furthermore, the European Communities submits that the approach taken by the Panel to third party rights in this case fails to ensure that third parties will be fully informed about the arguments exchanged by the time of the substantive panel meeting. The European Communities disagrees with the Panel's conclusion that, since Article 10.3 of the DSU refers to the "first meeting" of the panel and since panels "ordinarily" meet twice, the DSU intends to limit third party access to the first written submissions of the parties in *all* cases. Rather, Article 10.3 is intended to ensure that third parties are familiar with the current state of the debate and can meaningfully contribute to it. The European Communities observes that nothing in the DSU requires a panel to hold two meetings and that Article 10.3 is drafted in general terms to be applicable in all cases, regardless of how many meetings are held.

2. Conditional Appeals

66. Should we reverse the Panel's findings, the European Communities requests us to address claims in respect of which the Panel exercised judicial economy. The conditional appeals made by the European Communities relate to the following claims that it made before the Panel:

> (a) that the tax exemption accorded, under the ETI Act, to income earned in transactions relating to goods produced *outside* the United States is contrary to Article 3.1(a) of the *SCM Agreement* in that it is contingent on export performance by virtue of the "fair market value rule";[48]

[48] European Communities' first submission to the Panel, para. 119; Panel Report, p. A-23.

(b) that the ETI Act provides subsidies which are specifically related to exports within the meaning of item (e) of the Illustrative List of Export Subsidies in Annex I to the *SCM Agreement*;[49]

(c) that the "fair market value rule" in the ETI Act renders the subsidies granted in respect of goods produced in the United States (and the subsidies granted in respect of goods produced outside the United States if they are not contrary to Article 3.1(a)), contingent upon the use of United States' goods over imported goods, contrary to Article 3.1(b) of the *SCM Agreement*;[50] and

(d) that the United States, by failing to withdraw the FSC subsidies and to comply with the rulings and recommendations of the DSB by the end of the period of time allowed by the DSB, has also failed to comply with its obligations under Article 21 of the DSU.[51]

67. The European Communities requests us to consider these claims only if we reverse the findings which led the Panel to exercise judicial economy. In such case, the European Communities refers us to the arguments made by it before the Panel in respect of these claims.

D. Arguments of the United States – Appellee

1. Article 10.3 of the DSU: Third Party Rights

68. The United States claims that the Panel did not err when it declined to find that the rights of third parties include access to the parties' rebuttal submissions, and requests us to uphold the Panel's findings. Article 10.3 of the DSU does not require that *anything* submitted by the parties prior to the single meeting with the Panel must be made available to third parties. Rather, the Panel correctly concluded that Article 10.3 presupposes a context where there is more than one panel meeting.

69. To the United States, Article 10.3 is ambiguous when considered in the context of anything other than standard panel procedures. The Panel merely construed an ambiguous provision in accordance with the principles of Article 31 of the *Vienna Convention on the Law of Treaties* ("*Vienna Convention*").[52] The Appellate Body has held that the DSU, and in particular its Appendix 3, leave panels a margin of discretion to deal with specific situations that may arise in a particular case. In the view of the United States, the Panel's decision in this case was reasonable and was well within its margin of discretion.

2. Conditional Appeals

70. The United States submits that the conditions on which the European Communities appeals the various remaining issues are unclear. The European Communities states that the Appellate Body would need to consider them if it reversed "*any* of the findings of the Panel on the claims that the Panel did address."[53] (emphasis added) However, the United States considers it difficult to comprehend how the Ap-

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[49] European Communities' first submission to the Panel, para. 158; p. A-29.
[50] *Ibid.*, paras. 183-184; p. A-34.
[51] *Ibid.*, para. 246; p. A-44.
[52] Done at Vienna, 23 May 1969, 1155 U.N.T.S. 331; 8 International Legal Materials 679.
[53] European Communities' other appellant's submission, para. 4.

pellate Body's reversal of certain findings would trigger a consideration of *all* of the claims identified by the European Communities, because considerations of judicial economy would continue to apply. Moreover, the Appellate Body's reversal of certain findings by the Panel would be dispositive of one or more such claims.

71. With respect to each of the European Communities' claims, the United States refers to the arguments made in its submissions to the Panel. With respect to the European Communities' claims under Article 3.1(b) of the *SCM Agreement*, the United States adds that the European Communities erroneously alleges that Article 3.1(b) is violated if there is "even a slight bias in favour of domestic goods"[54] or if a contingency on the use of domestic over imported goods "is not precluded."[55] The United States recalls that the European Communities advanced a similar standard in the *Canada – Autos*[56] case, and neither the panel nor the Appellate Body accepted it.

E. Arguments of the Third Participants

1. Australia

72. Australia agrees with the Panel's findings that the ETI Act provides prohibited export subsidies contrary to Article 3.1(a) of the *SCM Agreement*. Australia therefore requests us to uphold the Panel's conclusions that the United States has not implemented the recommendations and rulings of the DSB.

2. Canada

73. Canada asks us to sustain the Panel's findings under the *SCM Agreement*. Under the United States tax rules, if income fails to qualify as excluded extraterritorial income within the meaning of the ETI Act, it remains subject to taxation. Accordingly, there is a foregoing of government revenue otherwise due within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*. Canada also agrees with the findings of the Panel that the subsidy is *de jure* contingent on export performance by reason of the requirement in the ETI Act of use outside the United States. Furthermore, the Panel correctly determined that "the parameters of the ETI Act do not even roughly approximate the parameters of a measure to avoid the double taxation of foreign-source income"[57]; accordingly, the ETI Act falls outside the scope of footnote 59. Finally, Canada requests us to reverse the finding of the Panel that third parties are not entitled to receive all the main parties' submissions preceding a single panel meeting.

3. India

74. India requests that we uphold the Panel's findings under the *SCM Agreement.* The United States argues that when virtually any type of income could be excluded from tax, such exclusion would form part of the prevailing domestic standard for taxation, and would therefore not involve the foregoing of revenue. According to

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[54] European Communities' second submission to the Panel, para. 160; Panel Report, p. C-30.

[55] European Communities' response to Question 35 posed by the Panel, para. 101; Panel Report, p. F-17.

[56] Panel Report, *supra*, footnote 43; Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, DSR 2000:VI, 2985.

[57] Panel Report, para. 8.96.

India, such an interpretation would render Article 1.1(a)(1)(ii) meaningless and would seriously undermine the WTO disciplines on subsidies.

75. India also considers that the Panel was correct in finding that the ETI Act grants subsidies contingent upon export performance. While it might be true that by expanding the scope of the subsidy, certain non-exporting firms could qualify for tax benefits under the ETI Act, the fact remains that United States-based producers must export in order to obtain the subsidy.

76. India considers that for a measure to fall within the scope of footnote 59, it is not sufficient that such a measure may incidentally serve in a particular set of circumstances to avoid double taxation. If this were so, any WTO Member could grant export subsidies and escape sanction under WTO rules simply by declaring that its measures are measures to avoid double taxation.

4. Japan

77. Japan believes that the Panel's findings under the *SCM Agreement* should be upheld. The ETI Act excludes only a limited portion of a potential category of foreign trade income from taxation and the narrow character of this exclusion gives rise to the foregoing of revenue otherwise due in terms of Article 1.1(a)(1)(ii) of the *SCM Agreement*. The subsidy in this case is contingent upon export. Mere co-existence of one class of activities eligible for benefits under the Act does not change the status of the subsidy for the other class to which the benefits are available only upon exportation.

78. Japan also requests us to uphold the Panel's finding that the ETI Act is not a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59 to the *SCM Agreement*. The mere fact that some income excluded from taxation under the Act may potentially be subject to double taxation is not sufficient to make it a measure to "avoid the double taxation of foreign-source income" within the meaning of footnote 59.

79. Japan recalls that a measure violates Article III:4 of the GATT 1994 when an imported product is accorded less favorable treatment than the like domestic product. A measure can accord less favorable treatment even where there are no specific legal requirements to use domestic goods. Notwithstanding the fact that the ETI Act covers goods produced both within and outside the United States, the scope of the exclusion permitted under the ETI Act for United States-produced goods is wider than the exclusion permitted for foreign-produced goods. In Japan's view, so long as such disparity in treatment between imported products and domestic products exists, Article III:4 of the GATT 1994 is violated.

IV. ISSUES RAISED IN THIS APPEAL

80. This appeal raises the following issues:

(a) whether the Panel erred in finding, in paragraphs 8.30 and 8.43 of the Panel Report, that the ETI measure – which is described in paragraphs 12-25 of this Report – involves the foregoing of revenue which is "otherwise due" and thus gives rise to a "financial contribution" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*;

(b) whether the Panel erred in finding, in paragraphs 8.75 and 9.1(a) of the Panel Report, that the ETI measure includes subsidies "contin-

gent ... upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement*;

(c) whether the Panel erred in finding, in paragraphs 8.107 and 9.1(a) of the Panel Report that the ETI measure, viewed as a whole, does not fall within the scope of footnote 59 of the *SCM Agreement* as a measure taken to avoid the double taxation of foreign-source income;

(d) whether the Panel erred in finding, in paragraphs 8.122 and 9.1(c) of the Panel Report, that the ETI measure involves export subsidies inconsistent with the United States' obligations under Articles 3.3, 8 and 10.1 of the *Agreement on Agriculture*;

(e) whether the Panel erred in finding, in paragraphs 8.158 and 9.1(d) of the Panel Report, that the ETI measure is inconsistent with the United States' obligations under Article III:4 of the GATT 1994 because it accords less favourable treatment to imported products as compared with like products of United States origin;

(f) whether the Panel erred in finding, in paragraphs 8.170 and 9.1(e) of the Panel Report, that the United States has not fully withdrawn the subsidies found, in *US – FSC,* to be prohibited export subsidies under Article 3.1(a) of the *SCM Agreement*, and in finding that the United States has, therefore, failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 of the *SCM Agreement*; and

(g) whether the Panel erred in its interpretation of Article 10.3 of the DSU in declining, in its decision of 21 February 2001, reproduced in paragraph 6.3 of the Panel Report, to rule that all the written submissions of the parties filed prior to the only meeting of the Panel must be provided to the third parties.

V. ARTICLE 1.1 OF THE *SCM AGREEMENT*: "FOREGOING REVENUE" THAT IS "OTHERWISE DUE"

81. The Panel found that the ETI measure "results in the foregoing of revenue which is 'otherwise due' and thus gives rise to a financial contribution within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*." [58]

82. In appealing this finding, the United States asserts that the Panel misinterpreted and misapplied the applicable legal standard under Article 1.1(a)(1)(ii), and also mischaracterized the relevant provisions of the IRC.[59] The United States argues that the Panel failed to apply properly the appropriate comparison, as outlined by the Appellate Body in *US – FSC*, which involves comparing a contested tax measure against a "prevailing domestic standard". According to the United States, the ETI measure establishes a general rule of United States taxation whereby the income ex-

[58] Panel Report, para. 8.43. (footnote omitted)

[59] We observe that the United States does not appeal the Panel's finding, in paragraph 8.48 of the Panel Report, that the financial contribution it found to exist under Article 1.1(a)(1)(ii) of the *SCM Agreement* confers a "benefit" within the meaning of Article 1.1 of that Agreement.

cluded from taxation is "outside U.S. taxing jurisdiction".[60] The United States emphasizes that the ETI measure involves the allocation of income from certain foreign sales transactions according to its source. The allocation of such income into domestic and foreign portions, it states, is "a longstanding normative principle of our system of taxation." [61] The United States argues that the ETI measure reformulates the method by which the United States implements this principle, although still in a manner that is consistent with this principle. In this connection, the United States mentions that, traditionally, it has permitted the foreign portion of income from certain foreign sales transactions to be allocated outside the United States' taxing jurisdiction, and excluded from tax, through the use of a foreign-incorporated subsidiary of a United States taxpayer.

83. Furthermore, according to the United States, a Member may *exclude* from taxation a category of income, consistently with the *SCM Agreement*, even if it does not exclude *all* of the income in that category. The United States contends that when a particular category of income is excluded from taxation, a Member may choose to exclude, for revenue and other policy considerations, only a portion of that category of income.

84. The United States also contends that the Panel erred in its identification of the relevant domestic standard because it misconstrued the concept of "gross income" and ignored other provisions of the IRC that are relevant to this dispute. Consequently, the Panel erred in finding that, in the absence of the ETI measure, extraterritorial income would be "gross income" and would be taxed. According to the United States, under the IRC, "gross income" is the starting point for calculating taxable income, but "gross income" by itself is *not* necessarily subject to tax because a taxpayer can make "deductions " from it. The Panel thus erred in determining that the prevailing rule of taxation in the United States is that "gross income" is taxable.

85. Before turning to examine the Panel's finding under Article 1.1(a)(1)(ii), certain preliminary observations regarding the *SCM Agreement* and Article 1.1 thereto should be made. Article 1.1 of the *SCM Agreement* sets out a *definition* of a "subsidy" for the purposes of that Agreement. Although this definition is central to the applicability and operation of the remaining provisions of the Agreement, Article 1.1 itself does not impose any obligation on Members with respect to the subsidies it defines. It is the provisions of the *SCM Agreement* which follow Article 1, such as Articles 3 and 5, which impose obligations on Members with respect to subsidies falling within the definition set forth in Article 1.1. As we said in our Report in *Canada – Measures Affecting the Export of Civilian Aircraft – Recourse by Brazil to Article 21.5 of the DSU* ("*Canada – Aircraft (Article 21.5 – Brazil)* "):

> *… the granting of a subsidy is not, in and of itself, prohibited under the SCM Agreement. Nor does granting a "subsidy", without more, constitute an inconsistency with that Agreement*. The universe of subsidies is vast. Not all subsidies are inconsistent with the *SCM Agreement*.[62] (emphasis added)

86. In other words, Article 1.1 of the *SCM Agreement* does not prohibit a Member from foregoing revenue that is otherwise due under its rules of taxation, even if

[60] United States' appellant's submission, para. 71. See also United States' additional written memorandum, p. 4.

[61] United States' additional written memorandum, p. 2.

[62] Appellate Body Report, WT/DS70/AB/RW, adopted 4 August 2000, DSR 2000:IX, 4299, para. 47.

this also confers a benefit under Article 1.1(b) of the *SCM Agreement*. However, if a Member's rules of taxation constitute or provide a subsidy under Article 1.1, and this subsidy is specific under Article 2, the Member must abide by the obligations set out in the *SCM Agreement* with respect to that subsidy, including the obligation not to "grant [] or maintain" any subsidy that is prohibited under Article 3 of the Agreement. It was in this context that we said in our Report in *US – FSC*, that, in principle, a Member is free not to tax any particular category of income it wishes, even if this results in the grant of a "subsidy" under Article 1.1 of the *SCM Agreement*, provided that the Member respects its WTO obligations with respect to the subsidy.[63]

87. The issue we examine under Article 1.1 with respect to the disputed measure is, therefore, a threshold issue that, by itself, does not determine whether the United States has acted inconsistently with its obligations under the *SCM Agreement*. With this in mind, we now turn to examine Article 1.1(a)(1)(ii) of the *SCM Agreement*. Pursuant to this provision, there is a "financial contribution by a government" where "government revenue that is otherwise due is foregone or not collected". We considered the meaning of this phrase in our Report in *US – FSC*, where we stated:

> … the "*foregoing*" of revenue "*otherwise* due" implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, "otherwise". Moreover, the word "foregone" suggests that the government has given up an entitlement to raise revenue that it could "otherwise" have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues. *There must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised "otherwise".* We, therefore, agree with the Panel that the term "otherwise due" implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. We also agree with the Panel that *the basis of comparison must be the tax rules applied by the Member in question. ... What is "otherwise due", therefore, depends on the rules of taxation that each Member, by its own choice, establishes for itself.*[64] (italics in original, underlining added)

88. There are several elements in this statement that bear repeating. The first is that, under Article 1.1(a)(1)(ii), a "financial contribution" does not arise simply because a government does not raise revenue which it could have raised. It is true that, from a *fiscal* perspective, where a government chooses not to tax certain income, no revenue is "due" on that income. However, although a government might, in a sense, be said to "forego" revenue in this situation, this alone gives no indication as to whether the revenue foregone was "otherwise due". In other words, the mere fact that revenues are not "due" from a fiscal perspective does not determine that the revenues are or are not "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.

89. A second element which emerges from our earlier Report is that the treaty phrase "otherwise due" implies a comparison with a "defined, normative benchmark". The purpose of this comparison is to distinguish between situations where

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[63] *Supra*, footnote 3, para. 90.

[64] Appellate Body Report, *supra,* footnote 3, para. 90.

revenue foregone *is* "otherwise due" and situations where such revenue is *not* "otherwise due". As Members, in principle, have the sovereign authority to determine their own rules of taxation, the comparison under Article 1.1(a)(1)(ii) of the *SCM Agreement* must necessarily be between the rules of taxation contained in the contested measure and other rules of taxation of the Member in question. Such a comparison enables panels and the Appellate Body to reach an objective conclusion, on the basis of the rules of taxation established by a Member, by its own choice, as to whether the contested measure involves the foregoing of revenue that would be due in some other situation or, in the words of the *SCM Agreement*, "otherwise due".

90. In our Report in *US – FSC*, we recognized that it may be difficult to identify the appropriate normative benchmark for comparison under Article 1.1(a)(1)(ii) because domestic rules of taxation are varied and complex.[65] In identifying the appropriate benchmark for comparison, panels must obviously ensure that they identify and examine fiscal situations which it is legitimate to compare. In other words, there must be a rational basis for comparing the fiscal treatment of the income subject to the contested measure and the fiscal treatment of certain other income. In general terms, in this comparison, like will be compared with like. For instance, if the measure at issue involves income earned in sales transactions, it might not be appropriate to compare the treatment of this income with employment income.

91. In identifying the normative benchmark, there may be situations where the measure at issue might be described as an "exception" to a "general" rule of taxation. In such situations, it may be possible to apply a "but for" test to examine the fiscal treatment of income absent the contested measure. We do not, however, consider that Article 1.1(a)(1)(ii) always *requires* panels to identify, with respect to any particular income, the "general" rule of taxation prevailing in a Member. Given the variety and complexity of domestic tax systems, it will usually be very difficult to isolate a "general" rule of taxation and "exceptions" to that "general" rule. Instead, we believe that panels should seek to compare the fiscal treatment of legitimately comparable income to determine whether the contested measure involves the foregoing of revenue which is "otherwise due", in relation to the income in question.[66]

92. In addition, it is important to ensure that the examination under Article 1.1(a)(1)(ii) involves a comparison of the fiscal treatment of the relevant income for taxpayers in comparable situations. For instance, if the measure at issue is concerned with the taxation of foreign-source income in the hands of a domestic corporation, it might not be appropriate to compare the measure with the fiscal treatment of such income in the hands of a foreign corporation.

93. Against this background, we turn to the ETI measure. This measure lays down rules of taxation for United States citizens and residents, including both natural and legal persons. These rules also apply to foreign corporations which elect to be

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[65] Appellate Body Report, *supra,* footnote 3, para. 91.

[66] We recognize that a Member may have several rules for taxing comparable income in different ways. For instance, one portion of a domestic corporation's foreign-source income may not be subject to tax in any circumstances; another portion of such income may always be subject to tax; while a third portion may be subject to tax in some circumstances. In such a situation, the outcome of the dispute would depend on which aspect of the rules of taxation was challenged and on a detailed examination of the relationship between the different rules of taxation. The examination under Article 1.1(a)(1)(ii) of the *SCM Agreement* must be sufficiently flexible to adjust to the complexities of a Member's domestic rules of taxation.

treated, for tax purposes, as United States corporations.[67] The ETI measure permits these taxpayers to elect to have the income they earn from certain transactions, involving certain property, taxed according to the rules set forth in the measure.[68] The property involved must be "qualifying foreign trade property" ("QFTP"), which, *inter alia*, must be "manufactured, produced, grown, or extracted within or outside the United States" and must be held primarily for use "outside the United States".[69] The measure applies, *inter alia*, to income earned from transactions involving the sale or lease of QFTP, and to income earned through the performance of certain services, including the performance of services "related and subsidiary" to the sale or lease of QFTP.[70] However, subject to limited exceptions, the measure applies to the income arising in a transaction only if the transaction also satisfies the "foreign economic process requirement" set out in Section 942(b) IRC. This requirement will be satisfied, generally speaking, where at least some of the activities comprising the transaction take place outside the United States.

94. Under the ETI measure, certain income earned by United States citizens and residents through certain relevant transactions, involving QFTP, is known as "extraterritorial income".[71] Section 114(a) IRC excludes extraterritorial income from "gross income" and from the operation of the rules applicable to "gross income" under Sections 61 and 63 IRC. However, Section 114(b) provides that this exclusion of extraterritorial income from gross income applies solely to that portion of extraterritorial income which is defined as "qualifying foreign trade income" ("QFTI"). The amount of QFTI is determined using one of the three formulae set forth in Section 941(a)(1) IRC.

95. In sum, therefore, under the ETI measure, a portion of income – QFTI – earned by United States citizens and residents is excluded from "gross income" under Section 114(a) and (b) IRC and, thereby, this income is excluded from taxation in the United States. Where a taxpayer elects to use the ETI measure, it must give up any tax credits it has obtained through taxation of its income in a foreign jurisdiction that are attributable to the QFTI excluded from taxation.[72]

96. The Panel reached the conclusion that the exclusion of QFTI from gross income means that the measure involves the foregoing of revenue on this portion of income, and also that revenue is otherwise due on this income. The Panel reasoned that United States taxpayers would "ordinarily" be subject to tax on all income earned in transactions covered by the measure and that the measure "effectively carves ... out" certain income from this other, "ordinary", situation of taxation.[73]

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[67] Section 943(e) IRC. Thus, although the ETI measure applies to foreign corporations, these corporations are deemed for these purposes to be United States corporations and not foreign corporations. In our discussion below, we treat these foreign corporations as United States corporations.

[68] Section 942(a)(3) IRC. We have outlined the United States rules of taxation, including the ETI measure, in Section II of this Report.

[69] Qualifying foreign trade property is defined in Section 943(a)(1) and (2) IRC, while Section 943(a)(3) and (4) identifies property that is excluded from the definition.

[70] The transactions giving rise to income covered by the measure are described in Section 942(a)(1) IRC. We recall that we refer to sale and lease transactions as a shorthand reference to the "sale, exchange or other disposition" of QFTP, and to the "lease or rental" of this property. See Section 942(a)(1)(A) and (B) IRC.

[71] Section 114(e) IRC, read together with Section 942(a) IRC.

[72] See *infra*, paras. 104 and 181-183.

[73] Panel Report, paras. 8.25-8.26.

97. In examining the Panel's findings, we observe that the United States argues that, under the ETI measure, QFTI is confined to the *foreign-source income* earned by United States citizens and residents in transactions covered by the measure. For the purposes of reviewing the Panel's findings under Article 1.1(a)(ii) of the *SCM Agreement*, we will assume, *arguendo*, without trying to reach any conclusion on the issue at this stage, that the United States correctly characterizes QFTI as foreign-source income.[74] For these purposes, we assume, also *arguendo*, that the United States correctly maintains that the measure is merely a continuation of the "long-standing" principle of the United States rules of taxation that seeks to allocate income between domestic- and foreign-source income.

98. As we said earlier, under Article 1.1(a)(1)(ii) of the *SCM Agreement*, the normative benchmark for determining whether revenue foregone is otherwise due must allow a comparison of the fiscal treatment of comparable income, in the hands of taxpayers in similar situations. Accordingly, in identifying the normative benchmark for comparison in these proceedings, we must look to the United States' other rules of taxation applicable to the foreign-source income of United States' citizens and residents earned through the sale or lease of property, or through the performance of "related" services.[75] In so doing, we must ascertain whether, and to what extent, the United States imposes tax on foreign-source income of United States citizens and residents, including the income covered by the measure at issue which the United States considers to be foreign-source income. In other words, our inquiry under Article 1.1(a)(1)(ii) is not simply ended at this stage of analysis because the measure involves an allocation of income between domestic- and foreign-source income. Rather, we must compare the way the United States taxes the portion of the income covered by the measure, which it treats as foreign-source, with the way it taxes other foreign-source income under its own rules of taxation.

99. Under Sections 1 and 11 IRC, the United States imposes tax on the "taxable income" of each United States citizen and resident. According to Section 63(a) IRC, taxable income means "gross income minus the deductions allowed" under the IRC. Under Section 61(a) IRC, gross income means "*all income from whatever source derived*". (emphasis added) Thus, Sections 61(a) and 63(a) IRC do not distinguish between income depending on whether the income is treated by the United States as domestic- or foreign-source.[76] Rather, these provisions treat "all income from whatever source" in identical fashion so that, in principle, foreign-source gross income of United States' citizens and residents, less allowable deductions, is subject to tax as taxable income.

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[74] We examine below the merits of the United States' characterization of QFTI as "foreign-source income", which the United States is entitled to exempt to avoid double taxation of this income, when we review the Panel's findings regarding footnote 59. See *infra*, paras. 121-186.

[75] We recall that the measure applies to certain foreign corporations that elect to be treated as United States corporations. For the purpose of United States taxation, these corporations are deemed to be United States corporations. (*supra*, para. 93 and footnote 67 thereto) Thus we do not examine the United States' fiscal treatment of the foreign-source income of *foreign* corporations including foreign subsidiaries of United States corporations – that do *not* elect to be treated as United States corporations. We do not, therefore, examine the rules of taxation for the foreign-source income of foreign subsidiaries of United States corporations. See United States' appellant's submission, paras. 34-36.

[76] Sections 861-865 IRC and 26 CFR 1.861-1.865 provide rules to determine whether income of United States citizens and residents is from sources within or outside the United States.

100. However, where a portion of the taxable income of a United States citizen or resident is subject to tax in a foreign jurisdiction, the United States *credits* the taxpayer, subject to certain limitations, with the amount of foreign taxes paid or deemed to have been paid by that taxpayer.[77] Thus, the tax payable to the United States is reduced by the amount of the tax credit. However, the tax credit granted cannot, as a proportion of the tax due, exceed the proportion of total taxable income which foreign-source income makes up.[78] In this situation, where a taxpayer pays taxes in a foreign jurisdiction, the United States treats a proportion of the tax due to the United States as a tax on foreign-source income, and grants a tax credit with respect to that income.[79]

101. In our view, the normative benchmark for determining whether the ETI measure involves the foregoing of revenue otherwise due, under Article 1.1(a)(1)(ii) of the *SCM Agreement*, is contained in the United States rules of taxation regarding the foreign-source income of United States' citizens or residents, which we have outlined in the preceding paragraph. Thus, we must compare the taxation of foreign-source income under these "other" rules of taxation, with the taxation of QFTI, which the United States also treats as foreign-source income of these same taxpayers.

102. In so doing, there appears to be a marked contrast between the "other rules" of taxation applicable to foreign-source income and the rules of taxation applicable to QFTI. For United States citizens and residents, the United States, in principle, taxes *all* foreign-source income, subject to permissible deductions, although the United States grants tax credits for foreign taxes paid. However, under the ETI measure, QFTI is definitively excluded from United States taxation.

103. In addition, as we noted above, United States citizens and residents can *elect*, at their own discretion: *either* to have certain of their income treated as extraterritorial income under the ETI measure, with the result that a portion will be definitively excluded from taxation as QFTI; *or* these same taxpayers can elect to have the same income taxed under the "other" rules applicable to foreign-source income, with tax credits being recognized for, at least, a portion of foreign taxes paid. Where the taxpayer elects not to be taxed under the ETI measure, the United States taxes this income under the "other" rules of taxation applicable to foreign-source income. We see this as confirmation that, absent the ETI measure, the United States would tax the income under the "otherwise" applicable rules of taxation we have used as our benchmark.

104. Clearly, a taxpayer may be expected to elect to use the rules of taxation which result in the payment of the lowest amount of tax.[80] Thus, where a taxpayer *elects* to

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[77] Section 901(a) IRC. Such creditable foreign taxes are those listed in Sections 901(b), 902 and 960 IRC, but these tax credits are subject to the limitation set forth in Section 904. See also the applicable Federal Regulations in 26 CFR 1.901-1.902, 1.904 and 1.960.

[78] Section 904(a) IRC. We understand this provision to mean that if foreign-source income makes up, for instance, 10 percent of the total taxable income, the amount of the tax credit cannot exceed 10 percent of the total tax due. The amount of the foreign-source income is determined by applying the source rules contained in Sections 861-865 IRC and 26 CFR 1.861-1.865.

[79] See J. Isenbergh, *International Taxation – U.S. Taxation of Foreign Persons and Foreign Income*, 2nd ed., (Aspen Law & Business, 1999), Vol. II, para. 30:4, p. 55:2, who states "[t]his limitation [in Section 904(a)] seeks to confine the credit to the U.S. tax attributable to foreign source income."

[80] We mentioned earlier that, where a taxpayer elects to use the ETI measure, it must give up any tax credits it has obtained through taxation in a foreign State that is attributable to the income excluded from taxation. Accordingly, the measure will be beneficial to taxpayers where the amount of

be taxed under the ETI measure, the amount of tax paid by the taxpayer will very likely be less than the tax which the taxpayer would have paid, on that income, under the rules "otherwise" applicable to foreign-source income, if the taxpayer did not elect to use the ETI measure. This, too, confirms that the United States will forego revenue under the ETI measure that would be "otherwise due".

105. In our view, the definitive exclusion from tax of QFTI, compared with the taxation of other foreign-source income, and coupled with the right of election for taxpayers to use the rules of taxation most favourable to them, means that, under the contested measure, the United States foregoes revenue on QFTI which is otherwise due.

106. For these reasons, we uphold the Panel's finding, in paragraphs 8.30 and 8.43 of the Panel Report, that through the measure at issue, the United States government foregoes revenue that is otherwise due within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*, and that the ETI measure, therefore, gives rise to a financial contribution under Article 1.1(a)(1) of that Agreement. In so holding, we observe that our reasons have a different focus from those given by the Panel. In part, this is because, on appeal, the thrust of the United States' arguments has been directed towards the role of the measure in allocating income as either domestic- or foreign-source.

VI. ARTICLE 3.1(A) OF THE *SCM AGREEMENT*: EXPORT CONTINGENCY

107. Before the Panel, the European Communities drew a distinction between two *different* subsidies it alleged were granted under the ETI measure. The first subsidy which the European Communities identified was what it called the "*basic*" subsidy, which related to property produced "within the United States"; the second subsidy it identified was what it called the "*extended*" subsidy which related to property produced "outside the United States". The European Communities argued that both these subsidies are *de jure* contingent upon export performance.[81]

108. The Panel found that "the Act involves subsidies 'contingent ... upon export performance' by reason of the requirement of 'use outside the United States' and is therefore inconsistent with Article 3.1(a) of the *SCM Agreement*."[82] This finding does not expressly draw any distinction between property produced "within" the United States and property produced "outside" the United States, nor does it adopt the distinction the European Communities drew between the so-called "basic" and "extended" subsidies. However, this finding must be read in the light of the reasoning which supports it. In the course of that reasoning, the Panel stated:

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tax otherwise due on excluded QFTI is greater than the amount of tax credits which the taxpayer must give up in relation to the excluded QFTI. For instance, this calculus is likely to result in taxpayers electing to use the measure where: (a) the amount of income actually taxed in a foreign jurisdiction is less than the amount of excluded QFTI and (b) where the rate of taxation applied to income taxed in a foreign jurisdiction is lower than the United States rate of taxation that would "otherwise" be applied to the excluded QFTI.

[81] European Communities' first submission to the Panel, paras. 104-120; Panel Report, pp. A-21 – A-23. The European Communities also argued, in the alternative, that both the basic and the extended subsidies provided under the ETI Act are *de facto* export contingent. See European Communities' first submission to the Panel, paras. 131-145; Panel Report, pp. A-25 – A-28; European Communities' response to Question 2 posed by the Panel, para. 6-11; Panel Report, p. F-3.

[82] Panel Report, para. 8.75.

> … *in relation to US-produced goods*, the words of the statute itself make it clear that exporting is a necessary precondition to qualify for the subsidy. *In respect of US-produced goods*, the existence and amount of the subsidy depends upon the existence of income arising from the exportation of such goods. *In relation to US-produced goods*, the existence of such income is clearly conditional, or dependent upon, the exportation of such goods from the United States. We are therefore of the view that by necessary implication the scheme is *de jure* dependent or contingent upon export in relation to US-produced goods.[83] (emphasis added)

109. This passage indicates that the Panel's finding under Article 3.1(a) of the *SCM Agreement* addressed only the alleged export contingency of the measure "in relation to" property produced "*within*" the United States and the Panel concluded that, in respect of this property, the grant of the subsidy is contingent upon export performance. (emphasis added) The Panel's finding did not also address the alleged export contingency of the measure in relation to property produced "outside" the United States. In other words, the Panel examined the European Communities' claim concerning the "basic" subsidy, but not the claim regarding the "extended" subsidy.[84]

110. The United States appeals the Panel's finding that the measure involves the grant of a subsidy "contingent ... upon export performance". The United States contends that, under Article 3.1(a) of the *SCM Agreement*, export contingency is a *necessary* condition of grant if a subsidy is to be export contingent. It points out that the ETI measure is export-neutral as the tax exclusion is available with respect to property that is *not* produced in the United States and, therefore, not exported from the United States. Thus, it is argued, the tax exclusion can be obtained without exportation so that export performance is not a condition that must be satisfied in order to obtain this exclusion. The Panel, however, overlooked this fact and "artificially bifurcat[ed]" the ETI measure, examining it only as it relates to property produced in the United States.[85] The United States insists that no such distinction exists under the ETI measure.

111. We start with the text of Article 3.1(a) of the *SCM Agreement*, which provides that "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance" are prohibited. We have considered this provision in several previous appeals.[86] In *Canada – Aircraft*, we said that the key word in Article 3.1(a) is "contingent", which means "conditional" or "dependent for its existence on something else".[87] In other words, the grant of the subsidy must be conditional or dependent upon export performance. Footnote 4 of the *SCM Agreement*, attached to Article 3.1(a), describes the relationship of contingency by stating that the grant of a subsidy must be "tied to" export performance. Article

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[83] Panel Report, para. 8.60.

[84] *Ibid*., para. 8.163. The European Communities filed a conditional appeal relating to the Panel's failure to examine the "extended" subsidy, which we will come to below. (*infra*, paras. 253-255)

[85] United States' appellant's submission, paras. 164 and 169.

[86] Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft* ("*Canada – Aircraft*"), WT/DS70/AB/R, adopted 20 August 1999, DSR 1999:III, 1377, paras. 162-180; Appellate Body Report, *US – FSC*, *supra*, footnote 3, paras. 96-121; Appellate Body Report, *Canada – Autos*, *supra*, footnote 56, paras. 95-117; Appellate Body Report, *Canada – Aircraft (Article 21.5 – Brazil)*, *supra*, footnote 62, paras. 25-52.

[87] Appellate Body Report, *supra*, footnote 86, para. 166.

3.1(a) further provides that such export contingency may be the "sole []" condition governing the grant of a prohibited subsidy or it may be "one of several other conditions".

112. The Panel found that the measure involves *de jure* export contingency in relation to property produced in the United States and the United States appeals this finding. We recall that in *Canada – Autos*, we stated:

> … a subsidy is contingent "in law" upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure. ... [F]or a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfillment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.[88]

113. Under the ETI measure, the United States excludes from tax a portion of the income earned by United States citizens and residents through certain transactions involving, or related to, QFTP. We recall that Section 943(a)(1)(A) IRC defines QFTP, *inter alia*, as property "manufactured, produced, grown, or extracted *within or outside* the United States".[89] (emphasis added) The ETI measure, therefore, contemplates two different factual situations, one involving property produced within the United States and the other involving property produced outside the United States. The distinctiveness of these two situations is confirmed by the presence of two provisions in the IRC, each addressing one of these factual situations. Section 943(a)(2) IRC contains rules that apply only to property produced "outside the United States", while Section 943(c) IRC has source rules that address only the case of property produced "within the United States".

114. In respect of property produced within the United States, the taxpayer can obtain the subsidy only by satisfying the conditions in the measure relating to this property and, for this property, the measure provides only one set of conditions governing the grant of subsidy. The conditions for the grant of subsidy with respect to property produced *outside* the United States are distinct from those governing the grant of subsidy in respect of property produced *within* the United States.

115. In our view, it is hence appropriate, indeed necessary, under Article 3.1(a) of the *SCM Agreement*, to examine separately the conditions pertaining to the grant of the subsidy in the two different situations addressed by the measure. We find it difficult to accept the United States' arguments that such examination involves an "artificial bifurcation" of the measure. The measure itself identifies the two situations which must be different since the very same property cannot be produced both within and outside the United States.

116. We turn to examine the conditions in the measure governing the grant of the subsidy for property produced within the United States. In its definition of QFTP, the measure provides that, in order to obtain the subsidy, this property must be "held primarily for sale, lease, or rental, in the ordinary course of trade or business for *di-*

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[88] Appellate Body Report, *supra*, footnote 56, para. 100.

[89] Although Section 943(a)(1)(A) IRC applies to property "manufactured, produced, grown, or extracted within or outside the United States", we will refer to property "produced" within or outside the United States as a shorthand reference.

rect use, consumption, or disposition outside the United States …".[90] For property produced within the United States, this condition means that, for income to be eligible for the fiscal subsidy, the property must be exported. In other words, use outside the United States necessarily implies exportation of the property from the United States (the place of production) to the place of use.

117. At the oral hearing, we inquired of the United States whether, for property produced within the United States, such property must be exported from the United States in order to satisfy the condition of "direct use ... outside the United States". The United States confirmed that such property must be exported to satisfy this condition.[91] For this property, then, the requirement of use outside the United States makes the grant of the tax benefit contingent upon export.

118. It may also be recalled that the measure at issue in the original proceedings in *US – FSC* contained an almost identical condition relating to "direct use ... outside the United States" for property produced in the United States.[92] In that appeal, we upheld the panel's finding that the combination of the requirements to produce property in the United States and use it outside the United States gave rise to export contingency under Article 3.1(a) of the *SCM Agreement*. We see no reason, in this appeal, to reach a conclusion different from our conclusion in the original proceedings, namely that there is export contingency, under Article 3.1(a), where the grant of a subsidy is conditioned upon a requirement that property produced in the United States be used outside the United States.

119. We recall that the ETI measure grants a tax exemption in two different sets of circumstances: (a) where property is produced *within* the United States and held for use *outside* the United States; and (b) where property is produced *outside* the United States and held for use outside the United States. Our conclusion that the ETI measure grants subsidies that are export contingent in the first set of circumstances is not affected by the fact that the subsidy can also be obtained in the second set of circumstances. The fact that the subsidies granted in the second set of circumstances *might* not be export contingent does not dissolve the export contingency arising in the first set of circumstances.[93] Conversely, the export contingency arising in these circumstances has no bearing on whether there is an export contingent subsidy in the second set of circumstances. Where a United States taxpayer is simultaneously producing property within and outside the United States, for direct use outside the United

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[90] Section 943(a)(1)(B) IRC. (emphasis added)

[91] United States' response to questioning at the oral hearing.

[92] Under the FSC measure, qualifying property had to be produced in the United States *by a person other than an FSC*, and it had to be held primarily for sale, lease, or rental, in the ordinary course of trade or business *by, or to, an FSC* for direct use, consumption, or disposition outside the United States. (Section 927(a)(1)(A) and (B), now repealed by the ETI Act) Under Section 943(a)(1)(B), inserted into the IRC by Section 3 of the ETI Act, a United States citizen or resident producing property within the United States must hold this property "primarily for sale, lease, or rental, in the ordinary course of trade or business outside the United States." Thus, the only difference between the provisions at issue in the original proceedings and those at issue in these proceedings, relating to property produced in the United States, is that the FSC measure provided that the FSC could not produce the qualifying property, but that it had to be the seller or lessor, whereas the ETI measure does not state who must produce the qualifying property or who must sell it. This difference between the provisions has no bearing on the export contingency of the respective measures.

[93] We recall that the European Communities makes a conditional appeal of the Panel's exercise of judicial economy with respect to its claim concerning property produced outside the United States. We address this conditional appeal below. See *infra*, paras. 253-255.

States, subsidies may be granted under the ETI measure in respect of both sets of property. The subsidy granted with respect to the property produced within the United States, and exported from there, is export contingent within the meaning of Article 3.1(a) of the *SCM Agreement*, irrespective of whether the subsidy given in respect of property produced outside the United States is also export contingent.

120. For these reasons, we uphold the Panel's finding, in paragraphs 8.75 and 9.1(a) of the Panel Report – which is limited to property "manufactured, produced, grown, or extracted" within the United States – that the measure at issue grants subsidies contingent in law upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*.[94] We do not opine upon the alleged export contingency of the subsidy in relation to property "manufactured, produced, grown, or extracted" outside the United States.[95]

VII. FOOTNOTE 59 TO THE *SCM AGREEMENT*: AVOIDING DOUBLE TAXATION OF FOREIGN-SOURCE INCOME

121. The United States asserted, before the Panel, that, even if the Act involved export contingent subsidies, these subsidies would not be prohibited because of the fifth sentence of footnote 59 to the *SCM Agreement*, which is attached to item (e) of the Illustrative List of Export Subsidies in Annex I of that Agreement (the "Illustrative List").

122. The Panel began its inquiry by holding that the United States bore the burden of proving that the contested measure fell within the scope of the fifth sentence of footnote 59. The Panel recalled that the "party asserting the affirmative of a particular claim or defence bears the burden of proof with respect to that claim or defence," and that, in this case, the United States was asserting that the ETI Act was "justified" by footnote 59.[96]

123. In examining the United States' arguments under footnote 59, the Panel found that the term "foreign-source income" refers "to certain income susceptible to 'double taxation'."[97] The Panel observed that a measure need not avoid double taxation of foreign-source income with "precision", nor need it avoid double taxation "entirely" or "exclusively".[98] Nonetheless, the Panel said, "the relationship between the measure and its asserted purpose – i.e. 'to avoid the double taxation of foreign-source income …' – must be reasonably discernible."[99] The Panel examined the relationship between the measure and its asserted purpose by reviewing "the overall structure, design and operation of the Act".[100] The Panel found that the measure at issue is not taken "to avoid the double taxation of foreign-source income" within the meaning of the fifth sentence of footnote 59 to the *SCM Agreement*.[101]

124. The United States argues, on appeal, that the Panel erred in finding that the burden of proof was on the United States to demonstrate that the measure fell within

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[94] *Supra*, paras. 108-109.

[95] We note that the European Communities makes a conditional appeal concerning the Panel's exercise of judicial economy in relation to this issue. See *infra*, paras. 253-255.

[96] Panel Report, para. 8.90 and footnote 188 thereto. (footnote omitted)

[97] *Ibid*., para. 8.93.

[98] *Ibid*., para. 8.95. (footnote omitted)

[99] *Ibid*.

[100] *Ibid*.

[101] Panel Report, paras. 8.107 and 9.1(a).

footnote 59.[102] According to the United States, "the last sentence of footnote 59 is inextricably linked to ... Article 3.1(a) [of the *SCM Agreement*] and it serves to define the scope of Article 3.1(a)."[103] Thus, it contends, the European Communities bears the burden of proving that measure does *not* fall within footnote 59 to the *SCM Agreement*.

125. According to the United States, the fifth sentence of footnote 59 indicates that Members have "broad flexibility in fashioning double taxation relief".[104] It argues that foreign-source income "would appear to include income arising, at least in part, outside the borders or territory of the Member instituting a measure to avoid double taxation" as there is a "possibility of double taxation" of such income.[105] The United States points to the legislative history of the ETI Act to establish that the measure was taken to avoid double taxation within the meaning of footnote 59.[106] The United States maintains that measures to avoid double taxation, under footnote 59, need not be "comprehensive or all-encompassing."[107]

126. We address first the Panel's finding that the United States bears the burden of proving that the ETI measure falls within the scope of footnote 59. We have indeed stated that "the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence."[108] In applying this principle in *US – Wool Shirts and Blouses*, we said:

> Articles XX and XI:(2)(c)(i) are limited exceptions from obligations under certain other provisions of the GATT 1994, not positive rules establishing obligations in themselves. They are in the nature of affirmative defences. It is only reasonable that the burden of establishing such a defence should rest on the party asserting it.[109] (footnote omitted)

127. In *EC – Hormones*, we stressed that the usual rules on burden of proof could not be avoided simply by describing a particular provision as an "exception".[110] In that appeal, we explored the relationship between Articles 3.1 and 3.3 of the *Agreement on the Application of Sanitary and Phytosanitary Measures* (the "*SPS Agreement*"), as compared with the relationship between Articles I, III and XX of the GATT 1994. In the case of the GATT 1994 provisions, we observed that Article XX does not establish any "positive obligations" relevant to determining the proper scope of the obligations imposed under Articles I and III. Instead, Article XX sets out circumstances in which Members are entitled to "adopt or maintain" measures that are inconsistent with the obligations imposed under other provisions of the GATT 1994, such as Articles I and III.

128. Thus, in reviewing the Panel's finding on the burden of proof under the fifth sentence of footnote 59, we must determine whether that provision determines, in part,

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[102] United States' appellant's submission, para. 207.
[103] *Ibid*., para. 204.
[104] *Ibid*., para. 218.
[105] *Ibid*., paras. 187-188.
[106] *Ibid*., para. 194. See also Panel Report, footnote 197 to para. 8.95.
[107] United States' appellant's submission, para. 209.
[108] Appellate Body Report, *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India* ("*US – Wool Shirts and Blouses*"), WT/DS33/AB/R and Corr.1, adopted 23 May 1997, DSR 1997:I, 323, at 335.
[109] *Ibid*., at 337.
[110] Appellate Body Report, *supra*, footnote 40, para. 104.

the proper scope of the obligations under Article 3.1(a) of the *SCM Agreement*, or whether it provides an exception for a provision that is otherwise an export contingent subsidy.

129. We recall that, in the original proceedings in this dispute, we said that the fifth sentence of footnote 59 "does not purport to establish an exception to the general definition of a 'subsidy' …" [111] Thus, a measure taken to avoid the double taxation of foreign-source income, falling within footnote 59, may be a "subsidy" under the *SCM Agreement*.

130. Article 3.1 of the *SCM Agreement* provides specific obligations with respect to two types of subsidy: subsidies contingent upon export performance and subsidies contingent upon the use of domestic over imported goods. Subsidies of these defined types are prohibited under Article 3 of the *SCM Agreement*. Item (e) of the Illustrative List identifies a particular measure which is deemed to be a prohibited export subsidy under Article 3.1(a).

131. The fifth sentence of footnote 59 provides that item (e) "is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member." In the same way that we do not see the fifth sentence of footnote 59 as altering the scope of the definition of a "subsidy" in Article 1.1 of the *SCM Agreement*, we do not see it as altering either the scope of item (e) of the Illustrative List or the meaning to be given to the term "subsidies contingent ... upon export performance" in Article 3.1(a) of the *SCM Agreement*. Thus, measures falling within the scope of this sentence of footnote 59 may continue to be export subsidies, much as they may continue to be subsidies under Article 1.1 of the *SCM Agreement*.

132. The import of the fifth sentence of footnote 59 is that Members are entitled to "take", or "adopt" measures to avoid double taxation of foreign-source income, notwithstanding that they may be, in principle, export subsidies within the meaning of Article 3.1(a). The fifth sentence of footnote 59, therefore, constitutes an exception to the legal regime applicable to export subsidies under Article 3.1(a) by explicitly providing that when a measure is taken to avoid the double taxation of foreign-source income, a Member is entitled to adopt it.

133. Accordingly, as we indicated in *US – FSC*, the fifth sentence of footnote 59 constitutes an affirmative defence that justifies a prohibited export subsidy when the measure in question is taken "to avoid the double taxation of foreign-source income".[112] In such a situation, the burden of proving that a measure is justified by falling within the scope of the fifth sentence of footnote 59 rests upon the responding party.

134. We, therefore, uphold the Panel's finding, in paragraph 8.90 of the Panel Report, that, in this case, the burden of proof under the fifth sentence of footnote 59 falls on the United States.

135. We turn to the United States' appeal that the Panel erred in finding that the ETI measure is not one taken to avoid the double taxation of foreign-source income under footnote 59 to the *SCM Agreement*.

136. We recall that the fifth sentence of footnote 59 provides:

> Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

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[111] Appellate Body Report, *US – FSC*, *supra*, footnote 3, para. 93. (emphasis omitted)

[112] Appellate Body Report, *supra,* footnote 3, para. 101.

137. We note at the outset that "double taxation" occurs when the same income, in the hands of the same taxpayer, is liable to tax in different States. The fifth sentence of footnote 59 applies to a measure taken by a Member to avoid such double taxation of "foreign-source income". In examining the phrase "foreign-source income", we observe that, in ordinary usage, the word "source" can refer to the place where a thing originates, and that the words "source" and "origin" can be synonyms.[113] We consider, therefore, that the word "source", in the context of the fifth sentence of footnote 59, has a meaning akin to "origin" and refers to the place where the income is earned. This reading is supported by the combination of the words "foreign" and "source" as "foreign" also refers to the place where the income is earned. Used in this way, the word "foreign" indicates a source which is external to the Member adopting the measure at stake.[114] Footnote 59, therefore, applies to measures taken by a Member to avoid the double taxation of income earned by a taxpayer of that Member in a "foreign" State.

138. The fifth sentence of footnote 59 to the *SCM Agreement* permits a Member to take measures granting special fiscal treatment to "foreign-source income" in order to alleviate a "double taxation" burden on its taxpayer. Clearly, if the income benefitting from such special treatment could not be taxed twice, in two different States, there would be no double tax burden to alleviate, and hence no justification for permitting an exception to the prohibition on export subsidies. Thus, the term "foreign-source income" in footnote 59 refers to income which is susceptible of being taxed in two States. The Panel took a similar view when it stated that it understood "the term 'foreign-source income' ... to refer to certain income susceptible to 'double taxation' ".[115]

139. It is, however, no easy matter to determine in every situation when income is susceptible of being taxed in two different States and, thus, when a Member may properly regard income as "foreign-source income". We have emphasized in previous appeals that Members have the sovereign authority to determine their own rules of taxation, provided that they respect their WTO obligations.[116] Thus, subject to this important proviso, each Member is free to determine the rules it will use to identify the source of income and the fiscal consequences – to tax or not to tax the income – flowing from the identification of source. We see nothing in footnote 59 to the *SCM Agreement* which is intended to alter this situation. We, therefore, agree with the Panel that footnote 59 does not oblige Members to adopt any particular legal standard to determine whether income is foreign-source for the purposes of their double taxation-avoidance measures.[117]

140. At the same time, however, footnote 59 does not give Members an unfettered discretion to avoid double taxation of "foreign-source income" through the grant of export subsidies. As the fifth sentence of footnote 59 to the *SCM Agreement* constitutes an exception to the prohibition on export subsidies, great care must be taken in defining its scope. If footnote 59 were interpreted to allow a Member to grant a fiscal

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[113] *Shorter Oxford English Dictionary*, C. T. Onions (ed.) (Guild Publishing, 1983), Vol. II, p. 2057.

[114] *Ibid*., Vol. I, p. 788.

[115] Panel Report, para. 8.93.

[116] See Appellate Body Report, *Japan – Taxes on Alcoholic Beverages* ("*Japan – Alcoholic Beverages II*"), WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, DSR 1996:I, 97, at 110; Appellate Body Report, *Chile – Taxes on Alcoholic Beverages*, WT/DS87/AB/R, WT/DS110/AB/R, adopted 12 January 2000, DSR 2000:I, 281, paras. 59-60; and Appellate Body Report, *US – FSC*, *supra*, footnote 3, para. 90.

[117] Panel Report, para. 8.93.

preference for *any* income that a Member chooses to regard as foreign-source, that reading would seriously undermine the prohibition on export subsidies in the *SCM Agreement*. That would allow Members, relying on whatever source rules they adopt, to grant fiscal export subsidies for income that may not actually be susceptible of being taxed in two jurisdictions. Accordingly, the term "foreign-source income", as used in footnote 59 cannot be interpreted by reference solely to the rules of the Member taking the measure to avoid double taxation of foreign-source income.

141. Although there is no universally agreed meaning for the term "foreign-source income" in international tax law, we observe that many States have adopted bilateral or multilateral treaties to address double taxation. The United States, for instance, has more than fifty bilateral tax treaties addressing double taxation.[118] Frequently, bilateral tax treaties have been based on multilaterally developed model tax conventions dealing with double taxation.[119] In addition, the respective member States of the Andean Community and of the Caribbean Community have adopted multilateral agreements, binding on the members of each community, that seek to avoid double taxation.[120]

142. Although these instruments do not define "foreign-source income" uniformly, it appears to us that certain widely recognized principles of taxation emerge from

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[118] Department of the Treasury, Internal Revenue Service, Publication 901 (Rev. April 2001), Cat. No. 46849F.

[119] Two commonly used model tax conventions are the Organisation for Economic Co-operation and Development ("O.E.C.D.") *Model Tax Convention on Income and Capital* ("*O.E.C.D. Model Tax Convention*") and the United Nations *Double Taxation Convention between Developed and Developing Countries* ("*U.N. Model Tax Convention*"), which contain similar provisions. The majority of bilateral treaties adopt the principles of these two model tax conventions, with many also adopting their detailed provisions (see B. J. Arnold & M. J. McIntyre, *International Tax Primer* (Kluwer Law International, 1995), p. 100 and A. H. Qureshi, *The Public International Law of Taxation* (Graham & Trotman, 1994), p. 371). According to the O.E.C.D., there are close to 350 treaties between O.E.C.D. Members and over 1500 treaties world-wide which are based on the *O.E.C.D. Model Tax Convention* (O.E.C.D. website, www.oecd.org; 2001). The member States of the Andean Community (Bolivia, Colombia, Ecuador, Peru and Venezuela) adopted a model tax agreement among themselves, which is to be used when member States conclude bilateral taxation treaties with third States (Decision 40 of 8 November 1971 of the Andean Group, Annex II, *Standard Agreement to Avoid Double Taxation between Member Countries and Other States Outside the Subregion* (*Convenio Tipo para evitar la doble tributación entre los Países Miembros y otros Estados ajenos a la Subregión*) ("*Andean Community Model Tax Agreement*").

[120] The member States of the Andean Community (Bolivia, Colombia, Ecuador, Peru and Venezuela) adopted an agreement among themselves to address double taxation (Decision 40 of 8 November 1971 of the Andean Group approving the *Agreement to Avoid Double Taxation between Member Countries* (*Convenio para evitar la doble tributación entre los Paises Miembros*) ("*Andean Community Agreement*"). (www.comunidadandina.org/normativa/dec/d040.htm and www.comunidadandina.org/ingles/treaties/dec/d040e.htm) This agreement entered into force on 1 January 1981.

11 member States of the Caribbean Community (Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, and Trinidad and Tobago) also adopted an agreement on double taxation among themselves on 6 July 1994 (*Agreement Among the Governments of the Member States of the Caribbean Community for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Profits or Gains and Capital Gains and for the Encouragement of Regional Trade and Investment*) ("*CARICOM Agreement*"). (www.caricom.org under "Information Services" and "Treaties and Protocols")

them.[121] In seeking to give meaning to the term "foreign-source income" in footnote 59 to the *SCM Agreement*, which is a tax-related provision in an international trade treaty, we believe that it is appropriate for us to derive assistance from these widely recognized principles which many States generally apply in the field of taxation. In identifying these principles, we bear in mind that the measure at issue seeks to address foreign-source income of United States citizens and residents – that is, income earned by these taxpayers in "foreign" States where the taxpayers are not resident.

143. We recognize, of course, that the detailed rules on taxation of non-residents differ considerably from State-to-State, with some States applying rules which may be more likely to tax the income of non-residents than the rules applied by other States.[122] However, despite the differences, there seems to us to be a widely accepted common element to these rules. The common element is that a "foreign" State will tax a non-resident on income which is generated by activities of the non-resident that have some link with that State. Thus, whether a "foreign" State decides to tax non-residents on income generated by a permanent establishment or whether, absent such an establishment, it decides to tax a non-resident on income generated by the conduct of a trade or business on its territory, the "foreign" State taxes a non-resident only on income generated by activities linked to the territory of that State.[123] As a

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[121] We observe that, before the Panel, the United States provided examples of the source rules applied by Brazil, Canada, Chile, Malaysia, Panama, Saudi Arabia, Taiwan, the United Kingdom and the United States. The widely recognized principles of taxation appear to be reflected in these domestic rules of taxation. (United States' second submission to the Panel, para. 62; Panel Report, p. C-69; Exhibits US-24 – US-29 submitted by the United States to the Panel; United States' response to Question 12 posed by the Panel, paras. 27-29; Panel Report, pp. F-38 and F-39)

[122] For instance, some States will tax a non-resident only on business income generated by a *permanent establishment* on its territory. In that respect, we observe that the *O.E.C.D. Model Tax Convention* allows a State to impose tax on business profits generated by a non-resident through a "permanent establishment" situated on its territory. Article 5.1 of the Convention defines a "permanent establishment" as a "fixed place of business through which the business of an enterprise is wholly or partly carried on". This definition requires a relatively strong link with the "foreign" State before it may tax a non-resident. However, Article 5.5 of the Convention adds that a permanent establishment may exist where a person, other than the taxpayer, "habitually exercises ... an authority to conclude contracts" for the taxpayer. The *O.E.C.D. Model Tax Convention* itself, therefore, admits of differing standards to determine whether business income was generated by activities linked to the territory of a "foreign" State.

However, we also observe that some States will tax a non-resident on the basis of activities of a less permanent character provided there is nonetheless a sufficient connection between the activities generating the income and the territory of the taxing State. The United States, for instance, taxes the business income of non-residents if the income is "effectively connected" with a trade or business conducted in the United States. (Sections 871(b) and 882(b) IRC) The United States cites examples of other States which it considers tax non-residents on income generated through a trade or business conducted in that State, without the creation of a permanent establishment (see s*upra*, footnote 121).

[123] We note that the *Andean Community Agreement*, the *CARICOM Agreement*, and the *Andean Community Model Tax Agreement and the O.E.C.D.* and *U.N. Model Tax Conventions* describe a variety of situations in which a "foreign" State is entitled to tax a non-resident on income generated through activities which are linked to that State. The nature of the links required depends on the nature of the income.

Articles 7 of the *Andean Community Agreement* and of the *Andean Community Model Tax Agreement* provide that business profits are taxable only in the State where these profits are "obtained" through business activities conducted in that State. Article 8 of the *CARICOM Agreement* states that business profits are taxable only in the State where the business activities generating these profits are "undertaken". Thus, a non-resident will be taxed on business profits generated through activities undertaken in a "foreign" State. Articles 7 of the *O.E.C.D.* and *U.N. Model Tax Conven-*

result of this link, the "foreign" State treats the income in question as domestic-source, under its source rules, and taxes it. Conversely, where the income of a non-resident does not have any links with a "foreign" State, it is widely accepted that the income will be subject to tax only in the taxpayer's State of residence, and that this income will not be subject to taxation by a "foreign" State.

144. Although the participants, and third participants, disagree on precisely whether or to what extent a "foreign" State will tax the income of a non-resident, none has suggested that a non-resident will be taxed in a "foreign" State on income generated by activities that are not, in any way, linked to that "foreign" State. Indeed, the United States argues that QFTI is foreign-source income because this portion of extraterritorial income has "*sufficient foreign contacts* ... [such] that the transaction may be subject to tax in [a] foreign nation."[124] (emphasis added) According to the United States, these "foreign contacts" are established, under the measure, through the performance of the activities described in the foreign economic processes requirement under Section 942(b) IRC.[125] Thus, the United States accepts that "foreign-source income" in footnote 59 is income generated by economic activities that have "sufficient contacts" with a "foreign" State.

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tions provide that "business" income of a non-resident, generated through a "permanent establishment", may be taxed in the State where the permanent establishment is located (see *supra*, footnote 122).

Articles 5 and 12 of the *Andean Community Agreement* and the *Andean Community Model Tax Agreement*, Articles 6 and 7.2(i) of the *CARICOM Agreement*, and Articles 6 and 13 of the *O.E.C.D.* and *U.N. Model Tax Conventions* state that income, or capital gains, derived by a non-resident from immovable property, or from its alienation, are taxable in the "foreign" State where the property is situated.

Articles 8 of the *O.E.C.D.* and *U.N. Model Tax Conventions* provide that income generated from the "operation of ships or aircraft in international traffic" may be taxed in a "foreign" State if the "place of effective management" of the non-resident enterprise is situated in that State. Article 8 of the *Andean Community Agreement* and Article 9.1 of the *CARICOM Agreement* allow only the State of residence of the enterprise to tax such "international" income. However, Article 9.2 of the *CARICOM Agreement* provides that where the transport activities take place exclusively within the territory of one of the member States, that State shall tax the income, irrespective of the place of residence of the enterprise. Article 8 of the *Andean Community Model Tax Agreement* is similar to Article 8 of the *Andean Community Agreement*, while the alternative Article 8 of the *Andean Community Model Tax Agreement*, allows a State to tax transport activities that take place in that State, irrespective of the place of residence of the enterprise.

Articles 13 of the *Andean Community Agreement* and of the *Andean Community Model Tax Agreement*, and Articles 15 of the *CARICOM Agreement* and of the *O.E.C.D.* and *U.N. Model Tax Conventions*, indicate that the employment income of a non-resident may be taxed in a "foreign" State if the services are rendered or if the employment is exercised in that State.

According to Article 17 of the *CARICOM Agreement*, and Articles 16 of the *O.E.C.D.* and *U.N. Model Tax Conventions*, the fees of a non-resident director may be taxed in the "foreign" State if the corporation of which the person is a director is resident in that State. Under Article 14 of the *Andean Community Agreement* and of the *Andean Community Model Tax Agreement*, professional services provided by an enterprise may be taxed in a "foreign" State if the services are performed there.

Under Articles 16 of the *Andean Community Agreement* and of the *Andean Community Model Tax Agreement*, Article 18 of the *CARICOM Agreement*, and Articles 17 of the *O.E.C.D.* and *U.N. Model Tax Conventions*, the income of an entertainer derived from "activities" exercised in a "foreign" State may be taxed in that State.

Thus, in the case of each type of income addressed by these agreements and conventions, a "foreign" State may tax a non-resident only on income which is generated by activities which are linked to or connected with the territory of that State.

[124] United States' additional written memorandum, p. 2.

[125] *Ibid*.

145. Accordingly, in our view, "foreign-source income", in footnote 59 to the *SCM Agreement*, refers to income generated by activities of a non-resident taxpayer in a "foreign" State which have such links with that State so that the income could properly be subject to tax in that State.[126]

146. In view of the divergence in the detailed rules applied by States when taxing non-residents, there will be many situations where some States tax the income of a non-resident, while other States would consider that there was an inadequate link to justify the imposition of tax on non-residents. Thus, from the perspective of the State of residence, there will not be certainty as to when the income of its taxpayers will be subject to tax in a "foreign" State. Despite this uncertainty, one of the widely recognized methods of avoiding double taxation is the tax exemption method.[127] Under this method, States may exempt income from taxation to avoid double taxation, irrespective of whether or not another State taxes the exempt income. The avoidance of double taxation is not an exact science. Indeed, the income exempted from taxation in the State of residence of the taxpayer might not be subject to a corresponding, or any, tax in a "foreign" State. Yet, this does not necessarily mean that the measure is not taken to avoid double taxation of foreign-source income. Thus, we agree with the Panel, and the United States, that measures falling under footnote 59 are not required to be perfectly tailored to the actual double tax burden.[128]

147. However, the fact that measures falling under footnote 59 to the *SCM Agreement* may grant a tax exemption even for income that is not taxed in another jurisdiction does not mean that such tax exemptions may be granted, under the fifth sentence of footnote 59, for *any* income. Footnote 59 prescribes that the income benefitting from a double taxation-avoidance measure must be "foreign-source" and, as we have said, that means that the income must have links with a "foreign" State

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[126] We note that Isenbergh states that "the concept of source is not infinitely malleable. If only for practical reasons, some *connection with a country is required* to justify treating income as being from sources within that country." (emphasis added) Isenbergh also states that "commercial or industrial countries regard income as deriving its source from *specific economic activity conducted within them*, whereas many developing countries ... focus on whose pocket income is paid from." (emphasis added) (J. Isenbergh, *supra*, footnote 79, Vol. I, para. 5.1, p. 5:2)

[127] See, for instance, Articles 23A of the *O.E.C.D.* and *U.N. Model Tax Conventions*. Among bilateral tax treaties, see, for instance, Article 22(1)(a) of the *Agreement between the Federal Republic of Germany and the Islamic Republic of Pakistan for Avoidance of Double Taxation in the Area of Taxes on Income* (*Abkommen zwischen der Bundesrepublik Deutschland und der Islamischen Republik Pakistan zur Vermeidung der Doppelbesteuerung auf dem Gebiet der Steuern vom Einkommen*), 14 July 1994, Bundesteuerblatt 1995 I p. 617, Bundesgesetzblatt 1995 II p. 836; Article 22(2)(a) of the *Double Taxation Agreement between Mauritius and Madagascar* (*Convention entre le Gouvernement de la République de Maurice et le Gouvernement de la République de Madagascar tendant à éviter les doubles impositions et la prévention de l'évasion fiscale en matière d'impôts sur le revenu*), 30 August 1994; and Article 24(b)(1) of the *Double Taxation Agreement between the Republic of France and the United Kingdom* (*Convention entre la France et le Royaume-Uni de Grande-Bretagne et d'Irlande du Nord tendant à éviter les doubles impositions et à prévenir l'évasion fiscale en matière d'impôts sur les revenus*), 22 May 1968, *Journal Officiel de la République française*, 24 November 1969, p. 11476, as amended. See also A. H. Qureshi, *supra*, footnote 119, p. 370; B. J. Arnold & M. J. McIntyre, *supra*, footnote 119, pp. 40-43; J. Schuch, "The Methods for the Elimination of Double Taxation in a Multilateral Tax Treaty", in M. Lang *et al*. (eds.), *Multilateral Tax Treaties, New Developments in International Tax Law* (Kluwer Law International and Lindeverlagwien, 1998), pp. 129-152; and M. Pires, *International Juridical Double Taxation of Income* (Kluwer Law and Taxation, 1989), pp. 173-184.

[128] Panel Report, para. 8.95; United States' appellant's submission, paras. 216-220.

such that it could properly be subjected to tax in that State, as well as in the Member taking the double taxation-avoidance measure.

148. We also recognize that Members are not obliged by the covered agreements to provide relief from double taxation. Footnote 59 to the *SCM Agreement* simply preserves the prerogative of Members to grant such relief, at their discretion, for "foreign-source income". Accordingly, we do not believe that measures falling under footnote 59 must grant relief from *all* double tax burdens. Rather, Members retain the sovereign authority to determine for themselves whether, and to what extent, they will grant such relief.

149. We turn once more to the ETI measure and recall that footnote 59 to the *SCM Agreement* applies to measures "tak[en] ... to avoid the double taxation of foreign-source income …". Like the Panel, we will scrutinize the design, structure and architecture of the contested measure to determine whether it falls within footnote 59.

150. We recall that the United States points to the legislative history of the measure. According to certain passages from that legislative history, "the exclusion of ... extraterritorial income is a means of avoiding double taxation".[129] The legislative history also states that the measure was adopted "to comply with decisions of a World Trade Organization dispute panel and Appellate Body."[130] We take particular note of these statements, though we do not believe that it would be appropriate for us to end our inquiry here.

151. It is clear to us that the measure addresses situations where United States citizens and residents have engaged in certain economic activities in a "foreign" State. We note that a taxpayer will be treated as having foreign trading gross receipts, which give rise to exempt QFTI, only if the transaction generating these receipts satisfied the "foreign economic process requirement" in Section 942(b) IRC.[131]

152. Under this requirement, certain aspects of the transaction must take place outside the United States. First, the taxpayer must have "participated outside the United States" in one of the following activities: the "solicitation", "negotiation" or "making" of the contract, other than participation in advertising. Second, at least 50 percent of certain of the transaction costs must be attributable "to activities performed outside the United States." The relevant costs are those pertaining to the following five categories of activity: "advertising and sales promotion"; "the processing of customer orders and the arranging for delivery"; "transportation outside the United States in connection with delivery to the customer"; "the determination and transmittal of a final invoice or statement of account or the receipt of payment"; and, "the assumption of credit risk".[132]

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[129] United States' appellant's submission, para. 194, quoting the United States' *Senate Report on the FSC Repeal and Extraterritorial Income Exclusion Act* ("Senate Report"), S. Rep. No. 106-416 (2000), Exhibit US-2 submitted by the United States to the Panel, pp. 2 and 6; United States' *House of Representatives Report on the FSC and Repeal and Extraterritorial Income Exclusion Act* ("House Report"), H.R. Rep. No. 106-845 (2000), Exhibit US-3 submitted by the United States to the Panel, pp. 10 and 13.

[130] Panel Report, footnote 197 to para. 8.95 quoting House Report, p. 19.

[131] See *infra*, paras. 175-177, where we address the exception to this requirement in Section 942(c)(1) IRC.

[132] Sections 942(b)(2)(A)(ii) and 942(b)(3) IRC. As an alternative, the foreign economic process requirement may be satisfied where the costs attributable to activities performed outside the United States account for at least 85 percent of the costs in two of the five categories mentioned in paragraph 152. See Section 942(b)(2)(B) IRC.

153. The foreign economic process requirement focuses on activities of the taxpayer in respect of making and executing the sale or lease of the qualifying property. While we agree with the European Communities that the measure addresses only a limited range of economic activities, we also agree with the United States that these activities occur in a "foreign" State, as they must take place outside the United States. It is, therefore, clear to us that the foreign economic process requirement establishes a link between some part of the qualifying transactions covered by the ETI measure and a "foreign" State.

154. However, the fact that a transaction involves some foreign element, such as the "foreign economic process", does not necessarily mean that *all* of the income generated by such a transaction will be "foreign-source income" within the meaning of footnote 59 to the *SCM Agreement*. The sale or lease of property may give rise to taxable income attributable to a variety of activities, of which only some may occur in a "foreign" State. Thus, a sale or lease transaction may give rise to income attributable to activities such as research and development, manufacturing, advertising, selling, transport, and administration. In our view, under footnote 59 to the *SCM Agreement*, the "foreign-source income" arising in such a transaction is only that portion of the total income which is generated by and properly attributable to activities that do occur in a "foreign" State.[133] Conversely, the portion of the total income generated by and properly attributable to activities that occur within the State of residence is domestic-source income in that State. Thus, where sales or lease income *combines* domestic- and foreign-source income, *not all* of the income is foreign-source, just as *not all* of the income is domestic-source.

155. Under Section 942(a)(1) IRC, "foreign trading gross receipts" are the *entirety* of the receipts earned by the taxpayer in transactions covered by the measure. "Extraterritorial income" is defined in Section 114(e) IRC as the gross income attributable to foreign trading gross receipts of the taxpayer. "Foreign trade income" is defined in Section 941(b)(1) IRC as the (net) taxable income attributable to foreign trading gross receipts of the taxpayer. Under the ETI measure, as we read the statutory provisions, *all* of the receipts from a qualifying transaction involving qualifying property are treated as foreign trading gross receipts; *all* of the gross income earned in such a transaction is treated as extraterritorial income; and *all* of the (net) taxable income earned in such transaction is treated as foreign trade income.

156. We said earlier that the *exempt* income under the measure is only QFTI and that the amount of QFTI is calculated, at the choice of the taxpayer, using one of three different formulae set forth in Section 941(a)(1) IRC. Under one of these formulae, the amount of QFTI is equal to 15 percent of the (net) foreign trade income of the taxpayer[134] (the "15 percent rule"), while under a second, QFTI is equal to 1.2

[133] We note that Isenbergh states that, in the case of sale of goods by a producer, the income generated by the sales transaction is attributable to "easily distinguishable activities" which are "often combined", namely "production and sale" activities. Isenbergh indicates that in an international sales transaction, these production and sales activities may take place "in different countries". These activities, therefore, generate income that has different sources which are "compounded" unless the income from the different sources is separated. Isenbergh states that "ideally" the different "elements of the transaction" would be "disengaged" using arm's length pricing rules. The manufacturer would be treated as if it had sold the goods to an independent distributor at arm's length prices, who in turn resold the goods. This would "dissect" the transaction on the basis of the place where the different activities occurred. (J. Isenbergh, *supra*, footnote 79, Vol. I, para. 10.9, p. 10:16)

[134] Section 941(a)(1)(C) IRC.

percent of foreign trading gross receipts (the "1.2 percent rule").[135] Thus, under these two formulae, QFTI is a *fixed percentage* of either the net amount or the gross amount of *all* of the income earned by the taxpayer in any qualifying transaction. Under these formulae, QFTI, therefore, includes a percentage of the income earned by the taxpayer from the activities that, cumulatively, generated the totality of the income. In other words, in calculating QFTI under these formulae, the measure does not purport to distinguish, except on an "rule of thumb" basis, between domestic- and foreign-source income according to whether activities generating the income occurred in the United States or in a "foreign State".[136] Instead, QFTI is a fixed percentage of an amount that bundles together both domestic- and foreign-source income.

157. This may be illustrated by way of examples which are based on an example of the operation of the measure given in the United States' House Report.[137] The first example involves two separate sales transactions. We assume that a United States corporation manufactures property in the United States and sells it to an unrelated distributor in the United States, without satisfying the foreign economic process requirement. We assume that the sales price was $80, generating $30 of profit for the manufacturer. At the oral hearing, the United States confirmed that, in such a transaction, the manufacturer will have no extraterritorial income and no QFTI. All of the $30 profit will be gross income under Section 61(a) IRC. We next assume that the same distributor sells this same property to a foreign buyer, for use outside the United States, in a transaction satisfying the foreign economic process requirement. The sales price is $100, generating $20 of profit. At the oral hearing, the United States confirmed that the distributor will have $20 of extraterritorial income and, assuming this is all taxable income, the QFTI will equal $3 using the 15 percent rule in Section 941(a)(1)C) IRC.

158. In this first example, the manufacturer made $30 of profit and the distributor $20. Of this total of $50 of profit, only the distributor's $20 of profit is extraterritorial income. The exempt QFTI is a portion of distributor's sales and distribution profits, and does not include any profits made by the manufacturer. The United States explained that the 15 percent rule is intended to allocate the sales and distribution income earned in a transaction, in this example by the distributor, between the domestic portion (85%), and the foreign portion attributable to the activities involved in completing the foreign economic process (15%).[138] Thus, the $3 of QFTI is the amount the United States treats as exempt foreign-source income in this example, with the remaining $47 treated as United States domestic-source income.

159. Our second example is taken directly from the House Report itself, and uses the figures given in that Report. It involves precisely the same transactions as our first example, with the same sales prices and profits for the manufacturer and distributor. However, in this case the manufacturer and distributor are related parties. By virtue of Section 942(b)(4) IRC, the manufacturer is deemed to have satisfied the foreign economic process requirement in its transaction with the related distributor

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[135] Section 941(a)(1)(B) IRC. We note that, under Section 941(a)(1)(A) IRC, QFTI may be 30 percent of the "foreign sales and leasing income" of the taxpayer. We will examine this formula below. See *infra*, paras. 172-178.

[136] At the oral hearing, the United States referred to the formulae for calculating the amount of QFTI as "rules of thumb".

[137] House Report, p. 20. The figures used in these examples are also based on the example given in the United States' House Report.

[138] United States' response to questioning at the oral hearing.

because the distributor satisfied this requirement in the subsequent transaction with the foreign buyer. In other words, because the manufacturer and distributor are related, the measure deems the foreign economic process requirement to have been met in the sales transaction between the related parties, when, in fact, it was not met. At the oral hearing, the United States confirmed what is stated in the House Report, namely that as a result of the "deeming" provision in Section 942(b)(4) IRC, the manufacturer's $30 of profit is treated as extraterritorial income and, assuming this is all taxable income, the manufacturer's QFTI will equal $4.50 using the 15 percent rule in Section 941(a)(1)(C) IRC. The distributor will also still have $3 of QFTI. Thus, the related parties have a total of $7.50 of exempt QFTI, which the United States regards as foreign-source income.[139] The remaining $42.50 of profit is treated as domestic-source income. We will comment on this example below.

160. The third example involves only one transaction: the direct sale, by a United States corporation, of property which that corporation manufactured in the United States, to an unrelated foreign buyer for use outside the United States. In this example, we assume that the transaction satisfies the foreign economic process requirement. We assume also that the sales price was $100, generating $50 of profit for the manufacturer. Thus, like the last two examples, the total profit from all activities is $50. However, unlike the last two examples, the entire $50 profit is earned by the manufacturer. At the oral hearing, the United States confirmed that, in this example, the manufacturer will have $50 of extraterritorial income and, again assuming that this is all taxable income, it will have $7.50 of QFTI using the 15 percent rule. The United States argues that the $7.50 represents foreign-source income of the manufacturer, while the remaining $42.50 is taxed in the United States as domestic-source income.

161. The differences in tax treatment among these three examples are revealing. In each example, precisely the same total amount of profit ($50) is earned from precisely the same activities (manufacture, sales and distribution). Moreover, the nature and extent of the foreign-based activities are identical in each example. Yet, in these examples, the allocation between domestic- and foreign-source income that arises from the application of the ETI measure is very different. Indeed, in the second and third examples, the amount of income treated as exempt foreign-source income is more than twice the amount of such income in the first example.

162. The reason for the noteworthy difference in the exempt income between the first and third example is, as we said earlier, that QFTI is calculated as a fixed percentage of *all* of the income earned by the taxpayer in any qualifying transaction from the cumulation of activities which generated the income.[140] In the first example, QFTI was 15 percent of the entire $20 of income earned by the distributor from the cumulation of its sales and distribution activities; QFTI did not, however, include any of the $30 of profits earned by the manufacturer, in a separate transaction, from its activities. By contrast, in the third example, because the sale was made directly by a manufacturer, QFTI was 15 percent of the entire $50 of income earned by it from the cumulation of all of its activities, including manufacturing, sales and distribution. Thus, in the third example, QFTI bundles together, as exempt foreign-source income, 15 percent of the manufacturing income from the transaction, as well as 15 percent of the sales and distribution income.

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[139] The United States confirmed our understanding at the oral hearing.

[140] See *supra*, para. 25, for a description of the formulae used to calculate the amount of QFTI.

163. The difference in tax treatment between the first and second examples is explained by Section 942(b)(4) IRC, which provides that the transaction between the related manufacturer and distributor is deemed to satisfy the foreign economic process requirement because this requirement is satisfied in the *subsequent sale* by the distributor *to the unrelated foreign buyer*. Thus, in the absence of Section 942(b)(4) IRC, the domestic manufacturing income of the related parties would not be included in the calculation of QFTI. Yet, through the deeming provision, the measure allows the related parties to bundle together, in the calculation of QFTI, *all* of the profits earned by them, including profits earned in a purely domestic transaction between the related parties *inter se*. Thus, as in the third example, QFTI includes, in the second example, as exempt foreign-source income, 15 percent of the manufacturing income, as well as 15 percent of the sales and distribution income.

164. We note that our examples, like the one in the House Report, calculate QFTI using the 15 percent rule. However, if the taxpayer elected to calculate QFTI using the 1.2 percent rule, similar anomalies in the allocation of income as either domestic- or foreign-source would arise. Under this formula also, QFTI would be a portion of the combined domestic- and foreign-source income earned through the cumulation of activities that generated the foreign trading gross receipts of which 1.2 percent is QFTI.[141]

165. We have said that, under footnote 59 to the *SCM Agreement*, "foreign-source income" is income which is generated through activities linked with a "foreign" State. Although the ETI measure ensures that transactions giving rise to exempt QFTI have some link with a "foreign" State, through compliance with the foreign economic process requirement, two of the measure's allocation rules (the 15 percent and 1.2 percent rules) do not distinguish, on a proper basis, between income generated by activities that occur in the United States and income from activities that occur elsewhere. Rather, under these two rules, QFTI is a fixed portion of all of the income earned by the taxpayer in relevant transactions, including income generated by activities that occur in the United States, such as manufacturing income in our examples. As we have said, income generated by activities that do not have a link with a "foreign" State is not properly regarded as "foreign-source income" within the meaning of footnote 59, but as domestic-source income.

166. Accordingly, in our view, in the calculation of QFTI using the 1.2 and 15 percent rules set forth in Section 941(a)(1)(B) and (C) IRC[142], the ETI measure fails to distinguish between income which can give rise to foreign-source income – that is, sales and distribution income attributable to the foreign economic processes – and income which cannot, such as income attributable to United States' manufacturing activities. As a result, under these two formulae, the ETI measure improperly combines domestic-source income and foreign-source income in the calculation of QFTI. We, therefore, consider that, when taxpayers elect to use either of these two formu-

[141] Where the taxpayer elects to use the 1.2 percent rule to calculate the tax exemption with respect to any transaction, Section 941(a)(3) IRC confines the exemption to the income earned in that single transaction. Any income earned in any other transaction, relating to the same property, cannot benefit from an exemption, even in the case of a second transaction between related parties. This provision, therefore, effectively excludes the application of the deeming rule for related parties in Section 942(b)(4) IRC, which allows income from more than one transaction to be included in the calculation of QFTI. See *supra*, paras. 159 and 163.

[142] See *supra*, paras. 25 and 156.

lae, the ETI measure results systematically in a misallocation of domestic- and foreign-source income.

167. Furthermore, as we saw in the second example, through Section 942(b)(4) IRC, related parties are able to "sweep into" the calculation of QFTI income from purely domestic transactions, involving in that example domestic-source manufacturing income.[143] In the absence of this provision, the separate transactions between the manufacturer and related distributor, and between the distributor and unrelated foreign buyer, would have operated as a means of separating out some domestic- and foreign-source income in these separate transactions. In other words, the domestic-source income in the first transaction would not be included in the calculation of QFTI. However, the result of the deeming provision in Section 942(b)(4) IRC is to misallocate domestic-source income from the first transaction as foreign-source income.[144]

168. Finally, with respect to the two formulae we have just examined – namely, the 1.2 percent rule or 15 percent rule – we note that the last sentence of this provision states that the amount determined under the 1.2 percent rule shall in no case exceed 200 percent of the amount determined under the 15 percent rule. This last sentence of Section 941(a)(1) suggests to us that there could be situations where the QFTI claimed by a taxpayer under the 1.2 percent rule could be as much as 200 percent of the QFTI computed for the same transactions under the 15 percent rule. This reinforces our view that the approach embodied in the ETI measure can lead to very different allocations of income between domestic-and foreign-source in respect of precisely the same transaction. This implies to us that the different formulae for calculating QFTI result in a misallocation of income as between the domestic- and foreign-source and, through the election which the taxpayer can make between these formulae, allows the taxpayer to obtain the maximum benefit from the misallocation.

169. The third and final formula for calculating QFTI addresses "foreign sales and leasing income" ("FSLI") and is set forth in Section 941(c)(1) IRC. This provision states that QFTI may be 30 percent of the taxpayer's FSLI. The definition of FSLI contains some noteworthy differences from the allocation rules under the two formulae we have just examined. Whereas the first two formulae base the calculation of QFTI on *combined* domestic- and foreign-source income, in contrast, the definition of FSLI, under Section 941(c)(1)(A) IRC, does not. Under this provision, FSLI is limited to the "foreign trade income properly allocable to activities" that are "performed ... *outside* the United States" in satisfaction of the foreign economic process requirement described in Sections 942(b)(2)(A)(i) and 942(b)(3) IRC.[145]

170. Thus, under this third formula, FSLI is a portion of foreign trade income.[146] We recall that, under Section 941(b) IRC, foreign trade income bundles together both domestic- and foreign-source income. However, in contrast, FSLI is only that portion

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[143] See *supra*, para. 159.

[144] We acknowledge that, for certain purposes, related parties may be treated as a single economy entity. Yet, the application of the deeming rule here adds another situation where the ETI measure misallocates domestic- and foreign-source income.

[145] This method of determining FSLI does not apply to income derived from the "lease or rental" of QFTP. We examine below the calculation of FSLI in transactions involving the "lease or rental" of QFTP. See *infra*, paras. 170-174.

[146] We note that, under Section 941(c)(3)(B) IRC, only "*directly* allocable expenses" are to be "taken into account in computing foreign trade income" for purposes of FSLI. (emphasis added)

of foreign trade income "properly allocable" to foreign sales and distribution activities. We note that, although the IRC does not define the words "properly allocable", the Senate and House Reports indicate that those words limit FSLI to foreign trade income "*associated with sales* activities" described in the foreign economic process requirement.[147] We envisage that the application of such a rule requires the taxpayer to establish that, in fact, the "alloca[tion]" made is, indeed, "proper". Interpreted in this way, FSLI is *not* the *entirety* of the taxpayers' sales and leasing income, but is only the portion "properly allocable" or attributable to foreign activities. By requiring such a process of separating domestic- and foreign-source income, on the basis of the locus of the activities generating the income, Section 941(a)(1)(A) IRC includes in the calculation of FSLI only income which may properly be regarded as "foreign-source income" under footnote 59 of the *SCM Agreement*. In other words, Section 941(c)(1)(A) IRC separates out, or unbundles, the domestic- and foreign-source income that are combined in foreign trade income.

171. We note, however, that rules on "proper alloca[tion]" in Section 941(c)(1)(A) IRC do *not* apply to income derived from the lease or rental of QFTP. In the case of income derived from the "lease or rental" of QFTP, FSLI is simply the "foreign trade income" derived from these transactions.[148] We recall that foreign trade income bundles together domestic- and foreign-source income[149], in other words, the process of separating domestic- and foreign-source income that we consider is contemplated by the words "properly allocable" does *not* apply to FSLI which is lease or rental income.

172. However, the provisions relating to FSLI include "special rules for leased property" in Section 941(c)(2) IRC for the calculation of foreign trade income. These special rules apply in two situations. First, where qualifying property is leased by the manufacturer and, second, where qualifying property which has been leased is sold by the manufacturer. In these two situations, FSLI is determined as if the manufacturer had acquired the property from a third party at an arm's length price. The Senate and House Reports explain that:

> This limitation is intended to *prevent* foreign sales and leasing income from including *profit associated with manufacturing activities*.[150] (emphasis added)

173. We agree that, under the "special rules for leased property", the use of the arm's length rule effects a separation of manufacturing income from all other income.[151] The amount of FSLI is *all* of the income, *less* manufacturing income, earned through the lease transaction, or through the sale of leased property. FSLI, therefore, combines or bundles together the *remaining* income, irrespective of the locus of the activities that generated this income. The remaining FSLI could combine income generated by domestic activities and income generated by foreign activities. As a result the calculation of FSLI for leased property could result in a misallocation of domestic-source income as foreign-source income.

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[147] Senate Report, p. 10; House Report, p. 24. (emphasis added)
[148] Section 941(c)(1)(B) IRC.
[149] See *supra*, paras. 155 and 166.
[150] Senate Report, p. 11; House Report, p. 24.
[151] We note that Isenbergh considers that the use of arm's length pricing is an appropriate method for separating manufacturing income from sales income. (J. Isenbergh, *supra*, footnote 79, Vol. I, para. 10.9, p. 10:16) See also *supra*, footnote 133.

174. To our minds, the inclusion of certain restrictions in calculating FSLI – the "properly allocable" rule and the exclusion of manufacturing income – makes all the more striking the omission of any such restrictions where QFTI is calculated using the other two formulae, that is, the 1.2 percent and 15 percent rules. We find it particularly incongruous that one part of the ETI measure expressly requires a "proper alloca[tion]" of foreign-source income, on the basis of activities "performed ... outside the United States", while the remainder of the measure does not. We also find it noteworthy that, in one part of the ETI measure, a restriction is included specifically "to prevent" an exemption being granted to "profit associated with manufacturing activities" – which activities will often take place within the United States – while under the 1.2 percent and 15 percent rules no such limitation is provided to exclude domestic-source manufacturing income.

175. We turn now to two other aspects of the ETI measure which we consider similarly result in domestic-source income being treated as exempt foreign-source income. First, for taxpayers with declared foreign trading gross receipts of up to $5,000,000, Section 942(c)(1) IRC dispenses entirely with the foreign economic process requirement. Thus, a portion of the taxpayers' income is treated as exempt foreign-source income even though it has not been established – and need not be established – that the taxpayer undertook any activities outside the United States. However, in the absence of an established link between the income of such taxpayers and their activities in a "foreign" State, we do not believe that there is "foreign-source income" within the meaning of footnote 59 of the *SCM Agreement*.

176. The United States argued, at the oral hearing, that, in the case of "small" taxpayers with foreign trading gross receipts of only up to $5,000,000, the burden under the foreign economic process requirement is too great to justify imposing this requirement.[152] At the oral hearing, the United States also asserted that, where the exception in Section 942(c)(1) IRC applies, there is in any event a link with a foreign State because, in these cases, the qualifying property in the transaction must be used outside the United States.[153] In our view, however, sales income cannot be regarded as "foreign-source income", under footnote 59, for the sole reason that the property, subject-matter of the sale, is exported to another State, for use there. The mere fact that the buyer uses property outside the United States does not mean that the seller undertook activities in a "foreign" State generating income there. Such an interpretation of footnote 59 would, in effect, allow Members to grant a tax exemption in favour of export-related income on the ground that the exportation by itself of the property renders the income "foreign-source". In our view, this reading would allow Members easily to evade the prohibition on export subsidies in Article 3.1(a) of the *SCM Agreement* and render this prohibition meaningless.

177. Accordingly, where and to the extent that the "$5,000,000"exception in Section 942(c)(1) IRC applies, the measure grants a tax exemption in favour of income which is not demonstrated to be "foreign-source income" within the meaning of footnote 59 to the *SCM Agreement*. Rather, this income remains domestic-source.

178. Second, the measure treats domestic-source income as exempt foreign-source income in connection with the performance of services "related and subsidiary" to the

[152] We note that a taxpayer with no more than $5,000,000 of declared foreign trading gross receipts may have other gross receipts which are not declared as foreign trading gross receipts.

[153] Clearly, where the transaction involves the production of QFTP outside the United States, there would be other foreign links than the use outside the United States. We deal here with the United States' argument as it relates to property produced within the United States.

sale or lease of qualifying property under Section 942(a)(1)(C) IRC. Under this provision, the performance of certain services in connection with qualifying property, for example repair or maintenance services, can generate foreign trading gross receipts and, hence, exempt QFTI.

179. The IRC does not state expressly that these subsidiary and related service activities need to be performed outside the United States. We note that the rules contained in the Code of Federal Regulations, which applied to the FSC legislation, continue to apply to the provisions of the measure regarding foreign trading gross receipts.[154] According to these regulations, subsidiary and related services "may be performed *within* or without the United States."[155] (emphasis added)

180. The measure, in conjunction with these regulations, therefore, exempts QFTI derived by a United States citizen or resident from the performance of services *within* the United States. The activities which generate the services income may occur entirely in the United States. In our view, such income has no link with any "foreign" State which could lead to that State taxing the income and therefore, is not "foreign-source income" within the meaning of footnote 59 to the *SCM Agreement.* Rather it is domestic-source income.

181. There is one final aspect of the measure to be highlighted. The measure provides rules that exempt a portion of income as QFTI so as to avoid, the United States argues, the double taxation of foreign-source income. The measure does not, however, displace the rules the United States otherwise applies to avoid the double taxation of foreign-source income. These other rules involve the grant of tax credits with respect to foreign-source income on which the taxpayer has paid tax in a "foreign" State.[156] Both the ETI measure and these rules continue to be available, and taxpayers with foreign trading gross receipts under the ETI measure have a *choice*, on a transaction-by-transaction basis, to opt either for an exemption of a portion of their income as QFTI or to have the income taxed under the other rules with tax credits granted to offset the taxes due in the United States.[157] Moreover, if a taxpayer elects to have income from a transaction taxed under the ETI measure, the taxpayer also has a choice as to the formula to be used to calculate the amount of QFTI.

182. As we said earlier, taxpayers will obviously opt to use the rules which result in the most favourable tax treatment for them. In making its choices, the taxpayer will naturally decide whether the tax which is due on exempt QFTI is greater than the tax credits which it could claim if it did not elect to take a tax exemption under the ETI measure.[158]

183. Under the ETI measure, the taxpayer can obtain a tax exemption even for income that is domestic-source income. The taxpayer will not have foreign tax credits with respect to this domestic-source income. In these circumstances, with no tax credits to surrender, the taxpayer would very likely opt for an exemption under the ETI measure of income that includes domestic-source income. The measure operates, in these circumstances, as a means to provide export subsidies for income earned from domestic activities. Correspondingly, the greater the amount of genuine "foreign-source income" included in QFTI, the more likely it is that the taxpayer will

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[154] Senate Report, p. 19; House Report, p. 33.

[155] 26 CFR 1.924(a)–1T–(d).

[156] See *supra*, para. 100.

[157] We recall that, under Section 114(d) IRC, a taxpayer gives up tax credits attributable to income excluded from taxation under the ETI measure.

[158] See *supra*, para. 104 and footnote 80 thereto.

have tax credits to give up, and the less likely it becomes that the ETI measure will be used by the taxpayer.

184. In conclusion, our examination discloses that the measure at issue is an extremely complex instrument. We set out to review whether the measure was "tak[en] ... to avoid the double taxation of foreign-source income" within the meaning of footnote 59 to the *SCM Agreement*. The ETI measure, viewed as a whole, does not permit us to conclude that this measure exempts *only* "foreign-source income". Rather, in some situations, the ETI measure exempts QFTI which is foreign-source income[159]; in other situations, the ETI measure exempts QFTI which is not foreign-source[160]; and, in yet other situations, the measure exempts QFTI which is a combination of both domestic- and foreign-source income.[161]

185. Certainly, if the ETI measure were confined to those aspects which grant a tax exemption for "foreign-source income", it would fall within footnote 59. However, the ETI measure is not so confined. Rather, in several important respects, two of the three basic allocation rules of the ETI measure, the (1.2 and 15 percent rules) provide an exemption for domestic-source income.[162] We have said that avoiding double taxation is not an exact science and we recognize that Members must have a degree of flexibility in tackling double taxation. However, in our view, the flexibility under footnote 59 to the *SCM Agreement* does not properly extend to allowing Members to adopt allocation rules that systematically result in a tax exemption for income that has no link with a "foreign" State and that would not be regarded as foreign-source under any of the widely accepted principles of taxation we have reviewed.

186. For these reasons, even though parts of the ETI measure may be regarded as granting a tax exemption for foreign-source income, we find that the United States has not met its burden of proving that the ETI measure, viewed as a whole, falls within the justification available under the fifth sentence of footnote 59 of the *SCM Agreement*. Accordingly, we uphold the Panel's finding in paragraphs 8.107 and 9.1(a) of the Panel Report.

VIII. ARTICLE 10.1 OF THE *AGREEMENT ON AGRICULTURE*: EXPORT SUBSIDIES

187. The United States appeals the Panel's finding that:

> … the United States has acted inconsistently with its obligations under Article 10.1 of the *Agreement on Agriculture* by applying the export subsidies, with respect to both scheduled and unscheduled agricultural products, in a manner that, at the very least, threatens to circumvent its

[159] See *supra*, para. 170, examining the rule that, where QFTI is calculated as 30 percent of FSLI, FSLI is the income "properly allocable" to certain foreign activities, other than in the case of "lease or rental" income.

[160] See *supra*, paras. 175-177, examining the exemption granted to certain taxpayers without satisfaction of the foreign economic process requirement and, paras. 178-180, examining the exemption granted for service-related income where the services are performed in the United States.

[161] See *supra*, paras. 156-168, examining the rules whereby QFTI may be calculated either as 1.2 percent of total foreign trading gross receipts or as 15 percent of total foreign trading income.

[162] In addition, under the third formula for FSLI, there are circumstances where the ETI measure could grant a tax exemption for lease or rental income which includes domestic-source income. See *supra*, para. 173.

export subsidy commitments under Article 3.3 of the *Agreement on Agriculture*.[163]

188. The Panel reached this conclusion because it considered that its reasoning under the *SCM Agreement* was "also applicable as regards whether the Act gives rise to subsidies contingent upon export performance within the meaning of Article 1(e) of the *Agreement on Agriculture* for the purposes of Article 10.1 of the *Agreement on Agriculture*." [164]

189. The United States argues that the ETI measure does not involve export subsidies under Article 1(e) of the *Agreement on Agriculture* because the measure is not a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*.[165] For this reason alone, the United States contends that the Panel erred in finding that the United States had acted inconsistently with its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture*.

190. Before addressing the ETI measure we consider it useful to recall our findings regarding the FSC measure in our Report in *US – FSC*. In that Report, we held that, under the *Agreement on Agriculture*, just as in cases under Article 1.1(a)(1)(ii) of the *SCM Agreement*, a subsidy may arise where a government foregoes revenues that are otherwise due.[166] In that Report, the reasons which led us to hold, under the *SCM Agreement*, that the FSC measure involved the foregoing of revenue otherwise due, also led us to the same conclusion under the *Agreement on Agriculture*.[167]

191. In its appeal in the original proceedings, the United States did not contest that, if the FSC measure involved a "benefit" under Article 1.1(b) of the *SCM Agreement*, it also involved a benefit under the *Agreement on Agriculture*. We reached the conclusion that the FSC measure "confer[red] upon the recipient the obvious benefit of reduced tax liability and, therefore, reduced tax payments". Accordingly, we found that the measure involved a subsidy under the *Agreement on Agriculture*.[168]

192. We held, in *US – FSC*, that there was no reason to read the requirement of "contingent upon export performance" differently in the *SCM Agreement* and in the *Agreement on Agriculture*. Therefore, for the reasons that led us to conclude, under Article 3.1(a) of the *SCM Agreement*, that this subsidy was contingent upon export performance, we reached the same conclusion under the *Agreement on Agriculture*.[169]

193. In consequence, we held that the FSC measure involved "subsidies contingent upon export performance" under Article 1(e) of the *Agreement on Agriculture*. As these subsidies had not been found to be listed in Article 9.1 of the *Agreement on Agriculture*, we examined whether they were inconsistent with Article 10.1 of that Agreement, as the European Communities claimed. We held that the subsidies were inconsistent with this provision.

194. In this appeal, the United States contends that the measure is not an export subsidy under Article 1(e) of the *Agreement on Agriculture* because, it argues, the measure is not an export subsidy under Article 3.1(a) of the *SCM Agreement*. We have rejected the United States' appeal regarding the proper characterization of the

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[163] Panel Report, para. 8.122.
[164] Panel Report, para. 8.116.
[165] United States' appellant's submission, paras. 247-248.
[166] Appellate Body Report, *US – FSC*, *supra*, footnote 3, para. 138.
[167] *Ibid*., para. 139.
[168] Appellate Body Report, *US – FSC*, *supra*, footnote 3, para. 140.
[169] *Ibid*., paras. 141-142.

measure under Article 3.1(a) of the *SCM Agreement*. The Panel held, and we have upheld, that the measure involves the foregoing of revenues that are otherwise due under Article 1.1(a)(ii) of the *SCM Agreement*. As we indicated in *US – FSC*, where a government foregoes revenues that are otherwise due in relation to agricultural products, a subsidy may arise under the *Agreement on Agriculture*. The fiscal treatment of agricultural products, under the measure, is not materially different from the fiscal treatment of products falling within the scope of the *SCM Agreement*. Accordingly, we see no reason to reach any conclusion under the *Agreement on Agriculture* that differs from our conclusion under the *SCM Agreement*. The ETI measure also reduces the liability of United States citizens and residents to pay tax on income earned from qualifying transactions involving agricultural products.

195. In addition, for the reasons we have given in Part VI of this Report with respect to Article 3.1(a) of the *SCM Agreement*, the measure makes the grant of subsidies "contingent ... upon export performance" where qualifying property is produced within the United States. We can see no reason to conclude otherwise under Article 1(e) of the *Agreement on Agriculture*, and none has been suggested to us. We, therefore, find that the measure also involves subsidies contingent upon export performance under Article 1(e) of the *Agreement on Agriculture*.

196. For these reasons, we uphold the Panel's finding that the measure involves export subsidies under Article 1(e) of the *Agreement on Agriculture* with respect to qualifying property produced within the United States. We also uphold the Panel's finding, in paragraphs 8.122 and 9.1(c), that the United States acted inconsistently with Articles 10.1 and 8 of the *Agreement on Agriculture*.[170]

IX. ARTICLE III:4 OF THE GATT 1994

197. Before the Panel, the European Communities challenged the consistency with Article III:4 of the GATT 1994 of Section 943(a)(1)(C) IRC, which establishes, as one of the conditions of eligibility for the tax benefits under the ETI measure, that not more than 50 percent of the fair market value of qualifying property be attributable to articles produced or direct labour performed *outside* the United States (the "foreign articles/labour limitation" or "fair market value rule").[171]

198. The Panel found that:

> … by reason of the foreign articles/labour limitation, the Act accords less favourable treatment within the meaning of Article III:4 of the *GATT 1994* to imported products than to like products of US origin ... [172]

[170] We note that the United States has not appealed any other aspect of the Panel's finding under Article 10.1 of the *Agreement on Agriculture*. In particular, the United States has not appealed the Panel's finding that it was appropriate to examine the European Communities' primary claim under Article 10.1 of the *Agreement on Agriculture*, without first examining its alternative claim under Article 9.1 of that Agreement. (Panel Report, para. 8.112 and footnote 219 thereto) Nor has the United States appealed the Panel's finding that the measure is "applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments" within the meaning of Article 10.1. (Panel Report, paras. 8.117-8.120) We note that the United States did not contest either of these issues before the Panel. (Panel Report, para. 8.112 and footnote 219 thereto; Panel Report, para. 8.121; and United States' first submission to the Panel, paras. 220-221; Panel Report, p. A-100)

[171] See *supra*, para. 21. See also *infra*, para. 201, for the text of Section 943(a)(1)(C) IRC of the fair market value rule.

[172] Panel Report, para. 8.158.

199. This finding was based on the following three findings by the Panel: (i) that the imported and domestic products at issue are "like products"[173]; (ii) that the measure is a "law, regulation, or requirement affecting their internal sale, offering for sale, purchase, transportation, distribution, or use"[174]; and (iii) that, by conferring an advantage upon the use of domestic products but not upon the use of imported products, the measure accords less favourable treatment to imported products in relation to like products of United States origin.[175]

200. In its appeal under Article III:4 of the GATT 1994, the United States does not challenge the Panel's finding on "like products". Rather, the United States confines its appeal to the Panel's findings: that the measure is a "law, regulation, or requirement *affecting* their internal sale, offering for sale, purchase, transportation, distribution, or use"; and that the measure provides "less favourable treatment" to imported products as compared with like products of United States origin. (emphasis added)

201. We note that the issues arising under Article III:4 of the GATT 1994 relate to the definition of "QFTP" in the measure, in particular the following requirement, which is contained in Section 943(a)(1)(C) IRC:

> (C) not more than 50 per cent of the fair market value of [Qualifying Foreign Trade Property may be] attributable to -
>
> > (i) articles manufactured, produced, grown, or extracted outside the United States, and
> >
> > (ii) direct costs for labour ... performed outside the United States.[176]

202. The European Communities' claim under Article III:4 of the GATT 1994, and the Panel's examination of the ETI Act, concern Section 943(a)(1)(C) solely as it relates to the production of qualifying property *within* the United States. We recall that, in examining export contingency under Article 3.1(a) of the *SCM Agreement*, we considered the ETI measure solely in relation to the conditions governing the grant of the subsidy for qualifying property produced *within* the United States. We do not, therefore, see that the Panel committed any error of law in adopting the same approach in its examination of the claim under Article III:4 of the GATT 1994.

203. Article III:4 of the GATT 1994 reads:

> The products of the territory of any Member imported into the territory of any other Member shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.

204. Article III:4 is one of a series of provisions in Article III which set forth obligations regarding "*National Treatment on Internal Taxation and Regulation*". In previous appeals, we have stated that:

> The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. More specifically, the purpose of Article III "is to ensure that internal measures 'not be applied to imported and domestic products so as to

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[173] Panel Report, para. 8.135.
[174] *Ibid.*, para. 8.149.
[175] *Ibid.*, para. 8.158.
[176] We refer to this provision as the "fair market value rule"; the Panel termed it the "foreign articles/labour limitation".

> afford protection to domestic production'". Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products. ... Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products.[177] (footnotes omitted)

205. We have also stated that, although this "general principle" is not explicitly invoked in Article III:4, nevertheless, it "informs" that provision.[178] In interpreting Article III:4 we are, therefore, guided by this principle.

206. With these general considerations in mind, we turn to the two issues raised by the United States in its appeal under Article III:4 of the GATT 1994.

A. *Law, Regulation or Requirement Affecting the Internal Use of Imported and Like Domestic Products*

207. The United States contests the Panel's finding that the measure "affects" the internal use of like imported products, and argues that there is no "necessary relationship" between the fair market value rule and the internal use of imported products. The United States emphasizes that the fair market value rule is a "measure of general application that is not directed against imports".[179] In such a situation, the United States argues, the word "affecting" in Article III:4 must be given a narrow scope. However, the United States does not contest the Panel's finding that the fair market value rule is a "law, regulation or requirement" within the meaning of Article III:4 of the GATT 1994.

208. We observe that the clause in which the word "affecting" appears – "in respect of all laws, regulations and requirements *affecting* their internal sale, offering for sale, purchase, transportation, distribution or use" – serves to define the scope of application of Article III:4. (emphasis added) Within this phrase, the word "affecting" operates as a link between identified types of government action ("laws, regulations and requirements") and specific transactions, activities and uses relating to products in the marketplace ("internal sale, offering for sale, purchase, transportation, distribution or use"). It is, therefore, not *any* "laws, regulations and requirements" which are covered by Article III:4, but only those which "*affect*" the specific transactions, activities and uses mentioned in that provision. Thus, the word "affecting" assists in defining the types of measure that must conform to the obligation not to accord "less favourable treatment" to like imported products, which is set out in Article III:4.

209. The word "affecting" serves a similar function in Article I:1 of the *General Agreement on Trade in Services* (the "GATS"), where it also defines the types of measure that are subject to the disciplines set forth elsewhere in the GATS but does

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[177] Appellate Body Report, *Japan – Alcoholic Beverages II*, *supra*, footnote 116, at 109-110, quoting from Panel Report, *United States – Section 337 of the Tariff Act of 1930*, adopted 7 November 1989, BISD 36S/345, para. 5.10. We cited this statement in Appellate Body Report, *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products* ("*EC – Asbestos*"), WT/DS135/AB/R, adopted 5 April 2001, DSR 2001:VII, 3243, para. 97, a dispute that also involved Article III:4 of the GATT 1994.

[178] Appellate Body Report, *EC – Asbestos*, *supra*, footnote 177, para. 98.

[179] United States' appellant's submission, paras. 254-256.

not, in itself, impose any obligation.[180] In *EC – Bananas III*, we considered the meaning of the word "affecting" in that provision of GATS. We stated:

> [t]he ordinary meaning of the word "affecting" implies a measure that has "an effect on", which indicates a *broad scope of application*. This interpretation is further reinforced by the conclusions of previous panels that the term "affecting" in the context of Article III of the GATT is wider in scope than such terms as "regulating" or "governing".[181] (emphasis added, footnote omitted)

210. In view of the similar function of the identical word, "affecting", in Article III:4 of the GATT 1994, we also interpret this word, in this provision, as having a "broad scope of application".

211. Turning to the fair market value rule, we recall that, under the ETI measure, a taxpayer producing property in the United States will be eligible to obtain a tax exemption in respect of income derived from an export-sale of such property on the condition that, *inter alia*, not more than 50 percent of the fair market value of the product is attributable to articles produced outside the United States or to direct costs for labour performed outside the United States. The United States regards the fair market value of property as the sales price of the property in the marketplace. Fair market value is attributable to three different elements: (i) inputs used to produce the property; (ii) direct labour used to produce the property, and (iii) "non-tangible elements, including intellectual property rights, goodwill, capital, marketing, distribution, and other services".[182]

212. Any taxpayer that seeks to obtain a tax exemption under the ETI measure must ensure that, in the manufacture of qualifying property, it does not "use" imported input products, whose value comprises more than 50 percent of the fair market value of the end-product. The fair market value rule, thus, places an express maximum limit on the extent to which the value of qualifying property can be attributable to imported input products. A manufacturer's use of imported input products always counts against the 50 percent ceiling in the fair market value rule, while in contrast, the same manufacturer's use of like domestic input products has no such negative implication. Manufacturers wishing to obtain the ETI tax exemption are not restricted, in any way, on the use they make of domestic inputs. The fair market value rule, therefore, influences the manufacturer's choice between like imported and domestic input products if it wishes to obtain the tax exemption under the ETI measure.

213. Accordingly, we agree with the Panel's finding, in paragraph 8.149 of its Report, that the fair market value rule "affects" the "internal ... use" of imported products, within the meaning of Article III:4 of the GATT 1994, as compared with like domestic products.

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[180] Article I:1 of the GATS provides that "[t]his Agreement applies to measures by Members *affecting* trade in services." (emphasis added)

[181] Appellate Body Report, *supra*, footnote 47, para. 220. We made the same statement regarding the word "affecting" in Article I:1 of the GATS in our Report in *Canada – Autos, supra*, footnote 56, para. 150.

[182] See United States' first submission to the Panel, para. 201; Panel Report, pp. A-95 – A-96. The United States confirmed our understanding of the fair market value rule in its response to questioning at the oral hearing.

B. "Less Favourable Treatment"

214. We now come to the second part of the United States' appeal of this issue, namely, its argument that the Panel erred in finding that the fair market value rule accords less favourable treatment to like imported products. The United States asserts that it is possible for a manufacturer to satisfy the fair market value rule without using as inputs *any* goods produced in the United States, and that the Panel could not, therefore, have found that the fair market value rule involves *de jure* discrimination against imports.

215. The examination of whether a measure involves "less favourable treatment" of imported products within the meaning of Article III:4 of the GATT 1994 must be grounded in close scrutiny of the "fundamental thrust and effect of the measure itself".[183] This examination cannot rest on simple assertion, but must be founded on a careful analysis of the contested measure and of its implications in the marketplace. At the same time, however, the examination need not be based on the *actual effects* of the contested measure in the marketplace.[184]

216. If a United States citizen or resident fulfills the prescribed conditions of grant, it obtains a clearly significant financial benefit in the form of a tax exemption.[185] The availability of such a tax exemption depends upon the taxpayer organizing its business affairs in such a way as to comply with the prescribed conditions of grant.

217. One of these conditions is the fair market value rule which places, as we have said, an express maximum limit on the extent to which the value of qualifying property can be attributable to imported input products. No such limit exists for like domestic input products. The fair market value rule, therefore, draws a formal distinction, on its face, between the treatment of like domestic and imported input products.[186] This formal difference also has substantive importance because, on its face, the fair market value rule constrains the use of like imported input products.

218. In situations where the use of imported input products in the manufacture of qualifying property may breach the 50 percent limit and thereby render a manufacturer ineligible to obtain a tax exemption, the manufacturer will avoid the use of like imported input products if it wishes to obtain a tax exemption. As the 50 percent limit is approached, the manufacturer will be increasingly sensitive to the value of the imported input products it can use and to the contribution these products will make to the fair market value of the property being manufactured. Before making purchasing decisions, the manufacturer will weigh the choice between domestic and imported input product, in the light of the anticipated value of the end-product, to ensure that the purchases of imported products do not adversely affect the availability of the tax exemption. These same considerations will never apply if the manufacturer opts to purchase domestic input products. Thus, for purposes of satisfying the fair market value rule and ensuring the availability of the tax benefit, a real and substantive advantage attaches to the use of domestic input products, and a corresponding disadvantage to the use of like imported products.

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[183] Appellate Body Report, *Korea – Various Measures on Beef*, *supra*, footnote 44, para. 142.

[184] Appellate Body Report, *Japan – Alcoholic Beverages II*, *supra*, footnote 116, at 110.

[185] We recall that the tax exemption may be: 1.2 percent of foreign trading gross receipts; 15 percent of foreign trade income; or 30 percent of foreign sales and leasing income. See *supra*, para. 25.

[186] See s*upra*, para. 201, for the text of the fair market value rule. See also Panel Report, para. 8.133.

219. The difference in resulting treatment between like domestic and imported products becomes very clear where the manufacturing process is product input-intensive and the value of input products typically constitutes more than 50 percent of the fair market value of the qualifying property.[187] In these situations, the measure in effect precludes United States manufacturers who desire the tax benefit, from making a free choice between like domestic and imported input-products on the basis of purely commercial considerations.

220. In sum, if the manufacturer wishes to obtain the beneficial tax exemption under the ETI measure, the fair market value rule provides a considerable impetus, and, in some circumstances, in effect, a requirement, for manufacturers to use domestic input products, rather than like imported ones. As such, the fair market value rule treats imported products less favourably than like domestic products.

221. In our view, the above conclusion is not nullified by the fact that the fair market value rule will not give rise to less favourable treatment for like imported products in each and every case. There may well be, as the United States maintains, property which does not require extensive material and labour inputs such that the fair market value rule would not, in those cases, bear upon the input choices manufacturers make. Even so, the fact remains that in an indefinite number of other cases, the fair market value rule operates, by its terms, as a significant constraint upon the use of imported input products. We are not entitled to disregard that fact.

222. For the above reasons, we uphold the Panel's finding, in paragraphs 8.154 and 9.1(d) of its Report that, by virtue of the fair market value rule, the measure accords less favourable treatment within the meaning of Article III:4 of the GATT 1994 to imported products than to like products of United States origin.

X. ARTICLE 4.7 OF THE *SCM AGREEMENT*: WITHDRAWAL OF FSC SUBSIDIES

223. The United States appeals the Panel's finding that:

> … the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies inconsistent with Article 3.1(a) of the *SCM Agreement* and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 *SCM Agreement*.[188]

224. The United States notes that the ETI Act repeals the FSC provisions and provides that no corporation can elect to be treated as an FSC after 30 September 2000. The ETI Act also contains certain transitional rules that, in the view of the United States, ensure taxpayers a degree of certainty in their tax planning and that are essential to the orderly passage from one set of tax rules to another. The United States submits that, in requiring a Member to change its tax rules, WTO rules cannot be intended to require such a Member to deny its taxpayers the right to an orderly transition. Thus, the United States reasons, the Panel's finding that the United States has acted inconsistently with Article 4.7 of the *SCM Agreement* should be reversed.

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[187] We note that the European Communities provided the Panel with a list of circumstances, for illustrative purposes, where such a requirement to use like domestic products may arise. (Annex to the European Communities' second submission to the Panel; Panel Report, pp. C-46 – C-52)

[188] Panel Report, para. 8.170.

225. We recall that, in our Report in *US – FSC*, we upheld the panel's finding "that the FSC measure constitutes a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*".[189] In its report, the panel recommended, pursuant to Article 4.7 of the *SCM Agreement*, that the United States withdraw the FSC subsidies found to be prohibited export subsidies under Article 3.1(a) of the *SCM Agreement* by 1 October 2000".[190] On 12 October 2000, the DSB acceded to the United States' request "that the DSB modify the time-period in this dispute so as to expire on 1 November 2000".[191]

226. Article 4.7 of the *SCM Agreement* reads:

> 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*. (emphasis added)

227. In examining this provision in *Brazil – Aircraft (Article 21.5 – Canada)*, we said:

> Turning to the ordinary meaning of "withdraw", we observe first that this word has been defined as "remove" or "take away" , and as "to take away what has been enjoyed; to take from." This definition suggests that "withdrawal" of a subsidy, under Article 4.7 of the *SCM Agreement*, refers to the "removal" or "taking away" of that subsidy.[192] (footnotes omitted)

228. Under the ETI Act, no corporation may elect to be treated as an FSC after 30 September 2000.[193] However, for FSCs in existence as of that date, the repeal of the original FSC measure "shall not apply" to any transaction which occurs before 1 January 2002.[194] Moreover, even after that date, existing FSCs can continue to use the original FSC measure for transactions pursuant to a binding contract between the FSC and any unrelated person that was in effect on and after 30 September 2000.[195] Thus, by the United States' own acknowledgement, the original FSC measure continues to apply, unmodified, to existing FSCs in respect of a defined set of transactions.[196] The success of the United States' appeal depends on the success of its argument that prohibited FSC subsidies can continue to be granted to protect the contractual interests of private parties and to ensure an orderly transition to the regime of the new measure. In short, on the basis of these arguments, the United States seeks to have the time-period for the full withdrawal of the prohibited FSC subsidies extended, in some circumstances, indefinitely.

229. Article 4.7 of the *SCM Agreement* requires prohibited subsidies to be withdrawn "without delay", and provides that a time-period for such withdrawal shall be specified by the panel. We can see no basis in Article 4.7 of the *SCM Agreement* for extending the time-period prescribed for withdrawal of prohibited subsidies for the reasons cited by the United States. In that respect, we recall that, in *Brazil – Aircraft*

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189 Appellate Body Report, *supra*, footnote 3, para. 177(a).
190 Original Panel Report, *supra*, footnote 4, para. 8.8.
191 WT/DS108/11, 2 October 2000. See also WT/DSB/M/90, paras. 6-7.
192 Appellate Body Report, *supra*, footnote 86, para. 45.
193 Section 5(b)(1) of the ETI Act.
194 Section 5(c)(1)(A) of the ETI Act.
195 See Section 5(c)(1)(B)(ii) of the ETI Act.
196 Panel Report, para. 8.169.

(Article 21.5 – Canada), Brazil made a similar argument to the one made by 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 *SCM Agreement* to withdraw prohibited subsidies "without delay" is unaffected by contractual obligations that the Member itself may have assumed under municipal law. Likewise, a Member's obligation to withdraw prohibited export subsidies, under Article 4.7 of the *SCM Agreement*, cannot be affected by contractual obligations which private parties may have assumed *inter se* in reliance on laws conferring prohibited export subsidies. Accordingly, we see no legal basis for extending the time-period for the United States to withdraw fully the prohibited FSC subsidies.

231. Accordingly, we uphold the Panel's finding, in paragraphs 8.170 and 9.1(e) of its Report, that the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies under Article 3.1(a) of the *SCM Agreement* and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 of the *SCM Agreement*.

XI. ARTICLE 10.3 OF THE DSU

232. In its first written submission to the Panel, the European Communities requested:

> … the Panel to make a preliminary ruling to the effect that third parties are entitled to receive all written submissions of the parties submitted prior to the meeting of the Panel and to make this preliminary ruling and communicate it to the parties and the third parties as soon as possible after receipt of the US first written submission and before the date for the presentation of the second written submissions.[199] (footnote omitted)

233. The United States requested the Panel to reject the European Communities' request and to find, on the basis of reasoning employed by previous panels proceeding under Article 21.5 of the DSU, "that the third parties in this proceeding do not have a right to the parties' rebuttal submissions."[200]

234. On 21 February 2001, the Panel issued a decision to the parties refusing the request of the European Communities and stating that:

> … we do not consider that Article 10.3 *DSU* requires that third parties receive all pre-meeting submissions of the parties (including rebuttal

[197] Appellate Body Report, *Brazil – Aircraft (Article 21.5 – Canada)*, *supra*, footnote 86, para. 46.
[198] *Ibid*., para. 45.
[199] Panel Report, para. 6.1; European Communities' first submission to the Panel, paras. 247-258 and 260; Panel Report, pp. A-44 – A-45.
[200] Panel Report, para. 6.2. (footnote omitted)

> submissions) in the context of an accelerated proceeding under Article 21.5 *DSU* that involves only one meeting of the parties and third parties with the panel.[201]

235. The European Communities appeals this interpretive preliminary ruling by the Panel. In the view of the European Communities, Rule 9 of the working procedures adopted by the Panel in this case (the "Working Procedures") conflicts with Article 10.3 of the DSU and does not respect the rights afforded to third parties under the DSU. According to the European Communities, although panels have a certain discretion to establish their own working procedures, they may not derogate from binding provisions of the DSU, including the requirement in Article 10.3 of the DSU that "[t]hird parties *shall receive* the submissions of the parties to the dispute to the *first meeting of the panel*." (emphasis added) In the view of the European Communities, this requirement means that third parties are entitled to receive *all* written submissions made *prior to* the *first* meeting of the panel – even if, as in many proceedings under Article 21.5 of the DSU, there is only one meeting with the panel.

236. We review briefly the factual background against which this appeal is made. The Working Procedures provide for two written submissions by each party to be made to the Panel, followed by a single meeting of the Panel. The Panel communicated its proposed Working Procedures to the parties on 20 December 2000, and requested that the parties comment on them at the organizational meeting of the Panel to be held the following day. The proposed Rule 9 provided, in relevant part, that:

> Third parties *shall receive* copies of the parties' *first written submissions*. Any party may decide to provide the third parties with a copy of its rebuttal or other submissions. (emphasis added)

237. Neither of the parties commented on the proposed Rule 9 at the organizational meeting.[202] The Working Procedures adopted by the Panel – including the above-quoted portion of Rule 9 – were communicated to the parties on 22 December 2000, and to the third parties on 4 January 2001.

238. In its first written submission to the Panel, submitted on 17 January 2001, the European Communities requested the Panel to amend Rule 9 of the Working Procedures to provide that third parties shall receive copies of *all* the submissions filed by the parties prior to the single meeting of the Panel.[203] The United States opposed the

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[201] Panel Report, para. 6.3, subpara. 2.

[202] Panel Report, para. 6.3, subpara. 11.

[203] By way of background, we note that the European Communities has, as a third party in four unrelated proceedings under Article 21.5 of the DSU, requested an Article 21.5 panel to amend a rule in its working procedures similar to the contested portion of Rule 9 of the Working Procedures. Two of those panels denied the request by the European Communities. (Panel Report, *Australia – Measures Affecting Importation of Salmon – Recourse to Article 21.5 of the DSU by Canada*, WT/DS18/RW, adopted 20 March 2000, DSR 2000:IV, 2031, paras. 7.5 – 7.6; and Panel Report, *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather – Recourse to Article 21.5 of the DSU by the United States*, WT/DS126/RW and Corr.1, adopted 11 February 2000, DSR 2000:III, 1189, paras. 3.9-3.10) According to the United States, a similar decision refusing the request of the European Communities was taken by the panel in a third case, although such decision was not published as the parties ultimately reached a mutually acceptable solution. (Panel Report, *United States – Anti-Dumping Duty on Dynamic Random Access Memory Semiconductors (DRAMS) of One Megabit or Above from Korea – Recourse to Article 21.5 of the DSU by Korea*, WT/DS99/RW, 7 November 2000; Decision of the panel concerning the EC request for access to the parties' rebuttal submissions, 27 June 2000, reproduced in part in the United States' first submission to the Panel, para. 236; Panel Report, p. A-103) One panel agreed to modify its working procedures to provide that the third parties

request in its first written submission, submitted to the Panel on 7 February 2001. On 21 February 2001, the Panel issued its decision denying the request of the European Communities.

239. We also note that in proceedings under Article 21.5, which are subject to considerably shorter time-frames than apply under Article 12.8 of the DSU[204], panels have adopted the practice of holding a single meeting with the parties, rather than two meetings. At the same time, Article 21.5 panels uniformly have maintained the practice of requiring parties to file two written submissions.

240. We begin our examination of the European Communities' appeal with Article 12.1 of the DSU, which states that panels "shall" follow the working procedure set out in Appendix 3 to the DSU "unless the panel decides otherwise after consulting the parties to the dispute". We observe, first, that the DSU and, in particular, paragraphs 5, 6 and 7 of Appendix 3 to the DSU, "contemplate two distinguishable stages in a proceeding before a panel."[205] The "first stage" comprises the first written submissions by the parties and the first meeting of the panel, while the "second stage" consists of the second written submissions – or "rebuttal" submissions – and the second meeting with the panel.[206] However, no provision of the DSU explicitly requires panels to hold two meetings with the parties, or to oblige the parties to submit two written submissions.

241. We have already observed that:

> [a]lthough panels enjoy some discretion in establishing their own working procedures, this discretion does not extend to modifying the substantive provisions of the DSU. ... Nothing in the DSU gives a panel the authority either to disregard or to modify other explicit provisions of the DSU.[207]

242. In this appeal, we must determine whether, in refusing to require that the third parties be given access to the second, "rebuttal", submissions filed prior to the sole substantive meeting with the Panel, the Panel acted inconsistently with any provision of the DSU.

243. In respect of the provisions of the DSU governing third party rights, we have already observed that, as the DSU currently stands, the rights of third parties in panel proceedings are limited to the rights granted under Article 10 and Appendix 3 to the DSU.[208] Beyond those minimum guarantees, panels enjoy a discretion to grant addi-

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in those proceedings were entitled to receive all written submissions submitted by the parties prior to the single substantive meeting of the panel. (Panel Report, *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products – Recourse to Article 21.5 of the DSU by New Zealand and the United States* ("*Canada – Dairy (Article 21.5 – New Zealand and US)*"), WT/DS103/RW, WT/DS113/RW, adopted 18 December 2001, as reversed by the Appellate Body Report, WT/DS103/AB/RW, WT/DS113/AB/RW, DSR 2001:XIII, 6878, paras. 2.32-2.35) This is the first occasion on which this issue has been raised on appeal.

[204] Article 21.5 of the DSU contemplates that panels will complete their work within 90 days, whereas Articles 12.6 and 12.8 of the DSU contemplate that panels will circulate their reports within six months.

[205] Appellate Body Report, *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*, WT/DS56/AB/R and Corr.1, adopted 22 April 1998, DSR 1998:III, 1003, para. 79.

[206] *Ibid*.

[207] Appellate Body Report, *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, adopted 16 January 1998, DSR 1998:I, 9, para. 92.

[208] Appellate Body Report, *United States – Anti-Dumping Act of 1916* ("*US – 1916 Act*"), WT/DS136/AB/R, WT/DS162/AB/R, adopted 26 September 2000, DSR 2000:X, 4793, para. 145.

tional participatory rights to third parties in particular cases, as long as such "enhanced" rights are consistent with the provisions of the DSU and the principles of due process.[209] However, panels have no discretion to circumscribe the rights guaranteed to third parties by the provisions of the DSU.

244. In this appeal, the European Communities alleges that the Working Procedures adopted by the Panel are inconsistent with the rights afforded to third parties pursuant to Article 10.3 of the DSU, which provides:

> Third parties *shall receive* the submissions of the parties to the dispute to the *first meeting* of the panel. (emphasis added)

245. Article 10.3 of the DSU is couched in mandatory language. By its terms, third parties "shall" receive "the submissions of the parties to the *first* meeting of the panels". (emphasis added) Article 10.3 does *not* say that third parties shall receive "the *first* submissions" of the parties, but rather that they shall receive "*the* submissions" of the parties. (emphasis added) The number of submissions that third parties are entitled to receive is *not* stated. Rather, Article 10.3 defines the submissions that third parties are entitled to receive by reference to a specific step in the proceedings – the first meeting of the panel.[210] It follows, in our view, that, under this provision, third parties must be given all of the submissions that have been made by the parties to the panel up to the first meeting of the panel, irrespective of the number of such submissions which are made, including any rebuttal submissions filed in advance of the first meeting.[211]

246. The Panel, however, reasoned that the use of the word "first" in Article 10.3 "presupposes a context where there is more than one meeting of a Panel."[212] The Panel concluded, from this "presupposition", that in proceedings involving a single panel meeting, Article 10.3 "must be understood as limiting third party rights in these proceedings to access to the *first* written submissions *only*, and as not including access to the written rebuttals."[213]

247. In our view, the interpretation of Article 10.3 of the DSU must start from the express wording of the provision. We have noted that the text of Article 10.3 does not limit the number of submissions which third parties may receive prior to the "first meeting". We do not see any reason to "presuppose" that such a limitation applies in cases where the "first meeting" with the Panel proves to be the only meeting. The DSU allows panels the flexibility, in determining their procedures, to request more than one submission in advance of the first meeting, and the DSU also allows for the possibility that panels may, ultimately, hold only one meeting. The text of Article 10.3 applies the same rule in each case – third parties are entitled to receive the submissions to the first meeting.

248. We read the reference to the "first meeting" as reflecting the flexibility that exists in panel proceedings under the DSU. Thus, in any proceedings, even if only one meeting with the parties is initially scheduled, it cannot be excluded that a sec-

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[209] Appellate Body Report, *US – 1916 Act*, *supra*, footnote 208, para. 150. See also Appellate Body Report, *EC-Hormones, supra*, footnote 40, para. 154.

[210] We note, in this regard, that paragraph 6 of Appendix 3 to the DSU also links the participatory rights of third parties to this step in the proceeding. It states that third parties "*shall be invited in writing to present their views during a session of the first substantive meeting of the panel*". (emphasis added)

[211] We note, in that respect, that the DSU does not place any limits on the number of submissions which panels can request of the parties in advance of the first meeting.

[212] Panel Report, para. 6.3, subpara. 5.

[213] *Ibid*., para. 6.3, subpara. 9. (emphasis added)

ond will not be held later. Panels have the discretion to request such an additional meeting with the parties, and the parties can also request such a meeting with the panel at the stage of interim review.[214] The wording of Article 10.3 provides for this flexibility by referring generically to the "first meeting", which may be one of a series of meetings or may be the only meeting.

249. Our interpretation of Article 10.3 is also consistent with the context of that provision. Article 10.1 directs panels "fully" to take into account the interests of Members other than the parties to the dispute, and Article 10.2 requires panels to grant to third parties "an opportunity to be heard". Article 10.3 ensures that, up to a defined stage in the panel proceedings, third parties can participate fully in the proceedings, on the basis of the same written submissions as the parties themselves. Article 10.3 thereby seeks to guarantee that the third parties can participate at a session of the first meeting with the panel in a full and meaningful fashion that would not be possible if the third parties were denied written submissions made to the panel before that meeting. Moreover, panels themselves will thereby benefit more from the contributions made by third parties and will, therefore, be better able "fully" to take into account the interests of Members, as directed by Article 10.1 of the DSU.

250. In this regard, we observe that we agree with the panel in *Canada – Dairy (Article 21.5 – New Zealand and US)*, which reasoned that:

> Third parties can only [participate in an informed and, hence, meaningful, manner] if they have received all the information exchanged between the parties before that session. Otherwise, third parties might find themselves in a situation where their oral statements at the meeting become partially or totally irrelevant or moot in the light of second submissions by the parties to which third parties did not have access. Without access to all the submissions by the parties to the dispute to the first meeting of the panel, uninformed third party submissions could unduly delay panel proceedings and ... prevent the Panel from receiving "the benefit of a useful contribution by third parties which could help the Panel to make the objective assessment that it is required to make under Article 11 of the DSU.[215] (footnote omitted)

251. For these reasons, we believe that Article 10.3 requires that third parties be provided with all of the submissions made by the parties up to the time of the first panel meeting in which the third parties participate – whether that meeting is the first of two panel meetings, or the first and only panel meeting. Read in this way, Article 10.3 has the same meaning, and can be applied in the same way, regardless of the number of panel meetings that are held in a particular case.

252. We, therefore, find that, in its decision refusing the European Communities' request to modify Rule 9 of the Panel's Working Procedures, the Panel erred in its interpretation of Article 10.3 of the DSU.

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[214] Paragraph 12 of Appendix 3 to the DSU recognizes that the standard timetable for panels may be adjusted to allow for "additional meetings with the parties", including a possible meeting at the stage of interim review.

[215] Panel Report, *supra*, footnote 203, para. 2.34.

XII. CONDITIONAL APPEALS

253. The European Communities makes four conditional appeals requesting us to consider claims in respect of which the Panel exercised judicial economy.[216] It declares that these appeals are made only "in case [the Appellate Body] should reverse those of the Panel's findings that led the Panel to exercise judicial economy."[217] The European Communities states explicitly that it is *not* challenging the Panel's exercise of judicial economy *as such*, and that it considers that "the Panel has effectively ruled on all elements of the subsidy scheme under review and has, accordingly, already given sufficiently precise guidance ... ".[218]

254. The United States observes that "the conditions that would trigger the Appellate Body's consideration of any of these claims is not clear".[219]

255. In this Report, we have upheld all of the Panel's findings under appeal. Therefore, in any event, none of the conditions on which the European Communities' appeal is predicated arise, and there is no need for us to examine any of the conditional appeals.

XIII. FINDINGS AND CONCLUSIONS

256. For the reasons set out in this Report, the Appellate Body:

(a) upholds the Panel's finding, in paragraphs 8.30 and 8.43 of the Panel Report, that the ETI measure involves the foregoing of revenue which is "otherwise due" and thus gives rise to a "financial contribution" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*;

(b) upholds the Panel's finding, in paragraphs 8.75 and 9.1(a) of the Panel Report, that the ETI measure includes subsidies "contingent ... upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement*;

(c) upholds the Panel's finding, in paragraphs 8.107 and 9.1(a) of the Panel Report, that the ETI measure, viewed as a whole, does not fall within the scope of footnote 59 of the *SCM Agreement* as a measure taken to avoid the double taxation of foreign-source income;

(d) upholds the Panel's finding, in paragraphs 8.122 and 9.1(c) of the Panel Report, that the ETI measure involves export subsidies inconsistent with the United States' obligations under Articles 3.3, 8 and 10.1 of the *Agreement on Agriculture*;

(e) upholds the Panel's finding, in paragraphs 8.158 and 9.1(d) of the Panel Report, that the ETI measure is inconsistent with the United States' obligations under Article III:4 of the GATT 1994 because it accords less favourable treatment to imported products as compared with like products of United States origin;

(f) upholds the Panel's finding, in paragraphs 8.170 and 9.1(e) of the Panel Report, that the United States has not fully withdrawn the subsidies found, in the original proceedings, to be prohibited export subsi-

[216] Panel Report, paras. 8.108, 8.162-8.163 and 8.171.
[217] European Communities' other appellant's submission, para. 31.
[218] *Ibid*., para. 30.
[219] United States' appellee's submission, para. 13.

dies under Article 3.1(a) of the *SCM Agreement*, and that the United States has, therefore, failed fully to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 of the *SCM Agreement*; and

(g) finds that the Panel erred in its interpretation of Article 10.3 of the DSU in declining, in its decision of 21 February 2001, reproduced in paragraph 6.3 of the Panel Report, to rule that all the written submissions of the parties filed prior to the only meeting of the Panel must be provided to the third parties.

257. The Appellate Body *recommends* that the DSB request the United States to bring the ETI measure, found in this Report, and in the Panel Report as modified by this Report, to be inconsistent with its obligations under Article 3.1(a) of the *SCM Agreement*, under Articles 3.3, 8 and 10.1 of the *Agreement on Agriculture*, and under Article III:4 of the GATT 1994, into conformity with its obligations under those Agreements, and 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*.

UNITED STATES – TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS"

RECOURSE TO ARTICLE 21.5 OF THE DSU BY THE EUROPEAN COMMUNITIES

Report of the Panel

WT/DS108/RW

Adopted by the Dispute Settlement Body on 29 January 2002
as Modified by the Appellate Body Report

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I. PROCEDURAL BACKGROUND

1.1 On 20 March 2000, the Dispute Settlement Body (the "DSB") adopted the Appellate Body Report in WT/DS108/AB/R and the Panel Report in WT/DS108/R as modified by the Appellate Body Report in the *United States - Tax Treatment for "Foreign Sales Corporations"* dispute. In its recommendations and rulings, the DSB requested the United States to bring the FSC measure that was found, in the Appellate Body Report and in the Panel Report as modified by that Report, to be inconsistent with its obligations under Articles 3.1(a) and 3.2 of the *Agreement on Subsidies and Countervailing Measures* (the "*SCM Agreement*") and under Articles 10.1 and 8 of the *Agreement on Agriculture*, into conformity with its obligations under those Agreements.[1] The DSB specified that the FSC subsidies had to be withdrawn "at the latest with effect from 1 October 2000".[2]

1.2 In its Report, the Appellate Body, *inter alia*, upheld the Panel's finding, in paragraph 7.130 of the original Panel Report, that the FSC measure constitutes a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*; reversed the Panel's finding, in paragraph 7.159 of the original Panel Report, that the FSC measure involves "the provision of subsidies to reduce the costs of marketing exports" of agricultural products under Article 9.1(d) of the *Agreement on Agriculture* and, in consequence, reversed the Panel's findings, in paragraphs 7.165 and 7.176 of the original Panel Report, that the United States has acted inconsistently with its obliga-

[1] Original Appellate Body Report, WT/DS108/AB/R, adopted 20 March 2000, DSR 2000:III, 1619, para. 178.

[2] Original Panel Report, WT/DS108/R, adopted 20 March 2000 as modified by the original Appellate Body Report, WT/DS108/AB/R, DSR 2000:IV, 1675, para. 8.8.

tions under Article 3.3 of the *Agreement on Agriculture*; and found that the United States acts inconsistently with its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture* by applying export subsidies, through the FSC measure, in a manner which results in, or which threatens to lead to, circumvention of its export subsidy commitments with respect to both scheduled and unscheduled agricultural products.[3]

1.3 On 29 September 2000, the Chairman of the DSB received a communication from the United States in which the United States "propose[d] that the DSB modify the time-period in this dispute so as to expire on 1 November 2000".[4] The United States asked "that the DSB approve this proposal and, to that end, request[ed] a meeting of the DSB on 12 October 2000 to consider this matter."[5] On 12 October 2000, the DSB, given that there was no opposition to the US request, agreed to accede to the request of the United States as formulated in its letter of 29 September 2000 and circulated in document WT/DS108/11.[6]

1.4 On 2 October 2000, the parties informed the DSB of their Understanding on "Agreed procedures under Articles 21 and 22 of the Dispute Settlement Understanding and Article 4 of the *SCM Agreement* applicable in the follow-up to the 'United States - Tax Treatment for "Foreign Sales Corporations' dispute", concluded between the parties on 29 September 2000.[7]

1.5 On 15 November 2000, the President of the United States signed into law an Act of the United States Congress entitled the "*FSC Repeal and Extraterritorial Income Exclusion Act of 2000*"[8] (the "Act"). With the enactment of this legislation, the United States considered that it had implemented the DSB's recommendations and rulings in the dispute and that the legislation was consistent with the United States' WTO obligations.[9]

1.6 On 17 November 2000, the European Communities requested the United States to enter into consultations under Articles 4 and 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "*DSU*"), Article 4 of the *SCM Agreement*, Article 19 of the *Agreement on Agriculture* and Article XXIII:1 of the *GATT 1994* with respect to the Act. The European Communities considered that the United States had failed to comply with the DSB recommendations and rulings by 1 November 2000. Furthermore, the European Communities alleged that the Act "appears to replicate the violations of the WTO Agreement found in the original dispute rather than remove them."[10]

1.7 Consultations were held between the parties on 4 December 2000 in Geneva, but the consultations failed to settle the dispute.

1.8 On 7 December 2000, the European Communities requested the establishment of a panel as "there is a disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings" of the DSB. The European Communities made the request pursuant to Article 6 and Article 21.5 of the *DSU*, Article 4 of the *SCM Agreement*, Article 19 of the *Agree-*

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3 Original Appellate Body Report, *supra*, note 1, para. 177 (a), (b) and (d).
4 WT/DS108/11, 2 October 2000.
5 *Ibid.*
6 See Minutes of the DSB meeting held on 12 October 2000, WT/DSB/M/90, paras. 6-7.
7 Circulated as document WT/DS108/12, 5 October 2000.
8 United States Public Law 106-519, 114 Stat. 2423 (2000), Exhibit EC-5; Exhibit US-1.
9 Minutes of the DSB meeting held on 17 November 2000, WT/DSB/M/92, para. 143.
10 WT/DS108/14 and Corr. 1., 21 November 2000.

ment on Agriculture and Article XXIII of the *GATT 1994*, and as envisaged in the "Agreed procedures under Articles 21 and 22 of the Dispute Settlement Understanding and Article 4 of the SCM Agreement applicable in the follow-up to the *United States - Tax Treatment for 'Foreign Sales Corporations*' WTO dispute" between the European Communities and the United States of 29 September 2000".[11]

1.9 At its meeting on 20 December 2000, the DSB decided, in accordance with Article 21.5 of the *DSU*, to refer to the original Panel the matter raised by the European Communities in document WT/DS108/16. At that DSB meeting, it also was agreed that the Panel should have standard terms of reference as follows:[12]

> "To examine, in the light of the relevant provisions of the covered agreements cited by the European Communities in document WT/DS108/16, the matter referred to the DSB by the European Communities in that document and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements."

1.10 The Panel was composed as follows:[13]

Chairman: Mr. Crawford Falconer

Members: Mr. Didier Chambovey

Professor Seung Wha Chang

1.11 Australia, Canada, India, Jamaica and Japan reserved their rights to participate in the Panel proceedings as third parties.

1.12 The Panel met with the parties on 13-16 March 2001 and with third parties on 14 March 2001.

1.13 The Panel submitted its interim report to the parties on 22 June 2001. On 2 July 2001, both parties submitted written requests that the Panel review precise aspects of the interim report. On 9 July 2001, each party submitted written comments on the other party's written request. The Panel submitted its final report to the parties on 23 July 2001.

II. FACTUAL ASPECTS

2.1 On 15 November 2000, the United States enacted the Act[14], which repeals the provisions in the United States Internal Revenue Code ("IRC") relating to taxation of foreign sales corporations[15], subject to certain transitional provisions. In particular, the Act specifies that, in general, the amendments made by the Act "shall apply to transactions after September 30, 2000".[16] In addition, no new FSCs may be created after that date.[17] However, in the case of a FSC in existence on 30 September 2000, the amendments made by the Act shall not apply to any transaction in the ordinary course of trade or business involving a FSC which occurs: (A) before 1 January 2002; or (B) after 31 December 2001, pursuant to a binding contract between the

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[11] WT/DS108/16, 8 December 2000.

[12] See document WT/DS108/19, 5 January 2001.

[13] *Ibid.*

[14] *FSC Repeal and Extraterritorial Exclusion Act of 2000*, United States Public Law 106-519, 114 Stat. 2423 (2000), Exhibit EC-5; Exhibit US-1.

[15] See section 2 of the Act, repealing subpart C of part III of subchapter N of chapter 1 of the IRC.

[16] Act, section 5(a).

[17] Act, section 5(b)(1).

FSC (or any related person) and any unrelated person that is in effect on 30 September 2000.[18] The original FSC scheme is described in paras. 2.1-2.8 of our original Panel Report.[19]

2.2 The Act amends the IRC by, *inter alia*, inserting a new section 114, entitled "extraterritorial income". Under the heading "exclusion", the Act[20] provides that "gross income does not include extraterritorial income". Under the heading "exception", the Act[21] provides that this exclusion "shall not apply to extraterritorial income which is not qualifying foreign trade income…".

2.3 Under the Act, certain income of a United States "taxpayer"[22] may be excluded from taxation. Such income - "extraterritorial income" that is "qualifying foreign trade income" - may be earned with respect to goods only in transactions involving qualifying foreign trade property.[23]

2.4 The Act defines "extraterritorial income" as the gross income of a taxpayer attributable to foreign trading gross receipts, i.e. gross receipts generated by certain qualifying transactions involving the sale or lease of "qualifying foreign trade property" not for use in the United States.[24]

2.5 "Qualifying foreign trade income" means, with respect to any transaction, the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest of:

- 30 per cent of the foreign sale and leasing income[25] derived by the taxpayer from such transaction,
- per cent of the foreign trading gross receipts[26] derived by the taxpayer from the transaction, or

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[18] Act, section 5(c)(1).

[19] See *supra*, note 2.

[20] Act, section 3; section 114(a) IRC.

[21] Act, section 3; section 114(b) IRC.

[22] Including a foreign corporation that has elected to be treated as a US corporation for the purposes of the Act. See Act, section 3; section 943(e) IRC.

[23] And, outside the goods area, such income may be earned in relation to services which are: related and subsidiary to (i) any sale, exchange, or other disposition of qualifying foreign trade property, or (ii) any lease or rental of certain qualifying foreign trade property; for engineering or architectural services for construction projects located (or proposed for location) outside the United States; or for the performance of managerial services for a person other than a related person in furtherance of the production of certain foreign trading gross receipts. Act, section 3; section 942 IRC. The only way to earn qualifying foreign trade income that does not involve qualifying foreign trade property is through certain engineering or architectural services.

[24] Act, section 3; sections 114(e) and 942 IRC. We note that the term foreign trading gross receipts also includes the gross receipts of the taxpayer which are for certain services, some of which must involve qualifying foreign trade property, as indicated *supra*, note 23. Section 942(a)(2)(A)(i) IRC, relating to the definition of "foreign trading gross receipts", states that such receipts shall not include receipts from a transaction if the qualifying foreign trade property or services are for ultimate use in the United States.

[25] The Act defines "foreign sale and leasing income" as foreign trade income properly allocable to certain foreign economic processes performed outside the United States or derived in connection with the lease or rental of qualifying foreign trade property outside the United States. Act, section 3; section 941(c)(1) IRC. The term "foreign sale and leasing income" includes "any foreign trade income derived by the taxpayer from the sale of property described in paragraph (1)(B)". Act, section 3, section 941(c)(2) IRC, dealing with "special rules for leased property", also contains certain "limitations" in sub-paragraph (B), and section 941(c)(3) IRC contains certain "special rules".

[26] I.e. with respect to goods, gross receipts generated by certain qualifying transactions involving the sale or lease of "qualifying foreign trade property" not for use in the United States. Act, section 3;

- 15 per cent of the foreign trade income[27] derived by the taxpayer from the transaction.[28]

2.6 Qualifying foreign trade property means property –

"(A) manufactured, produced, grown or extracted within or outside the United States,

(B) held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and

(C) not more than 50 per cent of the fair market value of which is attributable to -

(i) articles manufactured, produced, grown, or extracted outside the United States, and

(ii) direct costs for labour (determined under the principles of Section 263A) performed outside the United States."[29] […]

Certain property is excluded from "qualifying foreign trade property", including oil or gas (or any primary product thereof)[30], any unprocessed timber that is a softwood[31] and any property the President may designate as in "short supply".[32]

2.7 The Act's definitions of qualifying foreign trade property and foreign trading gross receipts - which determine income that qualifies as extraterritorial income, foreign trade income and qualifying foreign trade income - thus contain at least two requirements that must be satisfied in order for a taxpayer to qualify for the exclusion from taxation: (i) a requirement that a good produced within or outside the United States must be held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States[33] (referred to in this Report as the requirement of "use outside the United States"); and (ii) a requirement that no more than 50 per cent of the fair market value of such property can be attributable to articles manufactured, produced, grown, or extracted outside the United States, and direct costs for labour performed outside the United States (referred to in this Report as the "foreign articles/labour limitation").

2.8 Foreign trading gross receipts arise from any transaction only if certain foreign economic process requirements are fulfilled in respect of a transaction.[34] This requirement is met if the taxpayer (or any person acting under contract with such taxpayer) has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction, and the foreign direct costs (i.e. attributable to specified activities performed

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section 942 IRC. The term "foreign trading gross receipts" also includes certain gross receipts for certain services, some of which must involve qualifying foreign trade property. See *supra*, note 23.

[27] The Act defines "foreign trade income" as the taxable income attributable to foreign trading gross receipts (Act, section 3; Act, section 941(b)(1) IRC).

[28] Act, section 3; section 941(a)(1) IRC. Under section 941(a)(2) IRC, a taxpayer may compute its qualifying foreign trade income under one of these three methods other than the one that results in the greatest amount of such income.

[29] Act, section 3; section 943(a)(1) IRC.

[30] Act, section 3; section 943(a)(3)(C) IRC.

[31] Act, section 3; section 943(a)(3)(E) IRC.

[32] Act, section 3; section 943(a)(4) IRC.

[33] See *supra*, para. 2.6.

[34] Act, section 3; section 942(b) IRC, except where a taxpayer's foreign trading gross receipts do not exceed US$5 million, see section 942(c) IRC.

outside the United States) incurred meet a certain proportion of the total direct costs[35] (i.e. attributable to specified activities performed anywhere). The specified activities relating to qualifying foreign trade property are:

- advertising and sales promotion;
- processing of customer orders and arranging for delivery;
- transportation outside the United States in connection with delivery to the customer;
- determination and transmittal of final invoice or statement of account or the receipt of payment; and
- assumption of credit risk.[36]

III. FINDINGS REQUESTED BY THE PARTIES

3.1 The European Communities requests the Panel to find that[37]:

(a) The FSC Replacement scheme created by the FSC Replacement Act gives rise to subsidies within the meaning of the *SCM Agreement* and the *Agreement on Agriculture*.

(b) The FSC Replacement scheme provides subsidies contingent upon export performance contrary to Article 3.1(a) of the *SCM Agreement.* This prohibition is supported and confirmed by the fact that these subsidies are specifically related to exports within the meaning of item (e) to the Illustrative List in Annex I to the *SCM Agreement*.

(c) The foreign content limitation in the FSC Replacement scheme renders the basic FSC Replacement subsidy (and the extended FSC Replacement subsidy, if this is not contrary to Article 3.1(a)) contingent upon the use of US over imported goods contrary to Article 3.1(b) of the *SCM Agreement*.

(d) Consequently, the FSC Replacement scheme grants and maintains subsidies contrary to Article 3.2 of the *SCM Agreement*.

(e) The FSC Replacement scheme accords more favourable treatment to US than to like imported products in relation to the use of such products for the production of goods for export under the scheme, contrary to Article III:4 of *GATT 1994.*

(f) The FSC Replacement scheme is inconsistent with Articles 10.1 and 8 of the *Agreement on Agriculture* or, in the alternative, with Articles 3.3 and 8 of the *Agreement on Agriculture* in conjunction with Article 9.1 of the *Agreement on Agriculture*.

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[35] The foreign direct costs attributable to the transaction generally must exceed 50 per cent of the total direct costs attributable to the transaction, but the requirement will also be satisfied if, with respect to at least two categories of direct costs, the foreign direct costs equal or exceed 85 per cent of the total direct costs attributable to each category (Act, section 3; section 942(b)(2)(A)(ii) and (B)).

[36] Act, section 3; section 942(b)(3) IRC. Section 942(b)(4) states that a taxpayer "shall be treated as meeting the requirements of this subsection with respect to any sales transaction involving any property if any related person has met such requirements in such transaction or any other sales transaction involving such property".

[37] EC first written submission, Annex A-1, paras. 29 and 259.

(g) By maintaining the availability of FSC subsidies after 30 September 2000, for transactions effected by existing FSCs until 31 December 2001 (and, under certain conditions, for an indefinite period) the US has failed to withdraw the FSC subsidies as required by Article 4.7 *SCM Agreement* and the recommendations and rulings of the DSB and has also failed to comply with its obligations under Article 21 *DSU*.

(h) By failing to withdraw the FSC subsidies and to comply with the rulings and recommendations of the DSB by the end of the period of time allowed by the DSB, the US has also failed to comply with its obligations under Article 21 *DSU*.

3.2 In addition, the European Communities "requests the Panel to make a preliminary ruling to the effect that third parties are entitled to receive all written submissions of the parties submitted prior to the meeting of the Panel and to make this preliminary ruling and communicate it to the parties and the third parties as soon as possible after receipt of the US first written submission and before the date for the presentation of the second written submissions."[38]

3.3 The United States requests that the Panel find that[39]:

(a) The Act's exclusion of extraterritorial income from US taxation does not constitute a prohibited subsidy contingent upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*.

(b) The Act's exclusion of extraterritorial income from US taxation does not constitute a prohibited subsidy contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the *SCM Agreement*.

(c) The Act does not result in less favourable treatment being provided to imported goods in comparison to the treatment afforded to like domestic goods within the meaning of Article III:4 of *GATT 1994*.

(d) The Act's exclusion of extraterritorial income from US taxation is not inconsistent with US obligations under Articles 10.1 and 8, or Article 3.3 and 8, of the *Agreement on Agriculture*.

(e) The United States complied with the DSB's recommendations and rulings in the original FSC dispute.

(f) The third parties in this proceeding do not have a right to the parties' rebuttal submissions.

IV. ARGUMENTS OF THE PARTIES

4.1 The arguments of the parties are set out in their submissions to the Panel. The parties' submissions are attached to this Report as Annexes (see List of Annexes, page 120).

[38] EC first written submission, Annex A-1, para. 260.
[39] US first written submission, Annex A-2, para. 239.

V. ARGUMENTS OF THE THIRD PARTIES

5.1 The arguments of the third parties, Australia, Canada, India and Japan, are set out in their submissions to the Panel and are attached to this Report as Annexes (see List of Annexes, page 120). One third party, Jamaica, made no written or oral submissions to the Panel.

VI. PROCEDURAL MATTERS

A. Third Party Access to Rebuttal Submissions

6.1 In its first written submission, the European Communities requested "the Panel to make a preliminary ruling to the effect that third parties are entitled to receive all written submissions of the parties submitted prior to the meeting of the Panel and to make this preliminary ruling and communicate it to the parties and the third parties as soon as possible after receipt of the US first written submission and before the date for the presentation of the second written submissions."[40]

6.2 In response, the United States requested that we find that the third parties in this proceeding do not have a right to the parties' rebuttal submissions.[41]

6.3 On 21 February 2001, the Panel issued the following decision to the parties:[42]

> *Panel decision concerning the request by the European Communities relating to third party access to parties' rebuttal submissions*
>
> 1. The working procedures adopted by the Panel provide that third parties "shall receive copies of the parties' first written submissions" and that "[a]ny party may decide to provide the third parties with a copy of its rebuttal or other submissions." The European Communities contends that the working procedures conflict with Article 10.3 *DSU* as they do not require that third parties receive *all* of the parties' submissions preceding the one substantive Panel meeting in an accelerated panel process under Article 21.5 *DSU*. The European Communities requests that the Panel rule that third parties be allowed to receive all the main parties' submissions preceding the single Panel meeting.[1] The United States asks us to deny this request.[2]
>
> 2. For the reasons stated below, we do not consider that Article 10.3 *DSU* requires that third parties receive all pre-meeting submissions of the parties (including rebuttal submissions) in the context of an accelerated proceeding under Article 21.5 *DSU* that involves only one meeting of the parties and third parties with the panel. Accordingly, we deny the EC request.
>
> 3. The EC argument is based upon Article 10.3 *DSU*, which provides: "Third parties shall receive the submissions of the parties to the dispute to the first meeting of the panel."

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[40] EC first written submission, Annex A-1, para. 260. See paras. 247-258 for EC arguments in support of this request.

[41] US first written submission, Annex A-2, para. 239(f). See paras. 234-238 for US arguments in response to the EC request.

[42] We have made certain technical changes to the text of the decision.

4. In reaching our decision, we took note of the weight placed by the EC argument on the text of Article 10.3 *DSU*[3], as well as on certain perceived considerations in the *DSU*.[4] We were mindful also of the *Vienna Convention* rules on treaty interpretation, including the need to avoid isolating the words of a treaty from their context.[5]

5. We note, to begin with, the express reference in Article 10.3 to the "first" meeting of the panel. In our view, this reference in Article 10.3 to "submissions ... to the *first* meeting of the panel" (emphasis added) cannot be interpreted in such a way as to render the word "first" devoid of meaning. Its use clearly presupposes a context where there is more than one meeting of a Panel. This reflects the fact that the reference at issue is made in the context of standard panel procedures.

6. Under such procedures, a panel ordinarily holds two meetings. Documentation is submitted prior to each of these meetings.[6] Third parties ordinarily do not have a right to hear the oral statements of the parties at any panel meeting (including the first meeting). Rather, they attend a single special third party session set aside for this purpose and held subsequent to the first panel meeting with the parties.[7] In that context, it should be emphasized, the manifest effect of Article 10.3 *DSU* is to limit third party rights to receive only the parties' first written submissions (submitted to the first meeting); not the parties' written rebuttals (presented to the second meeting).

7. A panel under Article 21.5 must follow *DSU* panel procedures. But it must do so in a particular context, namely in the context of a much stricter timeframe. As a result, this Panel decided to hold only one meeting, rather than two, as would usually be the case (i.e. in the context of a proceeding with a lengthier timeframe). Our working procedures maintained the practice of obtaining from the parties two sets of documentation in the form of first written submissions and written rebuttals (both, however, prior to the single Panel meeting). We note, further, that such arrangements received the concurrence of the parties. It was, indeed, their declared preference.

8. In our view, the plain language of Article 10.3 *DSU* does not expressly address the extent of third party access to submissions in a situation where there is only one meeting pursuant to the constraints imposed by Article 21.5 *DSU*. This is manifest from the plain language which, as noted above in paragraph 5, refers to a "first" meeting. However, it is incumbent upon us to construe Article 10.3 *DSU* "…in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".[8]

9. In this regard, the Panel is of the view that in order to give effect to Article 10.3 *DSU*, this provision must be understood as limiting third party rights in these proceedings to access to the first written submissions only, and as not including access to the written rebuttals. In the absence of any explicit or express provision to the contrary in an Article 21.5 proceeding involving only one panel meeting, we can

find no basis to warrant a contrary approach. The drafters of the *DSU* restricted third party rights. It is not this Panel's task to extend them in Article 21.5 procedures.[9]

10. Nor, for that matter, can we see that there is any other reason why such an approach could be construed to be anything other than most consonant with Article 10.3 *DSU*. In our view, it is an arrangement that ensures that the situation of all parties is most consistently applied. As noted, had the Panel decided to hold two meetings with the parties - the more frequent situation envisioned in Article 10 and Appendix 3 *DSU* - third parties would have received the written submissions made prior to the first meeting, but not rebuttals or other subsequent submissions. Thus, in a more frequent procedure, third parties would be in precisely the same position as they are here with respect to their ability to present views to the Panel. Therefore, in our view, the procedures we have adopted more closely parallel the degree of access foreseen by Article 10.3 *DSU* than if they *required* that third parties receive the rebuttals. They are thus, in our view, in keeping with Article 10.3 *DSU* in a proceeding involving only one substantive meeting.

11. Moreover, we gave the parties an opportunity to comment on draft working procedures and timetable, and at no time did either party make any comment with respect to any modification of this aspect of the working procedures.

12. Finally, while we recognize that an extension of third party rights would not be precluded were special circumstances to arise, we note that no third party has requested any third party rights other than those referred to in our working procedures and see no special reason why any third party to this case would need extended third party rights.

13. While we decline the EC request to rule that third parties be allowed to receive all the main parties' submissions preceding the single Panel meeting, we recall that pursuant to our working procedures, "[a]ny party may decide to provide the third parties with a copy of its rebuttal or other submissions."

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1 EC first written submission, Annex A-1, paras. 247 *ff*.

2 US first written submission, Annex A-2, para. 237.

3 e.g. EC first written submission, Annex A-1, paras. 251-252.

4 *Ibid*., paras. 253-254.

5 Pursuant to Article 31 of the *Vienna Convention on the Law of Treaties* (23 May 1969, 1155 U.N.T.S. 331; 8 I.L.M. 679) to the extent it reflects customary international law, the Panel is required to interpret Article 10.3 *DSU* "in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".

6 Appendix 3 to the *DSU*, paras. 4-7.

7 *Ibid*., paras. 5 and 6.

8 See *supra*, note 5.

9 We note that at least two other Article 21.5 panels were of a similar view. See Article 21.5 Panel Report, *Australia - Subsidies Provided to Producers and Export-*

ers of Automotive Leather, Recourse to Article 21.5 of the DSU by the United States, WT/DS126/RW, adopted 11 February 2000, para. 3.9. See Article 21.5 Panel Report, *Australia - Measures Affecting Importation of Salmon, Recourse to Article 21.5 by Canada;* WT/DS18/RW, adopted 20 March 2000, para. 7.5.

B. Timing of Rebuttal Submissions

6.4 On 12 February 2001, the United States sent a written communication to the Panel requesting that we revise the schedule for this proceeding in order to provide for consecutive, rather than simultaneous, filing of the second written submissions by the parties. The United States stated that the existing schedule meant that any response by the United States to the EC second submission would have to be presented by the United States in its oral statement at the Panel meeting. The United States was of the view that consecutive filing would be of more assistance to the Panel in its work. The United States asserted that while the European Communities had new material from the United States to rebut in its rebuttal submission, the United States did not. The United States further argued that the European Communities has the opportunity to file two written submission, while the United States was limited to one.

6.5 On 14 February 2001, the European Communities sent a written communication to the Panel, asking that we "reject this request" and expressing surprise that the United States was trying to reopen this matter at this late stage in the proceeding, after the deadline for requesting preliminary rulings. The European Communities asserted that "[s]imultaneous rebuttals are required by Article 12.6 DSU" and that this rule had also been followed in previous panel proceedings under Article 21.5 *DSU*. The European Communities stated that these considerations had presumably led the Panel to reject the United States request at the organizational meeting with the parties in December 2000.

6.6 On 21 February 2001, the Panel issued the following decision to the parties:

Panel decision concerning the request by the United States relating to the timing of rebuttal submissions

1. We have carefully considered the request by the United States of 12 February 2001 that the Panel provide for consecutive, rather than simultaneous, filing of the parties' second written submissions, as well as the responding communication of the European Communities dated 14 February 2001.

2. We recall that we adopted our working procedures after having heard the views of the parties, including their views on the issue of the timing of the filing of their rebuttal submissions. We do not believe that any development or consideration has since arisen that would require us to reconsider this aspect of our working procedures, particularly given the current advanced stage of the proceedings and the difficulties inherent in adjusting other aspects of the Panel's schedule that such a change would necessitate.

3. We therefore deny this request by the United States to change the Panel's schedule with respect to the timing for filing the parties' second written submissions. We note that the United States, as well as the European Communities, if they wish, would be able to respond to,

or comment on, the other party's rebuttals in their oral statements at the substantive meeting.

VII. INTERIM REVIEW

7.1 The Panel submitted its interim report to the parties on 22 June 2001. On 2 July 2001, both parties submitted written requests that the Panel review precise aspects of the interim report. On 9 July 2001, each party submitted written comments on the other party's written request.

A. Original Comments by the European Communities

7.2 The **European Communities** suggests that we insert references to the panel report in *Canada-Autos*[43] in footnotes relating to paras. 8.148 and 8.157. The **Panel** has inserted such a reference in footnote 262 and clarified our reasoning in paragraph 8.157.

7.3 The **European Communities** asserts that we inaccurately reflected its argument concerning the treatment afforded by the Act to imported goods *vis-à-vis* domestic goods in paragraph 8.151 (and footnote 264). The **Panel** has adjusted the drafting in this paragraph (and footnote 264).

7.4 The **European Communities** further argues that the formulation that originally appeared in paragraph 8.164 suggested that the DSB had changed an adopted panel report, by referring to a date contained in the our original Report and then stating that the DSB had subsequently extended that date. In the EC view, the DSB agreed to accede to the request of the United States as formulated in document WT/DS108/11, which referred to a time-period set (implicitly) by the DSB for the "necessary measures" to be *adopted* by the United States; the DSB did not affect the explicit recommendation that the FSC subsidies "must be withdrawn at the latest with effect from 1 October 2000." The European Communities submits that paragraph 8.171 was also inaccurate as to the DSB specification in this dispute. The **United States** disagrees with the EC's "mischaracterization of the US request that was granted" at the 12 October 2000 meeting of the DSB. According to the United States, at that meeting, the United States requested, and was granted, an extension of the time-period within which the United States was to withdraw the measure. The **Panel** has made changes to paragraphs 8.164 and 8.171 in order to reflect more clearly our understanding of the US request acceded to by the DSB. We have, as well, made changes to paragraph 8.169 in order to maintain consistency.

7.5 The **European Communities** submits that it is not appropriate for us to make a recommendation in this case, as our mandate under Article 21.5 *DSU* is to decide a disagreement. In the EC view, this replaces the normal rule in Articles 7 and 11 *DSU* that a panel makes findings so as to assist the DSB in making recommendations and rulings. The European Communities argues that we have already made the recommendation referred to in Article 19 *DSU* in our original Report. The **Panel**, noting that the United States did not respond to this EC comment and that practice in this area has not been entirely consistent in Article 21.5 *DSU* proceedings[44], is of the

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[43] *Infra*, para. 231.

[44] Certain Article 21.5 *DSU* panels have made recommendations (e.g. Article 21.5 Panel Report, *European Communities - Regime for the Importation, Sale And Distribution of Bananas - Recourse*

view that the original recommendation adopted by the DSB on 20 March 2000 remains operative. We have therefore deleted what was originally paragraph 9.3 of the interim report (and made a consequential change in the title of Section IX of the Report).

B. Original Comments by the United States

7.6 The **United States** argues that we had omitted a reference in Section II to the fact that foreign tax credits are not allowed in respect of excluded extraterritorial income, as well as an indication that the "legislative history" of the Act "makes clear that because the Act's exclusion was intended to avoid double taxation, tax credits are not allowed on excluded income in order to avoid double relief of double taxation." The United States requests the insertion of a new paragraph to this effect. The **European Communities** considers that the new paragraph proposed by the United States is misleading and unnecessary, but that if we consider including a reference to the Act, section 3; section 114(d) IRC, we should also include a reference to the Act, section 3, section 943(d) IRC. The **Panel** notes that we refer to and elaborate upon certain of these elements in our examination under footnote 59 of the *SCM Agreement*, *infra*, paragraphs 8.76-8.108. We have therefore made modifications to footnote 197 to ensure that the text of the Senate and House Reports referred to by the United States are appropriately reflected in the substantive part of our analysis.

7.7 The **United States** submits that paragraph 2.3 is inaccurate as it states that certain income "may be" rather than "is" excluded from taxation, and that paragraph 2.7 was inaccurate as it stated that the definitions of qualifying foreign trade property and foreign trading gross receipts determine income that "may" qualify as extraterritorial income (rather than "income that qualifies as extraterritorial income"). The **European Communities** understands us to have used the word "may" in paragraph 2.3 because, pursuant to the Act[45], a taxpayer may elect to exclude certain receipts from foreign trading gross receipts so that the corresponding income will not be qualifying foreign trade income. The European Communities has no objection to the proposed change in paragraph 2.7. The **Panel** has maintained the term "may be" in paragraph 2.3. In our view, this term more accurately characterizes the situation, not least because, pursuant to the Act[46], the term "foreign trading gross receipts" shall not include receipts of a taxpayer from a transaction if the taxpayer elects not to have such receipts taken into account. Noting that the European Communities does not object to the change proposed by the United States in paragraph 2.7, and recalling the

To Article 21.5 By Ecuador, WT/DS27/RW/ECU, adopted 6 May 1999, DSR 1999:II, 803; Article 21.5 Panel Report, *Australia – Measures Affecting Importation of Salmon - Recourse to Article 21.5 by Canada*, WT/DS18/RW, adopted 20 March 2000, DSR 2000:IV, 2031; Article 21.5 Panel Report, *Mexico-Anti-Dumping Investigation of High Fructose Corn Syrup (HFCS) from the United States*, WT/DS132/RW, circulated 22 June 2001, DSR 2001:XIII, 6717), while others have not (e.g. Article 21.5 Panel Report, *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather - Recourse to Article 21.5 of the DSU by the United States*, WT/DS126/RW, adopted 20 March 2000, DSR 2000:III, 1189; Article 21.5 Panel Report, *Brazil – Export Financing Programme for Aircraft - Recourse By Canada To Article 21.5 of the DSU*, WT/DS46/RW, adopted 4 August 2000, DSR 2000:IX, 4093; Article 21.5 Panel Report, *Canada – Measures Affecting the Export of Civilian Aircraft*, *Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/RW, adopted 4 August 2000, DSR 2000:IX, 4315).

[45] Act, section 3; section 942(a)(3).

[46] Act, section 3; section 942(a)(3).

fact that income that "qualifies" as qualifying foreign trade income need not necessarily be excluded from taxation, we have made the requested change in paragraph 2.7.

7.8 The **United States** argues that our Report inaccurately indicated - in paragraphs 2.3, 2.4 and 2.5 (footnote 26) - that qualifying foreign trade income could be generated only by the sale or lease of qualifying foreign trade property, and submits that such income may also be generated by certain services, including engineering or architectural services without regard to qualifying foreign trade property. The **European Communities** agrees that qualifying foreign trade income may be earned from architectural or engineering services performed outside the United States. The European Communities submits that this is the only case in which foreign trading gross receipts may be earned that does not involve qualifying foreign trade property, but that this has not been considered relevant for the debate and is nowhere discussed in the Report. The **Panel** has made certain insertions in footnotes 23, 24, and 26, to clarify that foreign trading gross receipts may be generated in certain transactions relating to services involving qualifying foreign trade property, as well as engineering or architectural services for construction projects located (or proposed for location) outside the United States and not involving qualifying foreign trade property. We note that, with respect to goods, qualifying foreign trade income may be generated only in certain transactions involving qualifying foreign trade property and that we had originally been referring to the Act only in respect of goods, and had not originally elaborated upon the Act in respect of services.

7.9 The **United States** further submits that we had inaccurately omitted an element of the definition of "foreign sale and leasing income" in paragraph 2.5, footnote 25. The **European Communities** submits that a complete definition of foreign sale and leasing income would have to take into account all of the provisions of section 941(c) IRC. The **Panel** has inserted the additional element set out in the Act (section 3; section 941(c)(2) IRC), as identified by the United States, as well as referring to the remaining paragraphs of the provision concerned.

7.10 The **United States** suggests that we incorporate the precise wording of the Act in our description of the requirement of use outside the United States in paragraph 2.7. The **European Communities** does not object to this suggestion. The **Panel** has reflected the full wording of the text of the Act[47] in our description of the requirement in paragraph 2.7.

7.11 The **United States** submits that the list of findings it had requested was incomplete in paragraph 3.3, as it omitted the requested finding that third parties in this proceeding did not have a right to parties' rebuttal submissions. The **European Communities** submits that we deal with this US request in paragraph 6.2. The **Panel**, while noting that we deal with such procedural matters in Section VI of our Report, and that we already specifically refer to this US request in paragraph 6.2, has inserted the finding requested by the United States in paragraph 3.3. In order to maintain consistency, we have also inserted, in paragraph 3.2, the procedural finding requested by the European Communities.

7.12 The **United States** objects to our citation, in paragraph 8.38, of section 941(a)(1) IRC as support for our conclusion that the text of the Act is inconclusive on the question of whether extraterritorial income is excluded from gross income. In the US view, this citation is inaccurate and, as the United States submits it had explained

[47] Act, section 3; section 943(a)(1)(B) IRC:

during the proceedings[48], the rule set forth in this provision functions as a computational mechanism for determining the amount of the gross income exclusion. The **European Communities** considers that no change need be made to this paragraph, and that even if section 941(a)(1) IRC includes a "computational mechanism", the presence of such mechanism confirms that it is not the "extraterritorial income" as such that is excluded, but only a portion of it (and then only upon fulfilment of certain conditions). The European Communities submits that the reference to section 941(a)(1) IRC merely confirms the conclusion already drawn by referring to section 114 IRC, a provision making clear that only a fraction of the "category" "extraterritorial income" - qualifying foreign trade income - can actually be "excluded" (if the relevant conditions are met). The **Panel** takes note of these comments and has maintained the reference to the provision in question. It is the structure of the provision, read in conjunction with the other relevant provisions of the Act, that provides the basis for our analysis in paragraph 8.38.

7.13 The **United States** contends that in paragraph 8.40 (and elsewhere), we appear to attach significance to the fact that the exclusion of extraterritorial income is (according to the Panel) based on "highly selective qualitative conditions and quantitative requirements." We repeat this phrase several times, so, presumably, the US argues, we must consider this fact significant. In the view of the United States, however, the relevance of this fact is not readily apparent, and is not clarified by our analysis. Indeed, the United States submits that there is an inherent contradiction between our "repudiation of the relevance of the concept of specificity" in footnote 108, and our "repeated invocation of the "highly selective qualitative conditions and quantitative requirements" as a reason for finding the Act's exclusion to constitute the foregoing of revenue that is otherwise due". It seems to the United States that we are saying one of two things: (1) the exclusion for extraterritorial income constitutes foregone revenue that is otherwise due because the exclusion is "highly selective"; or (2) any exclusion from gross income, regardless of how broad it might be, constitutes foregone revenue that is otherwise due. In the view of the United States, it is essential that we clarify our analysis on this point. The **European Communities** submits that our reference to the "highly selective conditions" for obtaining the tax benefit is not contradictory with our "rejecting the relevance of the notion of "specificity"". According to the European Communities, our view on the specificity notion is clearly explained in footnote 108. For the European Communities, excluding the relevance, in interpreting Article 1 of the *SCM Agreement*, of a notion which becomes relevant under Article 2 of the Agreement (that is, once it is established that a subsidy exists), by no means takes away our duty to evaluate the structure of a measure in order to assess whether there is revenue foregone which is "otherwise due" in the sense of Article 1.1. The European Communities sees no reason to change this paragraph and notes that the United States makes no precise proposal. The **Panel** perceives no contradiction in our analytical approach. As we state *infra*, paragraph 8.26, "[b]y treating as "non-taxable" certain income on the basis of highly selective qualitative conditions and quantitative requirements, the Act effectively carves such income out from another situation….". This selective "carve-out" under the Act that we address in our Article 1.1(a) analysis is conceptually distinct from the notion of specificity within the meaning of Articles 1.2 and 2 of the *SCM Agreement*. We have, however, made

[48] The United States refers here to US response to Panel Question 7, Annex F-3, paras. 10-13.

certain clarifications of our reasoning in the text of Section VIII(B)(1)(b)(i) of our Report, including in footnote 108.

7.14 The **United States** argues that, in paragraphs 8.67 and 8.72, we state that a differentiation in treatment – *i.e.*, that domestically sold products may not be given less favorable treatment than export products – constitutes export contingency within the meaning of Article 3.1(a) of the *SCM Agreement*. In the view of the United States, our discussion of this point fails to connect the rule we articulate to the actual text of Article 3.1(a). In the view of the United States, we should fill in this gap in our analysis in order to add clarity to our resolution of a critical issue in this dispute. In the **European Communities'** view, the reference to "differentiation in treatment" is easily "connected" to the actual text of Article 3.1(a), contrary to the US suggestion. According to the European Communities, we make this perfectly clear in paragraph 8.72. The European Communities submits that if we wish to make the text of paragraph 8.67 even clearer for the United States, we could insert language clarifying that the differentiation in treatment is as regards eligibility or non-eligibility for the tax exemption. The **Panel** does not concur with the US view that we fail to connect the rule we articulate to the text of Article 3.1(a) of the *SCM Agreement*. In this context, we recall that an examination of *de jure* contingency under Article 3.1(a) calls for an examination of whether export contingency is apparent from the words of the Act, or can be derived by necessary implication (*infra*, paras.8.55-8.56). We then find that the words of the Act make clear that the subsidy is not available in relation to goods produced within the United States sold for use within the United States (*infra*, para. 8.60). It is the differential treatment provided for in the Act - that is, if US-produced goods are exported, the subsidy is available, while if they are sold in the domestic market, it is not - that renders the Act contingent upon export performance within the meaning of Article 3.1(a).

7.15 With respect to paragraphs 8.76-8.108, the **United States** submits that the parties disagreed during the proceedings as to which party bore the burden of proof with respect to footnote 59. However, the United States submits, in our discussion of footnote 59 and the status of the Act as a "double taxation avoidance measure", nowhere do we articulate which party bore the burden of proof.[49] In the view of the United States, our analysis of the footnote 59 issue is inadequate and incomplete without an explanation as to how we allocated the burden of proof. The **European Communities** does not agree that we are required to "articulate which party bore the burden of proof" as requested by the United States, and that the Appellate Body has confirmed on several occasions that this is not necessary.[50] The European Communities reads the interim report as indicating that we did not need to consider the issue of burden of proof because we had all the information we needed to come to the conclusions we did. In the EC view, a detailed consideration of the issue of bur-

[49] The United States notes that we also refrained from addressing the burden of proof with respect to other issues, as well. However, the United States note, with respect to these other issues there was no serious disagreement that the EC, as the complainant, bore the burden of proof.

[50] The European Communities cites Appellate Body Report, *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products ("Korea – Dairy Safeguards")*, WT/DS98/AB/R, adopted 12 January 2000, DSR 2000:I, 3, para. 145; Appellate Body Report, *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, adopted 16 January 1998, DSR 1998:I, 9, para. 74; and, more recently, Appellate Body Report, *Thailand – Anti-Dumping Duties on Angles, Shapes and Sections of Iron or Non-Alloy Steel and H-Beams from Poland ("Thailand – H-Beams")*, WT/DS122/AB/R, adopted 5 April 2001, DSR 2001:VII, 2701, para. 134.

den of proof is only really necessary when the evidence is incomplete or is in equipoise. According to the European Communities, the absence of a specific consideration of the burden of proof is also consistent with the Panel's approach of not considering, and therefore not prejudicing, the question of whether the last sentence of footnote 59 is an exception to Article 3.1(a) or not. The European Communities submits that we could explain in response to the United States request that, even if the European Communities were to have the burden of proof that the conditions of the last sentence of footnote 59 were not met, we consider that the European Communities had satisfied this burden. The **Panel** agrees with the United States that it is appropriate for us to identify who bears the burden of proof on this issue.[51] Accordingly, we have clarified *infra*, paragraph 8.90, that, in our view the United States bears the burden of proof in this context. In any event, we consider that the evidence and argumentation adduced by both parties was sufficient to enable us properly to weigh this evidence and argumentation in reaching our finding. Moreover, even if the European Communities bore the burden of proving that the Act was not within the scope of the last sentence of footnote 59, we consider that the European Communities discharged this burden.

7.16 The **United States** submits that the last sentence in paragraph 8.102 appeared to have disregarded the first element of the "foreign sales and leasing income" prong of the Act, which excludes income attributable to foreign economic processes.[52] In the view of the United States, the last sentence of paragraph 8.102, as well as our analysis related thereto, was inaccurate and incomplete to the extent that it failed to take this element of the "foreign sales and leasing income " prong into account. According to the **European Communities**, these US comments appear to be a rather artificial attempt to have us include in the Report consideration of an argument that the United States raised for the first time in its comments on the European Communities' answers to the Panel's questions (and that did not appear to bear any real connection therewith) and which had not been debated during the proceeding. The European Communities submits that the United States appears to argue that there may be a relationship between the extent of "foreign economic processes" conducted and the amount of the excluded income where qualifying foreign trade income is calculated on the basis of foreign sale and leasing income in accordance with Act, section 3; section 941(c)(1)(A) IRC. While the European Communities is of the view that it cannot be expected to deal with this complex issue at this stage of the proceedings, it made several brief points to demonstrate that the arguments are unmeritorious. The European Communities asserts that Act, section 3; section 941(c)(1)(A) IRC constitutes only one of two ways of calculating "foreign sales and leasing income" which in turn is only one out of three ways of calculating "qualifying foreign trade income".

[51] By contrast, we understand that a panel is not required to make an explicit ruling on whether a *prima facie* case has been established before proceeding to examine the evidence submitted with a view to rebuttal. See, for example, Appellate Body Report, *Korea- Dairy Safeguards, supra,* note 50, para. 145: "We find no provision in the DSU ... that requires a panel to make an explicit ruling on whether the complainant has established a *prima facie* case of violation before a panel may proceed to examine the respondent's defence and evidence." See also Appellate Body Report, *Thailand - H-Beams, supra*, note 50, para. 134: "…a panel is not required to make a separate and specific finding, in each and every instance, that a party has met its burden of proof in respect of a particular claim, or that a party has rebutted a *prima facie* case."

[52] The United States refers to Act, section 3, section 941(c)(1)(A) IRC; US first written submission, Annex A-2, para. 33, note 39; and US comments on EC Answers to Questions from the Panel, Annex F-6, paras. 64-68.

The alternative way of calculating "foreign sales and leasing income" is set out in Act, section 3; section 941(c)(1)(B) IRC, from which the "attributable" or "properly allocable" language on which the United States appears to rely is absent. According to the European Communities, the method for calculating qualifying foreign trade income based on "foreign sale and leasing income" in Act, section 3; section 941(a)(1) IRC in fact corresponds to the calculation of FSC income based on arm's length pricing under the original FSC scheme (which is why the exclusion is 30 per cent). Just as in the case of the FSC scheme, this provision cannot serve to justify the FSC Replacement scheme since taxpayers are always able to use the most favourable basis for calculating the exemption. In this connection, the European Communities observes that the definition of foreign trading gross receipts also covers lease income (Act, section 3; section 942(a)(1)(B) and (C)(ii) IRC). According to the European Communities, by raising this argument, the United States is effectively asking us to rule on a hypothetical scheme that does not at present exist by asking us to imagine a system where the amount of qualifying foreign trade income (that is "foreign sales and leasing income" calculated under Act, section 3; section 941(c)(1)(A) IRC) may arguably bear some relationship to the amount of the foreign activity. There are many reasons why such a hypothetical scheme based on Act, section 3; section 941(c)(1)(A) IRC would also not be a "measure to avoid the double taxation of foreign-source income." However, the European Communities submits, we may simply refuse to rule on such a hypothetical scheme, just as we refused to rule on a hypothetical scheme involving only wholly foreign transactions in paragraph 8.163 of the Report (even though, the EC submits, we had the benefit of a proper debate between the parties on the issue of wholly foreign transactions). The European Communities made certain drafting suggestions if we did wish to make changes to our Report. In light of the comments of the parties, the **Panel** has made certain clarifications in the text of paragraph 8.102 and inserted footnote 204.

7.17 The **United States** argues that the thrust of paragraph 8.104 appears to be that a measure to avoid double taxation within the meaning of footnote 59 must be general in nature. In the view of the United States, nothing in the text of footnote 59 suggests that a broad measure is necessary. Likewise, nothing in the text of footnote 59 suggests that a Member is precluded from using tax credits as a double taxation avoidance measure with respect to some products or some types of transactions and the exemption method with respect to other products or other types of transactions. Similarly, the United States submits, there is nothing in the text of footnote 59 which suggests that a Member is precluded from using a combination of tax credits and the exemption method with respect to a single transaction. It is an undisputed fact in this case that the exemption method results in more favorable tax treatment for exports. Therefore, a "reasonable legislature" – the role, the United States argues, that "the Panel has assigned to itself" – might very well decide to "draft legislation, such as the Act", which uses a combination of methods to avoid double taxation. Accordingly, in the view of the United States, we should clarify our discussion of footnote 59 by explaining why a measure to avoid double taxation, within the meaning of the footnote, must be of a general nature. Alternatively, if the United States has misunderstood our position, we should explain why we find the Act's perceived lack of uniformity relevant, or, to use our term, "striking." The **European Communities** does not understand us to be saying that measures relevant under footnote 59 must be general in nature, or that they must be "broad". If we are minded to further develop our reasoning to respond to the United States request, the European Communities sub-

mits that we may wish to consider the following comments. In the European Communities' view, we correctly weighed the "overall structure and design" of the specific measure before it and, based on its specific features, decided on the issue of whether it was a measure "to avoid" double taxation. As regards specifically the reference to legislative history, the European Communities submits, as observed by the Appellate Body in *Japan – Alcoholic Beverages*, and reiterated in *Chile – Alcoholic Beverages* (to which, the European Communities argues, we could also usefully refer), one has to proceed to "an examination of the design, architecture and structure of a tax measure precisely to permit identification of a measure's objectives or purposes *as revealed or objectified in the measure itself*" (emphasis added by EC).[53] For the record and in order to avoid any possible misunderstanding, the European Communities reiterates that it does not accept the United States' contention that the exemption method results in a more favourable tax treatment for exports – which is not, therefore, an undisputed fact – and refers us to the EC explanation of its position.[54]
The **Panel** has taken note of these comments of the parties. We disagree with the US characterization of our finding as requiring that a measure be "broad" or "general" to fall within the scope of the fifth sentence of footnote 59. We recall our statements *infra*, paragraph 8.97, that the Act is unusually broad for a measure whose purpose is to avoid double taxation, and at the same time, the Act is unusually narrow for a measure whose asserted purpose is to avoid double taxation. Further, we note there "that the Act overlaps with an extensive system of bilateral agreements designed to avoid double taxation through foreign tax credits, and its application is not designed to cover situations where such agreements did not exist." In particular, we reiterate that no single one of these elements, taken separately, would necessarily lead us to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income; taken together, however, they lead us to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income within the meaning of footnote 59. As to the alternative US argument that we should explain why we find the Act's perceived lack of uniformity relevant, or "striking", we recall our statement *infra*, paragraph 8.95, that "we consider that the relationship between the measure and its asserted purpose - i.e. "to avoid the double taxation of foreign-source income …" - must be reasonably discernable". As indicated there, we seek to ascertain whether the Act is a measure "to avoid" the double taxation of foreign-source income by concentrating our examination on a review of the overall structure, design and operation of the Act in the context of the broader United States tax system. Taken together, the Act's breadth - in certain respects - and its narrowness - in other respects, in conjunction with the other aspects of the Act's structure and design that we examine lead us to find that the relationship between the measure and its asserted purpose is not reasonably discernable. We have therefore maintained our original language while making an insertion in footnote 197.

7.18 We have also made certain technical revisions and clarifications in paragraphs 1.13, 8.60, 8.66, 8.80, 8.91, 8.94, 8.95, 8.97, 8.104, 8.105, 8.107, 8.108, 8.163 and 9.1, including in certain footnotes linked to those paragraphs.

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[53] Appellate Body Report, *Chile – Taxes on Alcoholic Beverages ("Chile – Alcoholic Beverages")*, WT/DS87/AB/R, WT/DS110/AB/R, adopted 12 January 2000, DSR 2000:I, 281, para. 71.

[54] The European Communities refers to EC Responses to Panel Questions, Annex F-1, paras. 54 to 57, and, in particular, para. 56.

VIII. FINDINGS

A. Panel's Approach to Examination of EC Claims in this Dispute

8.1 We note that the European Communities has confirmed that, in its view, "there would no longer be a prohibited subsidy within the meaning of Article 3 of the *SCM Agreement*" if the United States eliminated the requirements that the property be held for use outside the United States and the 50 per cent "foreign content limitation".[55] Therefore, we will focus our examination of the European Communities' claims on these two aspects of the Act.

B. Requirement of "use outside the united states"

1. Claims under Article 3.1(a) of the SCM Agreement

(a) Analytical Approach

8.2 In examining the European Communities' Article 3.1(a) claims in the original dispute, we first considered issues arising under Articles 1 and 3 of the *SCM Agreement*, rather than issues arising under footnote 59 attached to item (e) of the Illustrative List of Export Subsidies in Annex I to the *SCM Agreement*. The Appellate Body found that there was no "legal error" in this analytical approach.[56] The parties also do not expressly contest this approach in these Article 21.5 proceedings. Accordingly, we will adopt the same analytical approach in this Article 21.5 proceeding.

(b) Whether a Subsidy Exists within the Meaning of Article 1 of the *SCM Agreement*

(i) Financial Contribution

8.3 The first issue we address in this dispute is whether the Act's "exclusion" from "gross income" of certain "extraterritorial income" gives rise to a "financial contribution" in the form of a foregoing of "government revenue that is otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.

8.4 The European Communities submits that the Act gives rise to a "financial contribution" in the form of a foregoing of "government revenue that is otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*. In the EC view, there is no general US taxation rule excluding extraterritorial income from taxation. The majority of extraterritorial income - that is, the part that is not qualifying foreign trade income - is subject to the normal rate of tax.[57] The European Communities argues that the Act does not qualitatively define a class or category of income that is excluded from the tax base, but rather lays down conditions for the non-taxation of a part of extraterritorial income (i.e. qualifying foreign trade income) that would otherwise be taxed.[58]

8.5 In the EC view, section 114(a) of the IRC is a "limited exclusion or exemption" that confirms the general rule of world-wide taxation of income of US natural or legal persons.[59] With respect to "corporate income from a commercial activity"[60],

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55 EC response to Panel Question 39, Annex F-1, para. 148.
56 Original Appellate Body Report, *supra*, note 1, para. 89.
57 EC first written submission, Annex A-1, para. 51.
58 EC first written submission, Annex A-1, paras. 57, 61.
59 EC response to Panel Question 37, Annex F-1, para. 135.

the European Communities asserts that the US "prevailing domestic standard" is that such income may be taxed, if it is earned by a US corporation, under section 11, in conjunction with section 61, IRC. If such income is earned by a foreign corporation, it may be taxed under section 881 IRC if it is US-source income; or under section 882 IRC if it is "effectively connected" with a US trade or business.[61] The European Communities also argues that the "benchmark" for assessing the "extended"[62] FSC Replacement scheme under Article 1.1(a)(1)(ii) would be the situation prevailing if the conditions (notably sale "not for use within the United States" and the "foreign content limitation") were not fulfilled. Except in the case of a foreign corporation that is not a subsidiary of a US corporation[63], the Act, therefore, in the EC view, gives rise to a foregoing of revenue that is "otherwise due" and thus to a financial contribution within the meaning of Article 1.1(a)(1)(ii) *SCM Agreement*.

8.6 The United States asserts that the new measure is not a "financial contribution" within the ordinary meaning of the language of Article 1.1(a)(1)(ii) of the *SCM Agreement*. The United States submits that, taking the ordinary meaning of the terms in Article 1.1(a)(1)(ii) together, "the foregoing of revenue otherwise due means that a government has refrained from collecting income that in another circumstance would be legally owed to the government".[64] The United States asserts that the Act redefines the concept of gross income and that the revised definition of gross income is the "prevailing domestic standard" for US taxation. As the United States lacks the statutory authority to tax outside the definition of "gross income", there is no general rule of taxation that would apply "but for" the definition of gross income.[65] Taxes on ex-

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[60] EC second written submission, Annex C-1, para. 68.

[61] EC second written submission, Annex C-1, para. 68; EC response to Panel Question 37, Annex F-1, para. 124 *ff*. In response to Panel Question 36, Annex F-1, paras. 118-121 *ff*, the European Communities submits that "the foreign-source income of a foreign corporation that is not effectively connected with a trade or business in the US is not directly taxable in the US. If the foreign corporation is a subsidiary of a US corporation, the income would be taxable when remitted to the US as dividends (section 61(a)(7)) makes dividends received part of gross income). The dividends received deduction in section 243 of the IRC does not apply to dividends received from non-taxpayers such as the foreign subsidiary. The parent corporation may even have to pay tax earlier on deemed dividends if the anti-deferral provisions of sub-part F of the IRC are applicable. The corporation may however, under the generally applicable US rules, claim a foreign tax credit for the tax borne outside the US but this is limited to foreign source income (section 904 of the IRC)".

[62] The European Communities contends that there are two distinguishable subsidies in the Act. In its first written submission, the European Communities explains that it "will refer to the subsidy granted in respect of the export of US produced goods as the "basic FSC Replacement subsidy" and that accorded to transactions involving foreign produced goods as the "extended FSC Replacement subsidy" in order to distinguish them. When there is no need to distinguish the two cases, the EC will refer to them generally as the "FSC Replacement subsidy" or the "FSC Replacement subsidies"." See EC first written submission, Annex A-1, para. 64. We use these terms in describing the EC argument, but do not ourselves adopt this terminology.

[63] EC response to Panel Question 36, Annex F-1, para. 122. The EC submits: "If a foreign corporation that is not a subsidiary of a US corporation conducts the transaction, the income would not be taxable in the US either directly or indirectly. In this case, the application of the FSC Replacement scheme would not give rise to a subsidy because no revenue would be forgone." Subsequently, however, the European Communities states: "…the extended FSC Replacement scheme is elective and it is clear that companies will only invoke it where it gives rise to a reduction in taxation. That is why it is a subsidy no matter how rarely it may be used." EC response to Panel Question 36, Annex F-1, para. 123.

[64] US first written submission, Annex A-2, para. 61.

[65] US first written submission, Annex A-2, para. 77.

traterritorial income are thus not "foregone" or "otherwise due".[66] The United States submits that absent the Act, income defined as extraterritorial income may not be subject to tax at all, or taxed to a lesser extent.[67] The "exception" concerning extraterritorial income that is not qualifying foreign trade income is a revenue-raising exception, i.e. without it, all extraterritorial income would be excluded from gross income and revenues would be less.[68] The United States contends that the exclusion of extraterritorial income from US taxation represents a shift in US taxing jurisdiction and the "normative benchmark" for US taxation of "foreign income".[69]

8.7 The United States submits that section 61 IRC can be understood only in light of the other provisions of the IRC that define its terms and application and that section 114 IRC is an integral part of section 61 IRC. The US submits that the European Communities is, in effect, asking the Panel to assume that the United States normative benchmark is to tax all income earned by parties that may be subject to US tax. However, in the US system, "gross income" applies only as defined by the IRC and does not apply to all income.[70] According to the United States, the approach in the Act "is one that is faithful to the text of the Agreement and to the findings of the Panel and the Appellate Body [in the original dispute]".[71]

8.8 In commencing our analysis as to whether the Act involves a financial contribution, we first recall that Article 1.1 of the *SCM Agreement* provides, in relevant part:

> "For the purpose of this Agreement, a subsidy shall be deemed to exist if:
>
> (a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:
>
> …
>
> (ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)[footnote omitted];
>
> ….

8.9 As indicated above, the issue before us is whether the Act gives rise to "revenue forgone that is otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.

8.10 We recall that, in the original dispute, the Appellate Body largely agreed with our analytical approach under Article 1.1 of the *SCM Agreement*. The Appellate Body stated,

> "…the "*foregoing*" of revenue "*otherwise* due" implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, "otherwise". Moreover, the word "foregone" suggests that the government has given up an entitlement to raise revenue that it could "otherwise" have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues. There must, therefore, be some defined,

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66 US first written submission, Annex A-2, para. 79.
67 US first written submission, Annex A-2, paras. 101-105.
68 US first written submission, Annex A-2, para. 81.
69 US first written submission, Annex A-2, paras. 71-72.
70 US comments on EC response to Panel Question 36, Annex F-6, para. 51.
71 US closing oral statement, Annex D-4, para. 8.

> normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised "otherwise". We, therefore, agree with the Panel that the term "otherwise due" implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question. To accept the argument of the United States that the comparator in determining what is "otherwise due" should be something other than the prevailing domestic standard of the Member in question would be to imply that WTO obligations somehow compel Members to choose a particular kind of tax system; this is not so. A Member, in principle, has the sovereign authority to tax any particular categories of revenue it wishes. It is also free *not* to tax any particular categories of revenues. But, in both instances, the Member must respect its WTO obligations. What is "otherwise due", therefore, depends on the rules of taxation that each Member, by its own choice, establishes for itself.[72]

8.11 We further recall that the Appellate Body upheld our use of a "but for" analysis as to whether there was revenue foregone that was "otherwise due" in the original dispute. In the Appellate Body's view, that legal standard provided a "sound basis for comparison" as it was not difficult in that dispute to establish in what way the foreign-source income of a FSC would otherwise be taxed ("but for" the contested measure).[73] The Appellate Body opined, however, that it had,

> "… certain abiding reservations about applying any legal standard, such as this "but for" test, in the place of the actual treaty language. Moreover, we would have particular misgivings about using a "but for" test if its application were limited to situations where there actually existed an alternative measure, under which the revenues in question would be taxed, absent the contested measure. It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be *no* general rule that applied formally to the revenues in question, absent the contested measures…"[74]

8.12 As both parties used certain of the terminology referred to in the original Appellate Body Report in their argumentation before us, and as the United States asserts that its approach under the Act "is one that is faithful to the text of the Agreement and to the findings of the Panel and the Appellate Body…[in the original dispute]",[75] we consider the text of Article 1.1 of the *SCM Agreement*, coupled with the above citations from the Appellate Body decision, is a useful - although not necessarily the only possible - starting-point for our analysis of the measure before us.

8.13 In particular, we continue to be of the view that the basis of comparison in an analysis under Article 1.1(a)(1)(ii) *SCM Agreement* as to whether revenue "otherwise due" is foregone must be the tax rules applied by the Member in question.

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[72] Original Appellate Body Report, *supra*, note 1, para. 90.
[73] Original Appellate Body Report, *supra*, note 1, para. 91.
[74] Original Appellate Body Report, *supra*, note 1, para. 91.
[75] US closing oral statement, Annex D-4, para. 8.

8.14 In so approaching the matter, we emphasize our view that in order to discern whether revenue is "otherwise due", we are not assuming that this can only be ascertainable where a purely mechanical exercise of inspection is feasible. Clearly, a defendant Member would have an incentive to argue that what is argued by a complainant to be the foregoing of revenue otherwise due was never due in the first place. Indeed, one might reasonably surmise that any Member applying such a contested regime could have every reason to ensure that there was no automatic or explicit link to the situation of what would be otherwise due. The Appellate Body itself has been mindful of this circumstance when it observed, *a propos* of the concept of a "but for" test that:

> "It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be *no* general rule that applied formally to the revenues in question, absent the contested measures.[76]"

8.15 Indeed, it is worth underlining that the same may be said of the actual terms of the *SCM Agreement* when it comes to the term "otherwise due" itself. Were this term to be construed in an equivalent narrow and formalistic manner, the practical consequence would be precisely the same. It would effectively ensure that any Member that was careful enough to sever any self-evident formal link between a measure at issue and its default regime would thereby insulate itself from effective discipline under the *SCM Agreement*. The Member would be in a position to assert that what was claimed to be foregoing of revenue otherwise due was simply never due in the first place. Asserted compliance by a defendant Member would be tantamount to a definitive defence. This is manifestly absurd and would render the provisions of the *SCM Agreement* operationally ineffective.

8.16 Of course, this does not mean that one can run to the other extreme. As the Appellate Body has also observed:

> "…the word "foregone" suggests that the government has given up an entitlement to raise revenue that it could "otherwise" have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues... ."[77]

8.17 Thus, one cannot simply assert that revenue is otherwise due in the abstract. It cannot be presumed. The key is to apply critical judgement to the facts of the matter. In so doing, we follow the reasoning of the Appellate Body *viz* that the comparison to be made involves revenues due under the contested measure and those that would be due in some other situation and that the basis of the comparison must be the tax rules applied by the Member in question.[78]

8.18 In following this reasoning, we underline that while the inquiry cannot be inherently presumptive or speculative, neither can it be so exacting or confining that it is necessary to attain the level of establishing a mathematical deductive relationship between the contested measure and the default situation. To interpret the *SCM Agreement* in the latter manner would expose a panel to precisely the manifestly absurd consequence referred to in paragraph 8.15 above. The key point is that the tax rules applied by the Member in question are the *basis* for the comparison. Thus, any

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[76] Original Appellate Body Report, *supra*, note 1, para. 91.
[77] Original Appellate Body Report, *supra*, note 1, para. 90.
[78] Original Appellate Body Report, *supra*, note 1, para. 90.

finding that revenue has been foregone must be securely grounded on that foundation.

8.19 That, in our view, provides a sound basis for exercising reasonable judgement as to whether or not a defending Member's assertion that no revenue was due in the first place is, in fact, valid or whether the contested measure in effect masks the substance of what is actually the foregoing of revenue that is otherwise due.

8.20 Against that background, we therefore turn to the tax rules of the Member in question, in this case, the United States, in order to identify a basis for comparison for the purposes of our inquiry as to whether a "financial contribution" exists within the meaning of Article 1.1(a) of the *SCM Agreement*. In so doing, we look first to the Act.

8.21 Under the Act, certain income is "excluded" from taxation. In order to qualify as such "excluded" "extraterritorial income"[79], income must satisfy several stringently selective qualitative conditions and quantitative requirements.[80] The qualitative conditions include, first and foremost, the requirements relating to use outside the United States[81] and the foreign articles/labour limitation.[82] In addition, the Act stipulates, for example, that certain property is "excluded property"[83], and not included in the term "qualifying foreign trade property". Such property includes, *inter alia*, "oil and gas (or any primary product thereof)" and "any unprocessed timber which is a softwood".[84] Furthermore, the Act provides that the President may designate property that might otherwise constitute qualified foreign trade property as property in "short supply".[85] During the period that it is so designated, the property shall not be treated as "qualifying foreign trade property" and income derived in transactions relating to such property is therefore not eligible for the tax treatment available under the Act.

8.22 As we discuss further below, where income fails to qualify as excluded extraterritorial income within the meaning of the Act it remains subject to taxation.

8.23 Consistent with the approach outlined in paragraph 8.17 above, our task is to assess whether, in essence, this "exclusion" of "extraterritorial income" can properly be characterized as a situation in which no revenue is inherently due, or whether it is a situation in which revenue otherwise due is foregone. In doing so, we look at the overall situation as an integrated whole.

8.24 In this regard, we take note of the US assertion that the concept of "gross income" in section 61 IRC can be understood only in light of the other provisions of

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[79] The Act defines "extraterritorial income" as the gross income attributable to foreign trading gross receipts, i.e. derived from the sale of "qualifying foreign trade property" for ultimate use outside the United States. Act, section 3; sections 114(e) and 942 IRC. The Act defines "foreign trade income" as the taxable income attributable to foreign trading gross receipts. Act, section 3; sections 941(b)(1) and 942 IRC. *Supra*, paras. 2.4-2.6.

[80] The Act defines qualifying foreign trade income as the amount of gross income which, if excluded, will result in a reduction of taxable income by certain amounts defined in the Act. See Act, section 3; section 941(a)(1) IRC, described *supra*, para. 2.5.

[81] See Act, section 3; section 943(a)(1)(B) IRC relating to the definition of "qualifying foreign trade property", as well as, for example, section 942(a)(2)(A)(i) IRC relating to the definition of "foreign trading gross receipts".

[82] Act, section 3; section 943(a)(1)(C) IRC relating to the definition of "qualifying foreign trade property".

[83] Act, section 3; section 943(a)(3)(C) IRC.

[84] See Act, section 3; section 943(a)(3)(E) IRC.

[85] See Act, section 3; section 943(a)(4) IRC.

the IRC that define its terms and application and that section 114 ("excluding" from gross income extraterritorial income with the "exception" of non-qualifying foreign trade income) "is "an integral part" of section 61 IRC".[86] However, we consider significant the EC statement endorsed by the United States - that section 114 IRC is one of several, specific exclusions from the section 61 definition of gross income.[87]

8.25 On this basis, it is clear to us that where income does not qualify for the "exclusion" from "gross income" upon the fulfilment of the Act's stringently selective conditions, it is not shielded from taxation. It is part of gross income and is subject to taxation[88] under otherwise applicable US taxation rules. Reaching this view is not a matter of speculation or invention of an entitlement to tax where it is manifestly absent. This is not a matter of mere presumption or assertion of a hypothetical possibility in the abstract severed from the context of applicable US tax rules. On the contrary, it is grounded in the actual way in which the US tax regime functions. Based on this, it is clear to us that there is a "prevailing" domestic standard[89] and that the measure at issue functions, indeed, as an effective departure from it. In this respect, we understand, for example, that the income earned by a US corporate taxpayer in transactions not involving foreign trading gross receipts or qualifying foreign trade property would ordinarily be subject to taxation, under section 11 of the IRC, in conjunction with sections 61 and 63 of the IRC. [90] Foreign corporations pay tax in the United States on income "from sources within the United States" under section 881 of the IRC and on income "effectively connected with a United States trade or business" under section 882 of the IRC**.**

8.26 By treating as "non-taxable" certain income on the basis of highly selective qualitative conditions and quantitative requirements, the Act effectively carves such income out from another situation. The Act's demarcation - in a negative manner through a number of qualitative (and quantitative) conditions - of income that may be eligible for "exclusion" from "gross income" cannot be rationally understood as a self-standing autonomous construct, but rather only by comparison with another situation to which the Act itself explicitly refers. This other situation is the one that prevails where the Act's conditions for obtaining the "exclusion" are *not* fulfilled, most particularly, for example, where goods are for use *within* the United States or where they do not satisfy the foreign articles/labour limitation. That leads us to the

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[86] US comments on EC response to Panel Question 36, Annex F-6, para. 51.

[87] US comments on EC response to Panel Question 37, Annex F-6, para. 58, referring to EC response to Panel Question 37, Annex F-1, para. 132.

[88] We note that, in order to avail itself of the tax "exclusion", a foreign corporation must make domestication election, while a foreign branch of a US corporation need not make a domestication election (see US first written submission, Annex A-2, para. 139 ("…the Act applies to foreign branches of US businesses manufacturing outside the United States without the need for an election. This is because, under US law, a foreign branch of a US business is not treated as a separate entity for tax purposes"). We further note the European Communities' assertion that in the case where a foreign corporation that is not a subsidiary of a US corporation conducts the transaction, the income would not be taxable in the US either directly or indirectly, and the Act "would not give rise to a subsidy because no revenue would be forgone" (EC response to Panel Question 36, Annex F-1, para. 122).

[89] See original Appellate Body Report, *supra*, note 1, para. 90.

[90] Exhibit EC-21 and Exhibit US-4. Section 11 IRC states: "a tax is hereby imposed for each taxable year on the taxable income of every corporation". Section 61 states in pertinent part that: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived... ". Section 63 IRC provides in general that "taxable income means gross income minus the deductions allowed by this chapter."

conclusion that this is to be rightly characterized as the foregoing of revenue otherwise due.

8.27 Moreover, we do not see any other, countervailing, features that could reasonably lead us to conclude otherwise. Even if one seeks to discern some kind of overall rationale and coherence to the "extraterritorial income" "exclusion" that might even hypothetically (and we make no presumption that it would) lead one to modify the view that this is revenue that is "otherwise due", no such rationale is apparent here.

8.28 For instance – and without prejudice to what the status of such a measure might be under the *SCM Agreement* – the Act manifestly does not represent a coherent approach to corporate earnings derived from offshore activities only. The conditionality is such that the eligibility is, in fact, circumscribed carefully to render it only effective, for example, with respect to goods, only with respect to *certain* goods - i.e. *certain* "qualifying foreign trade property" - produced within or outside the United States, where those goods are for "use outside the United States" and where those goods fulfil the foreign articles/labour limitation included in the definition of qualifying foreign trade property. In short, one is left with the perspective simply of certain carve-outs being provided for in relation to what would otherwise be the prevailing regime of revenue liability in respect of the income concerned.

8.29 We add that while, in our view, the terms of the *SCM Agreement* are clear enough, their application to the facts of the multiplicity of Members' regimes will not necessarily be self-evident. Indeed, discerning what might be described as "the prevailing domestic standard" for a particular tax regime may be a particularly exacting exercise. In more common usage, it might be rather difficult to discern what is the exception, as it were, and what is the rule. But the terms of the *SCM Agreement* are clearly of general application: there is nothing which states that they are only to be applied when the results are self-evident. Be that as it may, we are not, in this dispute, presented with a situation of such complexity. This dispute does not involve a debatable call as to whether the glass is half-full or half-empty. As outlined above, we have looked at the essential shape and the rationale that is exhibited. In examining that, we have weighed such considerations as the degree of conditionality, the range of limitations and the manner in which the measure at issue relates to the overall regime. Taken together, they enable us to assess the nature of the relationship of the measure at issue and the overall regime. That is precisely how one is in a position to arrive at the judgement required by the terms of the *SCM Agreement*.

8.30 In light of these considerations**,** we are of the view that, through the tax "exclusion" provided by the Act, the United States government foregoes revenue that is otherwise due within the meaning of Article 1.1(a)(1)(ii). In our view, a "financial contribution" thereby arises within the meaning of Article 1.1 *SCM Agreement*.

8.31 We recall that in its Report in the original dispute, the Appellate Body referred on several occasions to the concept of "categories" of revenue and indicated that a Member is "free *not* to tax any particular categories of revenues".[91] Before us, the parties had divergent views on the utility and meaning of the term "categories" of revenue used by the Appellate Body. The parties disagreed on the nature of "categories" that could be excluded in a WTO-consistent manner from taxation, and on whether extraterritorial income (or foreign trade income or qualifying foreign trade income) constitutes such a "category".

[91] Original Appellate Body Report, *supra*, note 1, e.g. paras. 90, 98-99, 120.

8.32 We turn now to whether utilization of the term "category" would in any way alter the nature of our analysis to this point. However, before considering these issues, we first observe that the concept of "categories" of revenue to which the Appellate Body referred is not actual treaty language. We further note that the Appellate Body also emphasized that, regardless of any "category" of revenue that may be under consideration, a Member is bound at all times to respect its WTO obligations.[92]

8.33 According to the United States, the rationale for the Act's exclusion is "to treat all foreign transactions alike regardless of where goods are manufactured".[93] The United States asserts that the Act excludes extraterritorial income from gross income and that this constitutes a defined, normative benchmark for taxing income earned on foreign transactions.[94] The United States contends that the exclusion of extraterritorial income from gross income was an exercise of the United States sovereign right not to tax a particular category of revenue and that extraterritorial income is a "category" that may be excluded from taxation in a WTO consistent manner.[95] The European Communities contends that while foreign-source income may be a general "category" that WTO Members are free not to tax, "extraterritorial income" is not foreign-source income.[96] For the European Communities, "extraterritorial income" (and even less qualifying foreign trade income) is not a general category of income that a Member may choose not to tax in conformity with the *SCM Agreement*.[97] According to the European Communities, the Act does not qualitatively define a class or category of income that is excluded from taxation. Rather, it lays down conditions for the partial non-taxation of a quantity of income that would otherwise be taxed.[98]

8.34 Based on the facts of the situation, we understand the United States to be arguing in effect that it can simply exclude certain income from gross income and that, when it does so, the "excluded income" is, by definition, not "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.[99] It follows from this US argument that the United States may exclude *any* "category" of income[100] from "gross income" in this manner, and that there would *never* be a foregoing of revenue otherwise due within the meaning of Article 1.1 of the *SCM Agreement*. We further understand the United States to argue that, in any event, the exclusion of "extraterritorial income" excludes a "category" of income (income derived from "foreign transactions") that may be excluded consistently with the United States' WTO obligations.

8.35 In our view, although the terminology of "categories" is particular, we see no reason why the analysis utilized above is not just as applicable, even if one views the nexus of tax measures under this particular descriptor.

8.36 In this way, we turn first to the US argument that it can simply exclude certain income from gross income and that, when it does so, the "excluded income" is, by definition, not "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the

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92 See original Appellate Body Report, *supra*, note 1, para. 90.
93 US first written submission, Annex A-2, para. 116.
94 US first written submission, Annex A-2, para. 79.
95 US first written submission, Annex A-2, para. 83.
96 EC first written submission, Annex A-1, para. 59.
97 EC first written submission, Annex A-1, para. 60.
98 EC first written submission, Annex A-1, paras. 57, 61.
99 We refer also to our summary of US arguments *supra*, paras. 8.6-8.7.
100 US oral statement, Annex D-3, para. 77.

SCM Agreement.[101] This is, in substance, just as subject to the reasoning we applied above.[102] The situation is linguistically different, but the underlying substance remains the same. Here again, this effectively amounts to no more than the assertion that what is claimed to be otherwise due was never due in the first place, albeit that this is clothed in language which presents it as a "category".

8.37 In this context, we consider the US argument that the Act's revised definition of gross income is the "prevailing domestic standard" for US taxation and that once income is "excluded" from "gross income", there is no general rule of taxation that would apply "but for" the definition of gross income - and therefore no foregoing of revenue that is "otherwise due" under Article 1.1 *SCM Agreement* - to be a highly formalistic construct that is difficult to reconcile with the text and context of Article 1.1(a)(1)(ii) in light of the object and purpose of the *SCM Agreement*. To give due meaning and effect to Article 1.1 of the *SCM Agreement*, our examination as to whether there is revenue foregone that is "otherwise due" must be based on actual substantive realities and not be restricted to pure formalism.

8.38 That said, we observe that even under the highly formalistic approach advocated by the United States before us, the Act is inconclusive on its face. Looking to section 114(a) of the Act, we read that "gross income does not include extraterritorial income". In section 114(b), we read that this "exclusion" does not apply to certain extraterritorial income. Looking then to section 114(e), we see that "extraterritorial income" is defined as "…the *gross income* of the taxpayer attributable to foreign trading gross receipts" (emphasis added). In addition, the Act defines the term 'qualifying foreign trade income' as "the amount of *gross income* which, *if excluded*, will result in a reduction of the taxable income of the taxpayer…".[103](emphasis added) Thus, the text of the Act itself appears to indicate variously that extraterritorial income is excluded from gross income, while it also forms part of gross income that may or may not be excluded. We do not consider that it is discernable from the text of the Act itself whether extraterritorial income is actually "excluded" from gross income or is rather "gross income" that may become "excluded" upon fulfilment of certain conditions.[104]

8.39 More importantly, we point out the perilous systemic implications inherent in the approach advocated by the United States in these proceedings and the corrosive effect such an approach would have upon the legal foundations of the *SCM Agreement*. Particularly revealing in this regard was the US response to Panel questioning as to whether the United States believed that there would be revenue foregone that was "otherwise due" within the meaning of Article 1.1 of the *SCM Agreement* if the US legislation provided that "gross income does not include income generated from export activities". The United States was of the view that "…the ordinary meaning of the terms of Article 1.1(a)(ii) suggests that in such a situation there would *not* be a financial contribution within the meaning of Article 1.1(a)(1), as the "tax revenue on export activities would not be "otherwise due" under the law of the Member, which is

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[101] *Supra*, paras. 8.33-8.34.

[102] *Supra,* para. 8.23 *ff*.

[103] Act, section 3; section 941(a)(1).

[104] Furthermore, "foreign trade income" - which the Act defines as "taxable income" derived from foreign trading gross receipts (Act, section 3; section 941(b)(1)) - may be, in part, "excluded" as "qualifying foreign trade income". See Act, section 3; section 941(a)(1)(C). We also see in the Act (section 3, section 943(b)(4) IRC) that "Section 114 shall not be taken into account in determining the amount of gross income or foreign trade income from any transaction".

the normative benchmark for an Article 1 analysis".[105] Taken to its logical extreme, this US argument would be that a government could opt to bestow financial contributions in the form of fiscal incentives simply by modulating the "outer boundary" of its "tax jurisdiction" or by manipulating the definition of the tax base to accommodate any "exclusion" or "exemption" or "exception" it desired, so that there could *never* be a foregoing of revenue "otherwise due". This would have the effect of reducing paragraph (ii) of Article 1.1(a)(1) of the *SCM Agreement* to "redundancy and inutility"[106] and cannot be the appropriate implication to draw from the stipulation as to what constitutes one of the enumerated forms of "financial contribution" under Article 1.1 of the *SCM Agreement*. Furthermore, the consequences of this reasoning would also entirely undermine Article 3.1(a) of the *SCM Agreement*, as there could never be, in this situation, a subsidy contingent upon export in the form of a financial contribution involving of a foregoing of revenue that is otherwise due. As such, it is inherently contradictory to what may be viewed as the object and purpose of the *SCM Agreement* in terms of disciplining trade-distorting subsidies in a way that provides legally binding security of expectations to Members. In this regard, it is evident that the interpretation advanced by the United States would be irreconcilable with that object and purpose, given that it would offer governments "*carte-blanche*" to evade any effective disciplines, thereby creating fundamental uncertainty and unpredictability.[107] In short, such an approach would eviscerate the subsidies disciplines in the *SCM Agreement*.[108]

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[105] US response to Panel Question 20, Annex F-3, para. 62.

[106] It is well-established that an interpreter is not free to adopt a reading that would reduce whole clauses of a treaty to redundancy or inutility. See, for example, Appellate Body Report, *Brazil - Export Financing Programme for Aircraft*, WT/DS46/AB/R, adopted 20 August 1999, DSR 1999:III, 1161, para. 179 and note 110.

[107] In this respect, the panel in *Canada – Measures Affecting the Export of Civilian Aircraft* noted that "…the object and purpose of the SCM Agreement could more appropriately be summarized as the establishment of multilateral disciplines "on the premise that some forms of government intervention distort international trade, [or] have the potential to distort [international] trade." WT/DS70/R, adopted 20 August 1999, DSR 1999:IV, 1443, para. 9.119. We also find support for our view of the object and purpose of the *SCM Agreement* in the Appellate Body Report in *Canada - Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R, adopted 20 August 1999, DSR 1999:III, 1377, para. 157, where the Appellate Body referred to "the trade-distorting potential of a "financial contribution"".

[108] In response to the same Panel Question 20, the United States also submitted that, "a broader reading of the text could find that an exclusion incorporated into a general rule would constitute a financial contribution if the exception were expressly applicable to only a specific group …. If the Panel were to apply our alternative broader principle to this case, we do not believe that the Act's exclusion would be specific within the meaning of Article 2.3, because, for the reasons previously articulated, the exclusion is neither export contingent nor contingent upon the use of domestic over imported goods" (US response to Panel Question 20, Annex F-3, para. 60). We also do not consider this approach - which amounts to determining whether there is a financial contribution for the purposes of Article 1.1 on the basis of whether or not there is export-contingency under Article 3.1 of the *SCM Agreement* - to be an acceptable interpretation of the relationship between these provisions. We note, however, that even on the basis of its own theory, the United States' argument would fail. As we note in our examination below under Article 3.1(a) of the *SCM Agreement* (*infra*, para. 8.64 *ff*), we consider that the fact that the subsidy is available only in respect of transactions involving goods for use outside the US renders the subsidy export-contingent within the meaning of Article 3.1(a). We recall that, pursuant to Article 2.3 of the *SCM Agreement*, any subsidy falling under the provisions of Article 3 "shall be deemed to be specific". Thus, following the US logic, this would be specific within the meaning of Article 2 and, as such, would constitute a financial contribution within

8.40 We turn next to the argument of the United States that, in any event, the exclusion of "extraterritorial income" excludes a "category" of income (income derived from "foreign transactions") that may be excluded consistently with the United States' WTO obligations.[109] Even assuming that income attributable to "foreign transactions" might be a "category" of income that might be excluded in a WTO-consistent manner (an issue which we need not and do not decide here), the United States is not in fact excluding - or giving up an entitlement to raise revenue that it could "otherwise" have raised with respect to - all of the income attributable to "foreign transactions", but rather only a portion of certain income defined by highly selective qualitative conditions and quantitative requirements and attributable only to certain *qualifying* "foreign" transactions (as it itself characterizes the Act).[110] For example, we note that income derived from "foreign" transactions not involving qualifying foreign trade property or foreign trading gross receipts would not qualify for the Act's exclusion. Thus, income derived from transactions involving property for ultimate use *within* the United States (regardless of where it is manufactured or produced) and property not satisfying the foreign articles/labour limitation would not qualify. The Act contains additional restrictions with respect to the types of property and transaction that would give rise to income qualifying for the exclusion.[111]

8.41 Thus, even if one applies the term of "category" to the measure at issue, this linguistic or formal distinction in no way alters the underlying substance of the actual relationship between the measure at issue and the default tax regime as outlined above. Employment of the terminology in no way substantively modifies that relationship. Nor does it introduce any new elements or rationale to the measure at issue that change its essential character.

8.42 Irrespective of whether one simply denies that revenue is otherwise due, or describes what is "excluded" as a "category", in both guises, this amounts to an asserted view that ignores, almost by definition, the actual context in which the measure occurs. Both arguments are effectively flawed, in our view, for the same reasons.

8.43 We therefore conclude that the exclusion from taxation by the United States of certain income on the basis of the Act's highly selective qualitative conditions and quantitative requirements relating to the definitions of "qualifying foreign trade property" and "foreign trading gross receipts" - which define what income may become "extraterritorial income", "foreign trade income" and "qualifying foreign trade income" - results in the foregoing of revenue which is "otherwise due" and thus gives rise to a financial contribution with the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.[112]

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the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*. However, we certainly do not endorse the US approach.

[109] *Supra*, para. 8.33.

[110] US first written submission, Annex A-2, para. 114. In its oral statement, Annex D-3, para. 48, the United States similarly states that the exclusion of extraterritorial income applies to income earned in "*a wide range of* foreign transactions" (emphasis added).

[111] See *supra*, paras. 2.6-2.7.

[112] We wish to emphasize that we do not base our finding on whether or not the United States Constitution or the IRC may or may not require or permit the establishment or maintenance by the United States of a world-wide taxation system, nor do we make any pronouncement as to the US view that the scheme created by the Act introduces "territorial" aspects into its system of taxation. See *e.g.* US comments on EC responses to Panel Questions, Annex F-6, para. 56. Indeed, we do not believe it is necessary to presume in the abstract that, or opine on whether or to what extent, the United States "taxes *all* income" (see e.g. US oral statement, Annex D-3, para. 12) or is required or permitted to do

(ii) Benefit

8.44 Having found that the tax "exclusion" under the Act gives rise to a financial contribution within the meaning of Article 1.1(a) of the *SCM Agreement*, we must also examine whether a benefit is thereby conferred within the meaning of Article 1.1(b) of the *SCM Agreement*.

8.45 We recall that the term "benefit" has been found to imply "some kind of comparison", and that:

> "This must be so, for there can be no "benefit" to the recipient unless the "financial contribution" makes the recipient "better off" than it would otherwise have been, absent that contribution."[113]

8.46 Under the Act, a taxpayer involved in a qualifying transaction may exclude qualifying foreign trade income from its gross income and therefore need not pay a certain amount of tax that it would otherwise have to pay to the United States government. It is therefore "better off" than it would have been absent the contribution, that is, if it had been in another situation, where the conditions for obtaining the tax treatment under the Act were not fulfilled and it was therefore subject to otherwise applicable US taxation rules. We are of the view that the tax treatment in the Act confers a benefit.

8.47 Furthermore, the United States' arguments regarding the existence of a subsidy are limited to the contention that there is no foregoing of revenue that is "otherwise due". The United States does not specifically contest that, in the event that there is a foregoing of revenue "otherwise due", a benefit would be conferred by these rules of taxation.

8.48 We therefore find that there exists a financial contribution conferring a benefit, and that a subsidy therefore exists within the meaning of Article 1.1 of the *SCM Agreement*.[114]

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so by its domestic law, to reach this finding. With respect to the issue whether or not the United States maintains a "world-wide" tax system, we recall that the European Communities cites several treatises on US taxation and a study prepared by the United States Treasury in December 2000 for the proposition that the United States itself has recognized the maintenance of the world-wide taxation system, even following the enactment of the Act (EC response to Panel Question 37, para. 131, referring to Exhibit EC-22). The United States challenges this evidence and alleges that it either predates the Act or contains citations not mentioned by the European Communities that serve to refute the EC arguments US comments on EC responses to Panel Questions, Annex F-6, paras. 53-60.

We also do not rely on the evidence cited by the European Communities concerning a US Congressional budget report (EC first submission, Annex A-1, para. 21; EC rebuttal submission, Annex C-1, paras. 88-95) indicating that the measure will result in lost tax revenues, while noting the US response that the EC's reference to the Congressional budget report is misleading as it compares revenues under the Act versus the FSC and the former worldwide tax system (US first submission, Annex A-2, para. 106), and that "…the estimated revenue loss for the Act is independent of and greater than the revenue loss for the former FSC regime." (US response to EC question 2, Annex F-4).

[113] Appellate Body Report, *Canada-Measures Affecting the Export of Civilian Aircraft* (*"Canada-Aircraft*"), WT/DS70/AB/R, adopted 20 August 1999, DSR 1999:III, 1377, para. 157.

[114] A subsidy is subject to the provisions of the *SCM Agreement* only if it is specific within the meaning of Article 2. Article 2.3 provides, however, that "[a]ny subsidy falling under the provisions of Article 3 shall be deemed to be specific". Thus, we proceed directly to our analysis of whether the Act is contingent upon export performance and upon the use of domestic over imported goods within the meaning of Article 3 of the *SCM Agreement*.

(c) Whether the Subsidy is Contingent upon Export Performance within the Meaning of Article 3.1(a) of the *SCM Agreement*

8.49 Having determined that a subsidy exists within the meaning of Article 1 of the *SCM Agreement*, we next consider whether the subsidy is contingent upon export, that is, whether the "exclusion" from taxation is "contingent… upon export performance" under Article 3.1(a) of the *SCM Agreement*.[115]

8.50 The European Communities asserts that the "basic"[116] subsidy, relating to US-produced goods, is prohibited under Article 3.1(a) of the *SCM Agreement* because it is only applicable to profits arising from export transactions. In the EC view, the fact that there are other ways to earn the exclusion – e.g., by manufacturing and selling abroad, or by selling services abroad - does not vitiate the export-contingency of the subsidy in respect of US-produced goods.[117]

8.51 The United States argues that, in order to be inconsistent with Article 3.1(a) of the *SCM Agreement*, export performance must be a condition that must be satisfied in order to obtain the subsidy.[118] The Act's exclusion of extraterritorial income is therefore, in the US view, not export-contingent, either on its face[119] , or in operation.[120] The United States contends that under the Act, there is a single exclusion that applies to different types of foreign transactions, and that covers different situations.[121] The rationale for the exclusion was to treat all foreign transactions alike, regardless of where goods are manufactured.[122] According to the United States, the exclusion of extraterritorial income is not export-contingent because it applies to income earned in a broad range of foreign transactions wholly unrelated to exporting US goods.[123] In particular, US taxpayers may earn such income by manufacturing and selling abroad.[124] The United States asserts that there are even certain domestic transactions (e.g. domestic sales of products that are to be used outside of the United States) for which the exclusion is available.[125] Thus, the United States contends, while exporters are plainly among those taxpayers who can utilize the exclusion, the exclusion does not meet the ordinary meaning of the contingency test set out in the text of Article 3.1(a).[126]

8.52 The heart of the disagreement between the parties is, therefore, that the United States contends that the exclusion of "extraterritorial" income is not export-

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[115] We recall the rationale underlying the sequence of our analysis under Article 3.1(a), *supra*, para. 8.2, that is, commencing with Articles 1 and 3 of the *SCM Agreement*, rather than with the issues arising under footnote 59 attached to item (e) of the Illustrative List of Export Subsidies in Annex I to the *SCM Agreement.*

[116] See *supra*, note 62, for the EC arguments as to the "basic" and "extended" subsidies under the Act.

[117] E.g. EC written rebuttal submission, Annex C-1, paras. 101-102.

[118] US first written submission, Annex A-2, para. 109, 135. The United States cites Appellate Body Report, *Canada - Certain Measures Affecting the Automotive Industry* ("*Canada-Autos*"), WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, DSR 2000:VI, 2985, para. 100.

[119] US first written submission, Annex A-2, paras. 112-114.

[120] US first written submission, Annex A-2, paras. 115-127.

[121] US comments on EC responses to Panel Questions, Annex F-6, para. 1.

[122] US first written submission, Annex A-2, para. 116.

[123] US first written submission, Annex A-2, paras. 118-120.

[124] US oral statement, Annex D-3, paras. 88-89.

[125] US closing oral statement, Annex D-4, para. 9.

[126] US closing oral statement, Annex D-4, para. 9.

contingent because such income can be earned in many ways besides exporting US goods, while the European Communities asserts that the subsidy is export-contingent in respect of US-produced goods because it is conditioned upon exportation.

8.53 We must therefore consider whether the Act involves subsidies contingent upon export performance within the meaning of Article 3.1(a) *SCM Agreement* by reason of the requirement contained in the definition of "qualifying foreign trade property" and of "foreign trading gross receipts" that goods be held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition *outside* the United States. The precise issue that confronts us here is whether the export of US goods is a "condition" for satisfying the requirement of "use outside the United States", and therefore, for receiving the subsidy. As always, the starting-point of our analysis is the text of the *SCM Agreement*. Article 3.1(a) provides, in relevant part, that:

> "Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:
>
> (a) subsidies contingent, in law or in fact[4], whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I[5];
>
> ---
>
> [4] This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.
>
> [5] Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement."

8.54 In examining whether the exclusion of qualifying foreign trade income from gross income is "contingent ... upon export performance" within the meaning of Article 3.1(a), we recall that the meaning of "contingent" in that provision is "conditional" or "dependent for its existence upon".[127] We further recall that the legal standard expressed by the word 'contingent' is the same for both *de jure* or *de facto* contingency.[128] There is a difference, however, in what evidence may be employed to establish that a subsidy is export-contingent.[129] We understand the European Communities to be making a claim of *de jure* contingency, challenging the legislation "as such".[130] We will conduct our examination accordingly.

8.55 We recall the Appellate Body's statement that "*de jure* export contingency" is demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument[131], as opposed to the "total configuration of the facts constituting and

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[127] Appellate Body Report, *Canada-Aircraft*, *supra*, note 113, para. 166.
[128] Appellate Body Report, *Canada-Aircraft*, *supra*, note 113, para. 167.
[129] Appellate Body Report, *Canada-Aircraft, supra*, note 113, para. 167.
[130] EC response to Panel Question 2, Annex F-1, para. 6. We note the EC statement that "[a] complaint against a mandatory law that is not yet fully applied can in any event only be judged on the basis of the text and evident facts." See EC response to Panel Question 2, Annex F-1, para. 10.
[131] Appellate Body Report, *Canada-Aircraft*, *supra*, note 113, para. 167.

surrounding the grant of the subsidy."[132] The Appellate Body has also recently stated,

> "that a subsidy is also properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfilment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure."[133]

8.56 Applying these principles to the case at hand, we will examine whether export-contingency is apparent from the words of the Act, or can be derived by necessary implication from the words actually used in the Act.

8.57 We first turn to the text of the Act. We note that under the Act, "extraterritorial income" means "the gross income of the taxpayer attributable to the foreign trading gross receipts ... of the taxpayer."[134] "Foreign trade income" is the taxpayer's taxable income attributable to foreign trading gross receipts.[135] "Foreign trading gross receipts" means generally: "the gross receipts of the taxpayer which are - (A) from the sale, exchange, or other disposition of qualifying foreign trade property, [or] (B) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States, …".[136] The term "foreign trading gross receipts" does not include receipts of the taxpayer from a transaction if the qualifying foreign trade property (or services) are for ultimate use in the United States.[137] The Act defines the term 'qualifying foreign trade property' to mean property:

> "(A) manufactured, produced, grown or extracted within or outside the United States,
>
> (B) held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and
>
> (C) not more than 50 per cent of the fair market value of which is attributable to -
>
> > (i) articles manufactured, produced, grown, or extracted outside the United States, and
> >
> > (ii) direct costs for labour (determined under the principles of Section 263A) performed outside the United States."[138]

8.58 We observe that the text of the Act limits the definitions of "foreign trading gross receipts" and "qualifying foreign trade property" - which determine what income will qualify as "extraterritorial income", "foreign trade income" and "qualifying foreign trade income" - to property that is for ultimate use *outside the United States*. The subsidy is therefore only available in respect of income derived from transactions relating to such property.

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132 Appellate Body Report, *Canada-Aircraft*, *supra*, note 113, para. 167.
133 Appellate Body Report, *Canada-Autos*, *supra*, note 118.
134 Act, section 3; section 114(e) IRC.
135 Act, section 3; section 941(b) IRC.
136 Act, section 3; section 942(a)(1) IRC.
137 Act, section 3; section 942(a)(2)(A)(i) IRC.
138 Act, section 3; section 943(a)(1) IRC.

8.59 The definition of qualifying foreign trade property applies to goods manufactured, produced, grown or extracted *within* or *outside* the United States. The fact that the definition of the term "qualifying foreign trade property" refers to property manufactured, produced, grown or extracted within *or outside the United States* is, according to the United States "the most significant aspect of the definition of "qualifying foreign trade property"".[139] In the United States' view, this reference shows that the Act applies equally to all foreign transactions irrespective of whether goods are produced in the United States or abroad[140] and, we understand the United States to argue, essentially means that tax treatment under the Act is not export-contingent under Article 3.1(a).

8.60 We disagree. We consider that the words of the Act make clear that the subsidy is not available in relation to goods produced *within* the United States sold for use *within* the United States and that the following can be derived by necessary implication from the words actually used in the Act:

- goods produced outside the United States are eligible for the tax exclusion under the Act only if they are, *inter alia*, for use outside the United States.
- goods produced within the United States are eligible for the tax exclusion under the Act only if they are, *inter alia*, for use outside the United States.

Thus, in relation to US-produced goods, the words of the statute itself make it clear that exporting is a necessary precondition to qualify for the subsidy. In respect of US-produced goods, the existence and amount of the subsidy depends upon the existence of income arising from the exportation of such goods. In relation to US-produced goods, the existence of such income is clearly conditional, or dependent upon, the exportation of such goods from the United States. We are therefore of the view that by necessary implication the scheme is *de jure* dependent or contingent upon export in relation to US-produced goods.

8.61 We take note of the US argument that US manufacturers may earn extraterritorial income without exporting, as they have the option to produce and sell outside the United States.[141] That entities effecting transactions relating to goods in the United States could opt to source their goods from outside the United States and to engage in wholly non-US transactions does not, in our view, alter the fundamental reality that for US-produced goods, export is a necessary precondition for benefitting from the subsidy under the Act due to the requirement of "use outside the United States".

8.62 The United States emphasizes that the subsidy is also available under the scheme with respect to goods produced outside the United States, provided the transactions involve qualifying foreign trade property, and asserts that the subsidy is not export-contingent because it is available to other than exporters. By contrast, the European Communities argues that it is not necessary to show that all subsidies under the Act are export-dependent[142], and that a subsidy that is export-contingent in some situations does not cease to be so if it can also be obtained in other situations which do not require export.

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[139] US comments on EC response to Panel Question 35, Annex F-6, para. 46.
[140] US comments on EC response to Panel Question 35, Annex F-6, para. 44.
[141] US oral statement, Annex D-3, paras. 88-89.
[142] EC first written submission, Annex A-1, para. 96.

8.63 For the purpose of our analysis, and consistent with the stated view of both parties[143], we assume for the sake of argument that there may be a subsidy within the meaning of Article 1 of the *SCM Agreement* even in the case where a financial contribution confers a benefit exclusively in respect of production outside the territory of the Member providing the financial contribution. Given that a resolution of this question is not necessary to resolve this dispute, we need not decide this issue.[144]

8.64 We do not believe that it is necessary that the Act involves exclusively subsidies that are export-dependent in order to make a finding that the Act involves a defined segment of subsidies – i.e. in respect of US-produced goods - that are prohibited export subsidies because, in respect of this defined segment, the Act is inevitably and invariably conditioned on exportation.[145] The fact that the Act also involves subsidies with respect to goods produced outside the United States - that need not be exported from the United States by reason of the foreign use requirement alone in order to qualify for the subsidy - does not, in our view, vitiate the export-contingency of the Act that we find in respect of US-produced goods. We find support for our view that export-contingent subsidies may exist in the context of a broader subsidies scheme in the reasoning of the Appellate Body in *Canada-Aircraft*. There, the Appellate Body stated that,

> "the fact that some of TPC's contributions, in some industry sectors, are *not* contingent upon export performance, does not necessarily mean that the same is true for all of TPC's contributions. It is enough to show that one or some of TPC's contributions do constitute subsidies "contingent ... in fact ... upon export performance".[146]

There, the export-contingency of the subsidy *vis-à-vis* regional aircraft was not vitiated by the fact that it did not depend on exports *vis-à-vis* other products/sectors.

8.65 We recall that, in response to Panel questioning, the United States drew an analogy between export contingency and specificity under the *SCM Agreement*, arguing that just as "the conventional way of making a specific subsidy non-specific is to expand the universe of users or beneficiaries"[147], "the way to cure an export subsidy is to ensure that the benefit is provided to a larger group than just exporters; that is, to

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[143] See EC response to Panel Question 43, Annex F-1, paras. 149 *ff*; US response to Panel Question 43, Annex F-3, paras. 101 *ff*.

[144] If, however, a subsidy within the meaning of Article 1 *were* limited to a financial contribution provided by a Member only in respect of production inside its territory, then the availability of the exclusion provided by the Act to income derived from the sale or lease of foreign-produced goods would not constitute a subsidy within the meaning of Article 1. This would invalidate the United States argument that the "subsidy" is not export-contingent by reason of the requirement of "use outside the United States" on the grounds that it is also available in respect of goods that are produced and sold outside the United States and thus are not exported from the United States.

[145] In our view, the following analogy supports our conclusion. Assume that "goods produced outside the United States" may be referred to as "good A" (for example, toasters), and that "goods produced within the United States" may be referred to as "good B" (for example, aircraft). On this basis, the Act's requirement of use outside the United States is tantamount to a stipulation that "good A" (toasters) need not be exported from the United States, while "good B" (aircraft) must be for use outside the United States (i.e. be exported from the United States) in order to become eligible for the subsidy under the Act. In our view, this amounts to a provision making exportation a condition for receiving the subsidy with respect to "good B" (e.g. aircraft), although not with respect to "good A" (e.g. toasters).

[146] Appellate Body Report, *Canada-Aircraft*, *supra*, note 113, para. 179.

[147] US response to Panel Question 21, Annex F-3, para. 72.

a non-specific group".[148] While it may be that an expansion of the group of eligible recipients may be a way to eliminate the specificity of a subsidy, we do not consider that this logic can be extended to export contingency.

8.66 The analogy drawn by the United States with specificity does not, in our view, hold here at all. In the case of specificity, what might be loosely described in purely formal terms as an "expansion" cannot blind one to the fact that, as a matter of substance, this "expansion" of the subsidy itself thereby actually, inherently and invariably changes the nature of the subsidy at issue. A specific subsidy is, by definition, a subsidy that is only granted to a specific enterprise or industry or group of enterprises or industries.[149] In "expanding" the granting of the subsidy to a broad group of users or beneficiaries sufficient to achieve the standard of non-specificity, a Member is at the same time *necessarily* ceasing to grant it as a specific subsidy. The specificity and the non-specificity cannot in any manner objectively co-exist. The act of granting a non-specific subsidy in and of itself precludes specificity. Specificity is simply eliminated.

8.67 This is not at all the case we are dealing with here. In the case at hand, we are dealing with an "expansion" which does not inherently eliminate the objective existence of export-contingency. The fact that some other form of economic activity which relates to goods produced outside the territory of the Member concerned also obtains a subsidy does not in any way thereby eliminate the contingency of a subsidy on exports. The two can perfectly conceivably co-exist. This reflects the fundamental fact that "exports" here only have meaning in the context of sale or consumption of goods that are produced within the territory of the Member. In common usage, such goods can be either exported or sold domestically. That exhausts the alternative possibilities for their sale or consumption. As long as there is differentiation between the treatment of those domestically-produced goods depending on whether they are, respectively, either exported (subsidy provided) or sold domestically (subsidy not provided), the provision of such a subsidy is contingent on export. This is the defining contrast.

8.68 One can hardly "cure" a situation that essentially arises from - and is essentially related to -differential treatment of the sale of products that are domestically produced by providing subsidies in respect of economic activities that do not even involve those goods produced in the territory of a Member in the first place. Indeed, when conducting an analysis from the perspective of the Member granting the subsidy, the very concept of "exporting" does not even arise in the context of goods that are themselves not produced within the territory of the Member itself.[150] In effect, the United States seems to argue that a subsidy to economic activity that is entirely ir-

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[148] US response to Panel Question 21, Annex F-3, para. 73.

[149] See *SCM Agreement*, Article 2.1.

[150] We consider that the use of the term "export" in Article 3.1(a) of the *SCM Agreement* indicates that goods must be moved from the territory of one Member to that of another Member. For the purposes of this dispute, we consider that it is sufficient for us to clarify our view that this involves movement of a good from the territory of the Member granting the subsidy to the territory of another Member. We also consider that the treatment of domestically-produced goods sold domestically in the territory of the Member granting the subsidy is a useful basis for comparison for the purposes of an Article 3.1(a) analysis. We find contextual support for this approach in, for example, the text of Article XVI of the *GATT 1994*, which refers to granting "directly or indirectly any form of subsidy which operates to increase the export of any primary product from its territory…" (para. 3) and to subsidies resulting in the sale of a product for export "at a price lower than the comparable price charged for the like product to buyers in the domestic market" (para. 4).

relevant to export activity - indeed, is precluded from involving such exports - can effectively remove export contingency. This seems to be a manifestly unreasonable interpretation. Be that as it may, it would also have the practical effect of reducing the disciplines of the *SCM Agreement* to ineffectiveness and inutility.

8.69 This can be readily seen. If the provision of such a subsidy - that does not even relate to goods that can be, in principle, exported - could "cure" export-contingency, where would the line be drawn demarcating the parameters of such an approach? Manifestly, there could not be any such line. One could just as readily argue that the provision of subsidies in realms entirely unrelated to the sale or consumption of domestically-produced goods would eliminate export subsidies otherwise deemed to exist in respect of such domestically-produced goods.

8.70 Thus, the application here by the United States of a subsidy to offshore economic activity is, at most, the provision of a supplemental feature or an additional subsidy. But the fundamental differentiation that existed in the first place has still not thereby been eliminated. This contrast in respect of domestically-produced goods irrevocably remains. The analogy that more readily springs to mind is that a Member does not eliminate an export subsidy on apples by also granting a subsidy on oranges that is not contingent upon export performance.

8.71 In fact, the specificity analogy, if anything, actually implies the reverse of the US argument. The only way to eliminate an export subsidy in the manner equivalent to eliminating specificity is to eliminate the essential basis of the differentiation in the first place *viz* grant the equivalent subsidy also to the goods for sale or consumption on the domestic market. It would not then be contingent on export because it would be available in respect of goods produced in the US territory *irrespective of whether or not they are exported*. THAT would be the comparable case to the conversion from specificity to general availability.

8.72 Thus, in our view, a way to cure export-contingency in this case would be to eliminate the conditionality on export by making the subsidy available irrespective of whether a product of national origin is sold in the domestic market or abroad. It is the differential treatment provided for in the Act - that is, if US-produced goods are exported, the subsidy is available, while if they are sold in the domestic market, it is not - that renders the Act contingent upon export performance within the meaning of Article 3.1(a).[151] The addition of other circumstances or products in respect of which the subsidy may be available - i.e. foreign-produced goods - does not eliminate the conditionality of the subsidy upon export, and thus does not cure the inconsistency with Article 3.1(a) of the *SCM Agreement*.[152]

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[151] We note that the United States argues that such an approach to contingency (i.e. for owners of US produced goods, export is a condition for obtaining the benefits under the scheme for those goods, see e.g. EC rebuttal submission, para. 102), would mean that "territorial exemptions in most European countries provide export-contingent subsidies…" (US oral statement, Annex D-3, para. 91) and that most tax systems worldwide were inconsistent with the *SCM Agreement*, which could not have been intended by the drafters of the Agreement. The EC responds that "a territorial system taxes income from economic activity - the final destination of the product is irrelevant" (EC response to Panel Question 35, Annex F-1, para. 89).

[152] In this respect, we do not rely upon the phrase "solely or as one of several other conditions" in Article 3.1(a) of the *SCM Agreement*. Nor would our ruling mean, as the United States argues, that the application of Article 3.1(a) extends "to essentially any measure that has any relationship to exportation or that might result in exportation" (see US first written submission, Annex A-2, para. 133). We are not dealing here with a situation where a subsidy may be earned in respect of particular goods either through export or through sale in the domestic market. Nor is this a situation where a subsidy

8.73 We also take note of the US argument that the tax exclusion is even available for certain domestic transactions (domestic sales of products that are to be used outside of the United States).[153] In response to questioning from the Panel, the United States submits that "[a] manufacturer of goods can earn excluded income by sales to domestic buyers, provided that the goods in question are used outside the United States".[154] The United States contends, further, that:

> "Use outside the United States could occur, for example, if the good in question is a fishing boat sold to a United States person for use outside the territorial waters of the United States. In that case, income from the sale of the boat could qualify notwithstanding that the boat was not "consumed" within a foreign jurisdiction. Use outside the United States also could occur in certain circumstances if the article is incorporated into a good that is sold for use outside the United States. Thus, for example, extraterritorial income could be earned if a US manufacturer sells an aircraft engine to a US aircraft manufacturer for incorporation into a finished aircraft to be used outside the United States."[155]

8.74 These US statements do not change our view of the nature of the scheme in relation to US-produced goods. Since, in order for a transaction involving US-produced goods to qualify for the tax exclusion under the Act, the goods must not be "for use in the United States", it follows that these goods must be sent across the US border and moved outside US territory, generally, and in the usual case not involving questions of territorial waters, into another country. In our view, this means that, in respect of US-produced goods, the subsidy is conditioned upon export. The factual situation identified by the United States in these proceedings where a good could re-enter the United States – e.g. a US manufacturer of car tires may earn excluded extra-territorial income from the sale of tires to an unrelated US car manufacturer with a plant in Canada, even if the tires are installed on cars for sale in the US domestic market"[156] – still requires that the goods leave US territory and cross the US border (entering into another country) before they re-enter upon US territory. That the requirement of "use outside the United States" may require only "*predominant* foreign use"[157] still means that some extent of foreign use is a requirement, immaterial whether this is entire or predominant.[158] In short, for US-produced goods, the subsidy is available only upon the condition of exportation.

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might be earned in respect of US-produced goods if one of several alternative conditions was met (e.g. export or generation of employment). Thus, we do not address, and reserve our position on, the issue whether "one of several other conditions" in Article 3.1(a) refers to "additional" conditions beyond export-contingency or to conditions "alternative" to export contingency.

[153] US closing oral statement, Annex D-4, para. 9. US response to Panel Question 11, Annex F-3, paras. 22-26.

[154] US response to Panel Question 11, Annex F-3, para. 22.

[155] US response to Panel Question 11, Annex F-3, para. 22. In respect of these hypothetical situations it raises, the US states that "these examples follow from the language of the statute but the precise scope of these rules will be the subject of proposed regulations to be issued in the future" (US response to Panel Question 11, Annex F-3, para. 22).

[156] US response to Panel Question 11, Annex F-3, para. 24.

[157] US response to Panel Question 11, Annex F-3, para. 25.

[158] In this connection, we note that the requirement of "use outside the United States" can be met under the Act if, with other conditions being satisfied, property is held *primarily* for use outside the United States. Act, section 3, section 943(a)(1) IRC. Moreover, the Act, section 3, section 942(a)(2)(A)(i), relating to the definition of "foreign trading gross receipts" states that such receipts

8.75 We therefore find that the Act involves subsidies "contingent ... upon export performance" by reason of the requirement of "use outside the United States" and is therefore inconsistent with Article 3.1(a) of the *SCM Agreement*.[159]

2. *Footnote 59*

(a) Analytical Approach

8.76 The United States contends that, even if the Act's exclusion were an export-contingent subsidy, it would not be prohibited because the fifth sentence to footnote 59, when read in conjunction with footnote 5, provides that measures to avoid the double taxation of foreign-source income are not prohibited by the *SCM Agreement*.[160] In the view of the United States, the fifth sentence of footnote 59, which provides that "[p]aragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member", falls within the scope of footnote 5, which provides that, "[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement". The United States refers in this respect to the *Brazil – Aircraft* panel report, which opined that footnote 5 "could extend more broadly to cover cases where the Illustrative List contained some other form of affirmative statement that a measure is not subject to the Article 3.1(a) prohibition", and referred by way of example to the first and fifth sentences of footnote 59.[161]

8.77 The European Communities "sees no reason to contest that that the last sentence of footnote 59 may be an exception to Article 3.1(a)"[162], but, in response to a Panel question, asserts that it "was not stating that it considers that the last sentence of footnote 59 is an exception to Article 3.1(a)".[163] The European Communities submits that as the scheme is not a measure to avoid the double taxation of foreign-source income, the conditions of the last sentence of footnote 59 are not met. Accordingly, the European Communities asserts, the Panel need not reach the issue of whether the last sentence to footnote 59 is an exception to item (e) and thus within the scope of footnote 5.[164]

8.78 We recall that the fifth sentence of footnote 59 to item (e) of the Illustrative list of Export Subsidies in Annex I of the *SCM Agreement* states:

> "Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member".

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shall not include receipts from a transaction if the qualifying foreign trade property is for *ultimate* use in the United States.

[159] Having made this finding, we do not consider that it is necessary for us to further examine whether the Act also involves the full or partial exemption, remission or deferral "specifically related to exports", of direct taxes paid or payable by industrial or commercial enterprises within the meaning of item (e) of the Illustrative List of Export Subsidies in Annex I of the *SCM Agreement*.

[160] US first written submission, Annex A-2, para. 154.

[161] US first written submission, Annex A-2, para. 175, citing Article 21.5 Panel Report, *Brazil - Export Financing Programme for Aircraft - Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW, adopted 4 August 2000, as modified by the Appellate Body, DSR 2000:IX, 4093.

[162] EC written rebuttal submission, Annex C-1, para. 181.

[163] EC response to Panel Question 3, Annex F-1, para. 12.

[164] *Ibid.*

8.79 Footnote 5 of the *SCM Agreement* states:

> "Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement".

8.80 In order for the United States to prevail, on the basis of footnotes 59 and 5 of the *SCM Agreement*, with respect to the claims of the European Communities under Article 3.1(a), we must determine that:

- the Act is a measure to avoid the double taxation of foreign-source income within the meaning of the fifth sentence of footnote 59 of the *SCM Agreement*, and
- the fifth sentence of footnote 59 falls within the scope of footnote 5 of the *SCM Agreement.*[165]

(b) Whether the Act is a Measure to Avoid the Double Taxation of Foreign-Source Income under Footnote 59 of the *SCM Agreement*

8.81 We first turn to an examination of the United States argument that the Act is a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59 of the *SCM Agreement*.

8.82 The United States contends that the language in the fifth sentence of footnote 59 is "particularly flexible, imposing no *limit* on WTO Members in fashioning double tax relief *measures*."[166] The United States submits that the last sentence of footnote 59 suggests that WTO Members are not prevented by the *SCM Agreement* from taking "prophylactic steps to prevent their taxpayers from being subjected to taxation both at home and in a foreign jurisdiction."[167] The United States submits that the Act is a measure to avoid double taxation of foreign-source income and that the Act provides a partial exclusion from tax for foreign-source income (i.e. income derived from non-domestic sources). The United States points to legislative history that it contends indicates that the Act "was intended and designed" to serve as " a measure to avoid double taxation", and that the structure of the Act demonstrates this.[168]

8.83 The United States submits that while the terms "double taxation" and "foreign-source income" are terms widely used in the tax area, it is not clear that they have obtained universally agreed-upon "special meanings", and no such "special meanings" have been accepted by the WTO.[169] For the United States, the ordinary meaning of the terms in the fifth sentence of footnote 59 is readily ascertainable and

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[165] Footnote 59 of the *SCM Agreement* is linked to item (e) of the Illustrative List in Annex I of the *SCM Agreement*. Footnote 5 is linked to Article 3.1(a) of the *SCM Agreement*. As footnote 5 of the *SCM Agreement* relates to situations where a measure is referred to as *not* constituting an export subsidy in Annex I, it would thus be necessary for us to determine whether a measure found to fall within the scope of footnote 59, fifth sentence - which provides that "[p]aragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income…" - constitutes a measure referred to in Annex I as *not* constituting an export subsidy for the purposes of footnote 5.

[166] US oral statement, Annex D-3, para. 143.

[167] US oral statement, Annex D-3, para. 22.

[168] US oral statement, Annex D-3, paras. 138-139.

[169] US oral statement, Annex D-3, para. 111.

there is no need for recourse to supplemental means of interpretation for these terms.[170]

8.84 In the US view, the term "foreign-source income", as used in footnote 59, is not limited solely to income attributable to foreign economic activities.[171] The United States argues that there is no international consensus that a permanent establishment is necessary to tax income. The United States asserts that income covered by the Act's exclusion is income that faces the legitimate possibility of taxation outside the United States.[172] In the US view, the issue that arises is whether the Act does *not* constitute a measure to avoid double taxation under footnote 59 because it does not limit its exclusion to the amount of foreign taxes paid.[173]

8.85 The United States submits that the exemption (non-taxation) of foreign-source income is a widely accepted method of avoiding double taxation (along with foreign tax credits).[174] While the United States continues to use foreign tax credits, it asserts that nothing prevents it from using alternative means (tax credits and exclusions) to avoid double taxation.[175] The United States relies on the *OECD Model Tax Convention on Income and Capital* solely as an example, and does not consider it to be a substitute for the text of the relevant WTO provisions.[176] The United States refers to the OECD Commentary as relevant only in that it reflects that many countries are like the United States and offer a mix of exemptions and exclusions as well as foreign tax credits.[177] The United States asserts that there is no "double relief from double taxation" as "[f]oreign tax credits may not be used with respect to excluded extraterritorial income".[178]

8.86 For the European Communities, it is not necessary in this case to establish the exact status and meaning of footnote 59, but it is rather sufficient to note that the Act is not a measure for the avoidance of double taxation and is not limited to foreign-source income.[179] The European Communities submits that "whether one considers that this is a reference to a WTO standard or must be assessed, like revenue foregone, by a reference to the tax system of the country concerned, the Act does not satisfy this condition".[180] The European Communities contests US assertions that the legislative history shows that the purpose of the Act was to avoid double taxation.[181]

8.87 The European Communities argues that the provisions of the *OECD Model Tax Convention* apply only where income may, in accordance with its provisions, be taxed in another state, and the Convention provides evidence of the rule that business

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[170] US oral statement, Annex D-3, paras. 120-121.

[171] US first written submission, Annex A-2, para. 190-192, US written rebuttal submission, Annex C-2, paras. 56-59: US oral statement, Annex D-3, para. 133.

[172] US closing oral statement, Annex D-4, para. 15.

[173] US oral statement, Annex D-3, para. 8.

[174] US first written submission, Annex A-2, paras. 178, 180, citing to Articles 23A and 23B of the *Model Tax Convention on Income and Capital* ("*OECD Model Tax Convention*") (Exhibit US-7; Exhibit EC 12).

[175] US written rebuttal submission, Annex C-2, paras. 35-38.

[176] US oral statement, Annex D-3, para. 117.

[177] US oral statement, Annex D-3, para. 142, referring to the Commentary to Article 23 of the *OECD Model Tax Convention* (Exhibit US-7)

[178] US first written submission, Annex A-2, paras. 188-189; US oral statement, Annex D-3, para. 139; US comments on EC response to Panel Question 16, Annex F-6, para. 17, referring to ss. 114(c)-(d) IRC.

[179] EC closing oral statement, Annex D-2, paras. 29-30.

[180] EC closing oral statement, Annex D-2, paras. 29-30.

[181] EC written rebuttal submission, Annex C-1, paras. 41-42.

profits may only be taxed where an enterprise carries on business through a "permanent establishment".[182] The European Communities contends that under the Act, income may be excluded in respect of transactions where the taxpayer does not maintain a permanent establishment abroad and is thus not subject to taxation in another state. As the Act excludes from tax income which could not legitimately be taxed in any other country, it provides "single taxation relief".[183]

8.88 The European Communities contends that the source of income is the place in which the activities giving rise to these profits have taken place. The United States treats income as "extraterritorial" if the money or assets originate outside the United States. Thus, the income excluded by the Act is not foreign-source income. Nor is "extraterritorial income" foreign-source income within the meaning of US law.[184] In the EC view, the scheme allows what is claimed to be double taxation relief on both foreign-source income and domestic-source income. The availability of double taxation relief on domestic-source income under the FSC Replacement scheme is also not covered by the last sentence of footnote 59.[185]

8.89 Finally, the European Communities argues that the United States has no need of the Act to relieve double taxation, because it has a comprehensive system of foreign tax credits. Nor does the Act solve the problem of double taxation because, the amount of excluded income being limited, companies may still need to claim foreign tax credits to avoid double taxation. On the other hand, the Act in some cases permits an enterprise to take a foreign tax credit with respect to excluded income, thus providing "double relief from double taxation". Nor do the "formulaic" rules for calculating the amount of excluded income correspond to the arm's length apportionment of the profits which another country would seek to tax. Thus, the European Communities asserts, avoidance of double taxation cannot be the "real objective" of the Act.[186]

8.90 In considering this issue, we first recall that a party asserting the affirmative of a particular claim or defence bears the burden of proof with respect to that claim or defence.[187] It appears to us that the nature of the last sentence of footnote 59 is such that the party asserting that its measure falls within the scope of that sentence bears the burden of establishing that the measure fulfils the conditions set out in that sentence. We do not believe that it would be incumbent upon a party to assert that a measure was *not* a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59 before the party imposing the measure had invoked the last sentence of footnote 59 as a justification for its measure.[188]

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[182] Eg EC closing oral statement, Annex D-2, para. 22.

[183] EC written rebuttal submission, Annex C-1, paras. 186 – 198.

[184] EC written rebuttal submission, Annex C-1, paras. 199-208. The European Communities states that the United States deals with taxation of income from sources without the United States in section 862 IRC, submitted as part of Exhibit EC-21. See e.g. EC response to Panel Question 36, Annex F-1, para. 118.

[185] EC comments on US responses to Questions, Annex F-5, paras. 29-30.

[186] EC written rebuttal submission, Annex C-1, paras. 209-220.

[187] Appellate Body Report, *United States - Measure Affecting Imports of Woven Wool Shirts and Blouses form India*, WT/DS33/AB/R, adopted 23 May 1997, p. 15, DSR 1997:I, 323, at 336.

[188] We consider the original Appellate Body Report in this dispute to be instructive here. The Appellate Body stated that "… the United States did not indicate that, in its substantive arguments to the Panel, it had *justified* the FSC measure as a measure "to avoid double taxation" under footnote 59. Nor do we find any indication in the Panel Record that the United States ever *invoked this justification*. We, therefore, conclude that the United States *did not assert*, far less argue, before the Panel

8.91 We observe that the fifth sentence of footnote 59 contains several elements relating to the type of measure that item (e) "is not intended to limit a Member from taking". In this regard, footnote 59 refers to "measure[s] to avoid the double taxation of foreign-source income". Thus, item (e) "is not intended to limit a Member from taking measures: (i) "to avoid"; (ii) "the double taxation"; (iii) "of foreign-source income" earned by the enterprises of the Member concerned or of another Member. In order for a measure to fall within the scope of the fifth sentence of footnote 59, it must satisfy each of these three elements.

8.92 We do not understand the parties to disagree that the term "double taxation" refers to the situation where the same income is taxed in more than one jurisdiction. However, the parties have diverging views on the nature and scope of the justification provided by the fifth sentence of the footnote, on the meaning of the term "foreign-source income" as used in the footnote and on whether the Act is a measure "to avoid" double taxation. We therefore consider each of these other elements in turn.

8.93 We turn first to the term "foreign-source income". We recognize that this term in footnote 59 refers to a taxation concept. However, it is not clear to us that the term has obtained a universally agreed upon special meaning. Even if such a definition or special meaning existed, no such definition or meaning has been included in the *SCM Agreement* as a common understanding among WTO Members. Therefore, in our examination of the Act under footnote 59, we do not impose a single rigid definition or interpretation of the term "foreign-source income", as that term is used in footnote 59, nor do we import into the *WTO Agreement* any definition of the term that may exist in other international instruments or fora.[189] Nor are we of the view that the meaning of the term "foreign-source" as used in footnote 59 need necessarily be determined purely by reference to the domestic laws of the Member invoking the footnote, in this case, the United States.[190] We note, however, that footnote 59 refers to measures taken to avoid "the double taxation of foreign-source income". We understand the term "foreign-source income" as used in footnote 59 to refer to certain income susceptible to "double taxation".

8.94 We turn next to the term "to avoid" in footnote 59, fifth sentence. The term "avoid" is defined *inter alia* as "[t]o empty out; remove…to get rid of, put an end

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that the FSC measure is a measure "to avoid double taxation of foreign-source income" under footnote 59 (emphasis added)." Original Appellate Body Report, *supra*, note 1, para. 101. We consider that this supports our view that it is for the Member seeking to justify its measure under the last sentence of footnote 59 to invoke this provision and to bear the burden of proof by establishing an affirmative *prima facie* case that the conditions in that sentence of the footnote are fulfilled.

[189] We note that to the extent that it might be relevant to this proceeding as an example of international tax practice, the *OECD Model Tax Convention* refers to the concept of "source" but does not, in any event, contain such a definition. See also *infra*, note 195.

[190] Section 862 of the IRC refers to and describes "Income from sources without the United States". The European Communities contests the US assertion in its response to Panel Question 15 (Annex F-3, para. 51) that "excluded extraterritorial income would be foreign-source income under US sourcing rules, as set forth in section 862(a)(4) and 863(b) of the IRC" and offers explanation as to why "foreign-source income and extraterritorial income are entirely unconnected concepts". See EC comments on US response to Panel Question 15, Annex F-5, paras. 7-8. We do not consider the US definition of foreign-source income contained in the IRC decisive here. We observe that footnote 59 does not contain any statements analogous to the statement in footnote 6 to Article XIV of the *General Agreement on Trade in Services*, which reads: "Tax terms or concepts in paragraph (d) of Article XIV and in this footnote are determined according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure."

to…" and as "[t]o escape, evade; ... To prevent, obviate".[191] The use of the term "to avoid", rather than, for example, measures "that avoid", indicates to us that the *purpose* of the measure (or at least one of its purposes) must be to avoid (i.e. "prevent" or "obviate") the double taxation of foreign-source income.[192] Thus, the fact that a measure may incidentally prevent certain income from being subject to double taxation in a particular set of circumstances would not, in and of itself, be sufficient to bring the measure within the scope of footnote 59. We note, in any event, that virtually *any* subsidy provided through relief from income taxation might have such an incidental effect in certain circumstances. For example, a provision that income derived from exportation was not subject to income taxes would have at least an incidental effect in avoiding the double taxation of certain foreign-source income. We observe that such a broad interpretation of the term "to avoid" in footnote 59, fifth sentence would render item (e), and possibly all of Article 3 of the *SCM Agreement*[193], devoid of all meaning and do not believe that such an interpretation could have been intended. We note that the text also does not, for example, state that item (e) is not intended to limit Members from taking measures "that happen to avoid"; "in relation to avoiding"; "in respect of avoiding"; or "in regard to avoiding" the double taxation of foreign-source income. All of these might be seen as phrasings which are more consistent with the interpretative approach posited by the United States. But the language in the fifth sentence of footnote 59 is far more targeted than that.

8.95 We have a degree of sympathy for the US statement that "precision" in the relief of double taxation is ""probably impossible" given the many differences in taxation systems from one country to another and the many different ways that international commerce can be structured."[194] Indeed, we do not view footnote 59 as requiring that a measure "to avoid" the double taxation of foreign-source income must avoid double taxation entirely, exclusively or precisely.[195] However, we consider that the relationship between the measure and its asserted purpose - i.e. "to avoid the double taxation of foreign-source income …" - must be reasonably discernable.[196] We

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[191] *The Shorter Oxford English Dictionary* , 3rd ed. (Oxford University Press, 1965).

[192] We note that this term appears in the French text of the footnote as: "en vue d'éviter" and in the Spanish text as "destinadas a evitar". We consider that these translations are consistent with our view.

[193] We note the US argument that a measure falling under the fifth sentence of footnote 59 is "not prohibited" not only in respect of item (e), but also in respect of the *SCM Agreement* as a whole (including Article 3 thereof). See e.g. US first written submission, Annex A-2, para. 154. As noted *infra*, para. 8.108, we do not decide this issue here.

[194] US response to Panel Question 19, Annex F-3, para. 61.

[195] We recognize that the United States itself is not contending that the Act is a "narrowly-tailored, dollar-for-dollar offset of foreign taxes paid" (US oral statement, Annex D-3, para. 23), and we are not of the view that this would necessarily be the only type of measure that might qualify for justification under the footnote. To the contrary, such an interpretation would imply that only a system of foreign tax credits, and not a mechanism to exempt foreign-source income, would fall within the scope of footnote 59. Such an approach would be inconsistent with a broadly-held view, reflected in the *OECD Model Tax Convention*, that both the credit and exemption methods are appropriate means to avoid double taxation.

We want to be clear that when we refer to the *OECD Model Tax Convention* here and elsewhere in this Report, we are not suggesting that its provisions are somehow controlling of our interpretation of the *WTO Agreement*. Rather, we consider that the *OECD Model Tax Convention* can be relevant to the extent it is reflective of tax practices of certain WTO Members. We note that the United States itself has relied upon the *OECD Model Tax Convention* for this purpose (US oral statement, Annex D-3, para. 117).

[196] We note the US assertion that the language in footnote 59 is "particularly flexible, imposing no *limit* on WTO Members in fashioning double tax relief *measures*" (US oral statement, Annex D-3,

seek to ascertain whether the Act is a measure "to avoid" the double taxation of foreign-source income by concentrating our examination on a review of the overall structure, design and operation[197] of the Act in the context of the broader United States tax system.

8.96 Examining the overall structure, design and operation of the Act, we consider that the parameters of the Act do not even roughly approximate the parameters of a measure to avoid the double taxation of foreign-source income. With the Act, the United States has not approximated the boundaries relating to the type of income that might be subject to tax by another tax authority, but has rather drawn a distinct line demarcating what it refers to as "extraterritorial income" (and then provided for an exclusion from "gross income" of a portion thereof, i.e., qualifying foreign trade income).

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para. 143). While we agree with the United States that the language of the footnote may accommodate a certain degree of flexibility, we do not view this flexibility as extending entirely beyond the words and concepts actually used in the text of the provision.

[197] We find support for our approach in previous WTO dispute settlement reports. For example, in the context of an examination under Article III:2 of the GATT 1994, the Appellate Body has stated "[a]lthough it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure." See Appellate Body Report, *Japan - Taxes on Alcoholic Beverages*, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, pp. 29-30, DSR 1996:I, 97, at 121 ("*Japan-Alcoholic Beverages*"). In its Report in *Chile-Taxes on Alcoholic Beverages*, *supra*, note 53, para. 71, the Appellate Body characterized its approach in *Japan - Alcoholic Beverages* as calling "for examination of the design, architecture and structure of a tax measure precisely to permit identification of a measure's objectives or purposes as revealed or objectified in the measure itself." As well, in the context of an examination under Article XX(g) of the GATT 1994, the Appellate Body examined "the relationship between the general structure and design of the measure" at stake "and the policy goal it purports to serve". *United States - Import Prohibition of Shrimp and Shrimp Products*, WT/DS58/AB/R, adopted 6 November 1998, DSR 1998:VII, 2755, para. 137. See also *infra*, note 217.

In this context, we do not place great weight in our examination on the asserted intent of the United States legislators prior to enactment of the Act. We recall that the Act (section 3; section 114(d) IRC) disallows foreign tax credits that might otherwise be allowed with respect to excluded extraterritorial income (and that the Act, section 3; section 943(d) IRC contains rules relating to the treatment of "withholding taxes" for purposes of section 114(d) IRC). We note, in this regard, the references identified by the United States in the *US House of Representatives Report on the FSC Repeal and Extraterritorial Income Exclusion Act*, H.R. Rep. No. 106-845 (2000) ("*House Report*")(Exhibit US-3), (see e.g. US first written submission, Annex A-2, paras 188-189) as demonstrating that the Act was intended and designed to avoid double taxation of foreign-source income. We further note that the Reports of the United States Senate and House of Representatives relating to the Act state that,

> "Because the exclusion of such extraterritorial income is a means of avoiding double taxation, no foreign tax credit is allowed for income taxes paid with respect to such excluded income. An exception from this general rule is provided for extraterritorial income that is not qualifying foreign trade income."

(*US Senate Report on the FSC Repeal and Extraterritorial Income Exclusion Act*, S. Rep. No. 106-416 (2000) ("*Senate Report*") (Exhibit US-2), page 2; and *House Report*, Exhibit US-3, page 10. Also see, for example, *House Report*, page 18.) These references are not, in our view, decisive or conclusive here. They appear primarily to explain why foreign tax credits are disallowed, that is, to avoid a situation where foreign tax credits would be granted in respect of taxes on income that was, in any event, excluded from taxation in the United States. We further note that the stated purpose of the Act was, according to the *House Report,* "to comply with decisions of a World Trade Organization dispute panel and Appellate Body". *Ibid.,* p. 9.

8.97 As discussed in more detail below, the Act includes as "extraterritorial income" that is excluded from taxation income which would, in our view, not necessarily be treated as taxable in other jurisdictions. In this respect, the Act is unusually broad for a measure whose purpose is *to avoid* double taxation. At the same time, the "extraterritorial income" excluded from taxation does not include a range of income which *is* potentially subject to taxation in other jurisdictions. It is thus, in certain respects, unusually narrow for a measure whose asserted purpose is *to avoid* double taxation. Finally, we note that the Act overlaps with an extensive system of bilateral agreements to avoid double taxation through foreign tax credits, and its application is not designed to cover situations where such agreements did not exist. No single one of these elements, taken separately, would necessarily lead us to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income; taken together, however, they lead us to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income within the meaning of footnote 59.

8.98 First, we note that the Act is exceedingly broad in that it excludes income which would rarely be taxable in another jurisdiction.

8.99 We recall that a defining feature of the tax exclusion provided for by the Act is that it is only available in respect of income derived from the sale or lease of goods held primarily "for direct use, consumption or disposition outside the United States".[198] We consider it clear, however, that income is not necessarily subject to taxation outside the United States merely because the money originated outside the United States.[199] Rather, many countries impose limits on the extent to which they will seek to tax business income relating to transactions on their territory. One such approach, as evidenced in Articles 5 and 7 of the *OECD Model Tax Convention,* is to tax business profits of an enterprise only where that enterprise carries on business through a permanent establishment, and only to the extent those profits are attributable to that permanent establishment.

8.100 The parties have debated at length the issue of "permanent establishment". The United States, in particular, has argued that "[a] number of nations have broader jurisdiction under their tax laws to reach income of non-residents than that prescribed by the concept of 'permanent establishment'... "[200] We do not dispute this contention. Nevertheless, we observe that many countries appear to have rules concerning the taxation of certain earnings of foreign entities that are based on the "permanent establishment" principle or on an analogous basis. In fact, we note that the bilateral tax treaties of the United States and a number of other countries largely rely on this approach.[201] Thus, in cases where the United States maintains either a bilateral tax treaty reflecting the "permanent establishment" approach or the country in question has incorporated the concept of "permanent establishment" in its legislation, there is no potential for double taxation in the absence of a permanent establishment. The

[198] Act, section 3; section 943(a) IRC.

[199] We note, in any event, the US contention that "a manufacturer of goods can earn excluded income by sales to domestic buyers, provided that the goods in question are used outside the United States." (US response to Panel Question 11, Annex F-3, para. 22). Thus, even if we were to accept this US view, the Act would nevertheless be overbroad in this respect as a measure to avoid double taxation.

[200] US oral statement, Annex D-3, para. 127.

[201] See e.g. US oral statement, Annex D-3, para. 127; United States Model Tax Convention, Exhibit EC-13.

Act, however, contains no requirement that excluded income be derived from a permanent establishment. It may thus be anticipated that the Act will, in a range of situations, exclude from taxation income that could not, in any event, be taxed in the foreign jurisdiction in question.

8.101 We note the United States' contention that the foreign economic processes requirement in section 942(b) IRC is an indication that extraterritorial income must involve some foreign economic activity, as well as the US statement that "the Act requires that transactions giving rise to extraterritorial income must have a variety of foreign attributes that can result in a sufficient nexus to a foreign taxing regime so as to render US taxpayers subject to foreign taxation".[202] We further note that, while the foreign economic processes referred to and required by the Act must be performed outside the United States, the Act allows the solicitation or negotiation of a given contract to be conducted by the taxpayer or any person acting under a contract with such a taxpayer and that a taxpayer is treated as meeting the requirements with respect to activities relating to qualifying foreign trade property if any related person has met the requirements in a given transaction.[203] We take these as further indications that the Act does not require that excluded income be derived from a permanent establishment, and this indicates that the Act would exclude from taxation income that could not, in any event, be taxed in many of the foreign jurisdictions in question. Moreover, the foreign economic process requirements are not applicable to entities earning less than $5 million, thus indicating that for US taxpayers with earnings under this threshold no foreign economic processes creating any degree of "nexus" whatsoever with any foreign taxing regime need occur.

8.102 We recall our observation above that many countries impose limits on the extent to which they will seek to tax business income relating to transactions on their territory, and the *OECD Model Tax Convention* is reflective of one approach that contemplates taxation of business profits of an enterprise only where that enterprise carries on business through a permanent establishment, and only to the extent those profits are attributable to that permanent establishment. We understand the concept of profits "attributable to" a permanent establishment to refer to income bearing some relationship to the level of economic activity conducted through the permanent establishment. In this regard, we note that the costs incurred in conducting the foreign economic processes required by the Act need not bear any direct proportional relationship to the amount of "extraterritorial" income that may ultimately be excluded under the Act.[204]

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[202] eg US response to EC Question 20, Annex F-4, para. 31.

[203] Act, section 3; section 942(b)(2)(A)(i) and 942(b)(4) IRC.

[204] We note that one of the three bases for calculating qualifying foreign trade income under the Act is 30 per cent of "foreign sale and leasing income" (Act, section 3; section 941(a)(1)(A) IRC). Under the Act, "foreign sale and leasing income" is defined as foreign trade income "properly allocable" to certain enumerated foreign economic processes *or* as foreign trade income derived by the taxpayer in connection with the lease or rental of certain qualifying foreign trade property, and also includes any foreign trade income derived from the sale of such property (Act section 3; section 941(c) IRC). The other two bases for calculating qualifying foreign trade income under the Act contain no reference to any relationship between the foreign economic processes and the amount of income that may ultimately be "excluded" (that is, provided the "threshold" requirements of Act, section 3; section 942(b) IRC relating to foreign economic processes are fulfilled). We recall that a taxpayer may compute its qualifying foreign trade income on one of the three enumerated bases other than the one resulting in the greatest amount of such income (Act, section 3; section 941(A)(2) IRC). We consider that these elements support the proposition that the foreign economic processes need not bear any direct pro-

8.103 We do not mean to suggest that the absence of a permanent establishment requirement in the Act in itself means that the Act is not a measure to avoid double taxation within the meaning of footnote 59. We are conscious of the fact that "there are differing views and practices among countries as to what brings a non-resident enterprise within a country's taxing authority".[205] While we believe that the Act probably pushes close to the outer limit of the income that might be subject somewhere by some other jurisdiction to taxation, we do not preclude that the broad scope of the Act might nevertheless be justified as a "prophylactic", "preventive" measure to avoid double taxation.[206] We find it difficult, however, to reconcile the asserted desire of the United States to take such a prophylactic, preventive approach with the fact that the Act is in key respects quite narrow, excluding from "extraterritorial income" a wide range of income that could be subject to double taxation. It is to this issue that we now turn.

8.104 It is in our view striking that "extraterritorial income" does not include a range of income which is potentially subject to taxation in other jurisdictions. In this respect, we first note that the Act excludes entirely from "extraterritorial income" income related to sales *within* the United States or to sales outside the United States not meeting the foreign articles/labour limitation.[207] Furthermore, the Act makes access to the special tax treatment subject to several highly selective conditions. These are the conditions relating to ultimate use outside the United States[208] and the foreign articles/labour limitation. In addition, for example, Section 943(a)(3) of the Act stipulates that certain property is "excluded property", and not included in the term "qualifying foreign trade property". Such property includes, *inter alia*, "oil and gas (or a primary product thereof");[209] and "any unprocessed timber which is a softwood".[210] Moreover, the Act provides that the President may designate property that might otherwise constitute qualified foreign trade property as property in "short supply".[211] During the period that it is so designated, the property shall not be treated as "qualifying foreign trade property" and is therefore not eligible for the tax treatment. These additional narrowing conditions are manifestly and entirely unrelated to the source of the income or the potential for double taxation and seem to relate to other

portional relationship to the amount of income ultimately excluded. We underline that it is not this element of our examination, in isolation, that leads us to reach our findings, but rather this element taken together with other elements of our examination, see e.g. *supra*, para. 8.97.

[205] US oral statement, Annex D-3, para. 128.

[206] US oral statement, Annex D-3, para. 22.

[207] As the European Communities argues in its response to Panel Question 5, Annex F-1, para. 21, even for foreign-produced goods, some of the income could be US-source income (i.e. a US company distributing foreign-made goods).

[208] We note that the tax exclusion is available in respect of income derived from certain transactions involving qualifying foreign trade property, as well as from certain services (see *supra*, note 23). We observe that the structure and design of the Act relating to the treatment of services is similar to that of the treatment of goods in that access to the tax exclusion is subject to highly selective conditions. For example, the Act limits the definition of "foreign trading gross receipts"- which may give rise to excluded extraterritorial income - so as not to include qualifying foreign trade property or services for ultimate use in the United States. See Act, section 3; section 942(a)(2)(A)(i) IRC.

[209] Act, section 3; section 943(a)(3)(C) IRC.

[210] Act, section 3; section 943(a)(3)(E) IRC.

[211] See Act, section 3; section 943(a)(4) IRC.

policy concerns of the United States government.[212] Indeed, the range of selective conditions in the Act is inconsistent with the US characterization of the Act as constituting a "prophylactic step[] to prevent [its] taxpayers from being subjected to taxation both at home and in a foreign jurisdiction."[213]

8.105 Finally, we observe that the United States has numerous bilateral tax treaties with other countries that rely upon the foreign tax credit approach to avoiding double taxation.[214] The scope of the Act is not designed to cover, in particular, situations where such a tax treaty is not in place.[215] We are cognizant that some countries may utilize several means to avoid double taxation simultaneously[216], and do not mean to suggest that the last sentence of footnote 59 only applies to measures that are "necessary"[217] to avoid double taxation. We do consider, however, that the existence of this extensive system of bilateral agreements addressing double taxation, combined with the fact that the Act does not target those situations where such bilateral agreements were not in place, represents an additional element relevant to our consideration as to whether the Act was "intended and designed" to serve as a measure to avoid the double taxation of foreign-source income.

8.106 Put simply, the question we have posed is whether legislators concerned with avoiding the double taxation of foreign-source income might reasonably have been expected to draft legislation such as the Act. In our view, and for the reasons set forth above, the answer is no.

8.107 In light of these considerations, we find that the Act fails to fall within the scope of the fifth sentence of footnote 59 because it is not a measure to avoid the double taxation of foreign-source income within the meaning of the fifth sentence of footnote 59.

8.108 As we have found that the Act does not fall within the scope of the fifth sentence of footnote 59, we do not believe that it is necessary to reach the issue of

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[212] We note that the United States submitted, in response to questions from the EC, that "[n]either the Act nor the legislative history of the Act ... articulates the legislative intent behind…" these sections of the IRC. See US responses to Questions from the EC, Annex F-4, para. 8.

[213] US oral statement, Annex D-3, para. 22.

[214] US oral statement, Annex D-3, para. 127.

[215] We note that section 3 of the Act, section 942(a)(3) IRC, allows taxpayers the option to exclude any transaction from giving rise to foreign trading gross receipts and thus from the exclusion for extraterritorial income. We recall that the United States cites "legislative history" to the effect that: "A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a consequence of such an election, the taxpayer could utilize any related foreign tax credits in lieu of the exclusion as a means of avoiding double taxation" (US response to EC Question 5, Annex F-4, citing *Senate Report* (Exhibit US-2), *supra*, note 197, page 8; and *House Report*, (Exhibit US-3), *supra*, note 197, page 21. We further note that tax credits are not available for excluded extraterritorial income, pursuant to Act, section 3; Article 114(d) IRC. See *supra*, note 197.

[216] The United States points to the Commentary to Article 23 of the *OECD Model Tax Convention* for the proposition that countries may "offer a mix of exemptions and exclusions as well as foreign tax credits" (US oral statement, Annex D-3, para. 122). Although it is not dispositive to our analysis, we note that the Commentary (para. 31) merely states that "Contracting States may use a combination of the two methods". It does not explicitly state that Contracting States may offer taxpayers a choice between two *alternative* methods with respect to particular income.

[217] US oral statement, Annex D-3, para. 144. We observe that the term "necessary" appears in other provisions of the *GATT 1994*, for example, paragraphs (a), (b) and (d) of Article XX. The term "necessary" does not appear in the fifth sentence of footnote 59. As we have discussed above, *supra*, paras. 8.94 *ff*., the fifth sentence of footnote 59 refers to measures taken "to avoid" the double taxation of foreign source income.

whether the fifth sentence of footnote 59 also falls within the scope of footnote 5 of the *SCM Agreement*.

3. Claim under Article 3.2 of the SCM Agreement

8.109 The European Communities alleges that the Act grants and maintains subsidies contrary to Article 3.2 of the *SCM Agreement*.[218] The United States does not specifically contest that if it were found to be in violation of its obligations under Article 3.1, it would also be in violation of its obligations under Article 3.2. That provision states:

> "A Member shall neither grant nor maintain subsidies referred to in paragraph 1".

8.110 The parties submitted no additional or separate argumentation on this claim relating to any independent violation of this provision. We therefore view this claim as wholly dependent upon our resolution of the claims under Article 3.1 of the *SCM Agreement*. Recalling our finding that the Act involves prohibited export subsidies in breach of Article 3.1(a) of the *SCM Agreement* by reason of the requirement of "use outside the United States", we find that by maintaining the subsidies under the Act, 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*.

4. Claims under the Agreement on Agriculture

8.111 We turn to consider the claim by the European Communities that, by reason of the requirement of use outside the United States, the Act gives rise to export subsidies within the meaning of the *Agreement on Agriculture*, and that the subsidies it provides are contrary to Articles 10.1 and 8 thereof.

8.112 The European Communities submits that, as export subsidies are conferred within the meaning of the *SCM Agreement*, there is no reason that they are not also conferred within the meaning of the *Agreement on Agriculture*. The European Communities argues, on the basis of the Appellate Body's reasoning in the original dispute, that the Act involves export subsidies and also creates a legal entitlement for companies to receive these subsidies. This must "at the very least" threaten to lead to circumvention of export subsidy commitments. In the EC view, it is therefore inconsistent with Articles 10.1 and 8 of the *Agreement on Agriculture*.[219]

8.113 The United States contends that, as the Act's exclusion of extraterritorial income does not constitute an export subsidy within the meaning of Articles 1 and 3.1(a) of the *SCM Agreement*, it also does not constitute an export subsidy under

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[218] EC first written submission, Annex A-1, para. 186.

[219] The European Communities did not assert that the Act involved subsidies listed in Article 9.1 of the *Agreement on Agriculture*. It did, however, make an alternative claim under Articles 3.3, and 8 in conjunction with Article 9.1, of the *Agreement on Agriculture*, which claim was only applicable in the event that the United States so asserted. See EC first written submission, Annex A-1, para. 231. As neither party asserts that the Act involves export subsidies listed in Article 9.1 (see also US first written submission, Annex A-2, note 210) we do not address this alternative argument.

Article 1(e) of the *Agreement on Agriculture*. Thus, the United States argues, there is no violation of the *Agreement on Agriculture*.

8.114 Article 1(e) of the *Agreement on Agriculture* states:

> "(e) "export subsidies" refers to subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement;"

Article 10.1 of the *Agreement on Agriculture* provides:

> "1. Export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments; nor shall non-commercial transactions be used to circumvent such commitments."

Article 8 of the *Agreement on Agriculture* reads:

> "Each Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member's Schedule."

8.115 The question for determination is thus whether, for the purposes of the anti-circumvention provisions of Article 10.1 of the *Agreement on Agriculture*, the subsidies to which the Act gives rise constitute subsidies contingent on export performance (other than those listed in Article 9.1 of the Agreement) as defined in Article 1(e) of the *Agreement on Agriculture*.

8.116 In line with the decision of the Appellate Body in the original dispute concerning the scope and application of Article 10.1 of the *Agreement on Agriculture*[220], we consider that our reasoning and conclusions with respect to Articles 1.1 and 3.1(a) of the *SCM Agreement*[221], are also applicable as regards whether the Act gives rise to subsidies contingent upon export performance within the meaning of Article 1(e) of the *Agreement on Agriculture* for the purposes of Article 10.1 of the *Agreement on Agriculture*. Consequently, we find in the circumstances of the present case that the Act also involves subsidies contingent upon export performance within the meaning of Article 1(e) of the *Agreement on Agriculture* for the purposes of Article 10.1 of the *Agreement on Agriculture*.[222]

8.117 Turning to the issue of whether the export subsidies are "applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments" within the meaning of Article 10.1 of the *Agreement on Agriculture*,

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[220] Original Appellate Body Report, *supra*, note 1, paras. 133-154.

[221] *Supra*, paras. 8.43, 8.75.

[222] The parties disagree as to whether the subsidy under the Act could ever in practice be available in respect of agricultural products produced abroad. While the United States contends that an agricultural product produced abroad could satisfy the 50 per cent limit on certain foreign value, and, thus, could be eligible for the Act's exclusion, the European Communities underlines the obstacles to the availability of the subsidy in respect of an agricultural product produced abroad, and argues that taxpayers will be "well advised to turn to US production if they wish to be able to rely on the benefits of the FSC Replacement scheme." EC comments on US response to EC Question 19, Annex F-5, para. 80 ff. In this context, we recall our finding *supra*, para. 8.64 that the fact that the subsidy is also available with respect to goods produced outside the United States - that do not necessitate export - does not, in our view, vitiate the export-contingency of the scheme that we find in respect of US-produced goods and thus does not cure the inconsistency of the Act with Article 3.1(a) of the *SCM Agreement* by reason of the requirement of "use outside the United States". Thus, we need not resolve this issue.

we derive guidance from the approach of the Appellate Body in the original dispute and consider the structure and other characteristics of the measure.[223] We recall that the term "export subsidy commitments", defining the obligations that are to be protected under Article 10.1 of the *Agreement on Agriculture*, "… covers commitments and obligations relating to *both* scheduled and unscheduled agricultural products".[224]

8.118 We note that the Act creates a legal entitlement for recipients to receive export subsidies, not listed in Article 9.1[225], with respect to both scheduled and unscheduled agricultural products. Upon fulfilment by the taxpayer of the conditions stipulated in the Act, the United States government must provide the tax exclusion. As there is no limitation on the amount of extraterritorial income, and thus on the amount of qualifying foreign trade income, that may be claimed in respect of eligible transactions, the amount of export subsidies is unqualified.[226]

8.119 Thus, with respect to *unscheduled* agricultural products, we believe that the Act involves the application of export subsidies, *not* listed in Article 9.1, in a manner that, at the very least, "threatens to lead to circumvention" of that "export subsidy commitment" in Article 3.3.

8.120 With respect to *scheduled* agricultural products, we observe that the measure allows for the provision of an unlimited amount of subsidies, and scheduled agricultural products may, therefore, benefit from those subsidies even after the reduction commitment levels specified in the United States' Schedule for those agricultural products have been reached. Thus, we find that the Act is applied in a manner that, at the very least, threatens to lead to circumvention of the export subsidy commitments made by the United States, under the first clause of Article 3.3, with respect to scheduled agricultural products.[227]

8.121 We note that, in these proceedings, the United States does not contest that, if the measure gives rise to subsidies contingent upon export performance under the *Agreement on Agriculture*, then these subsidies would violate its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture*.

8.122 We therefore conclude that the United States has acted inconsistently with its obligations under Article 10.1 of the *Agreement on Agriculture* by applying the export subsidies, with respect to both scheduled and unscheduled agricultural products, in a manner that, at the very least, threatens to circumvent its export subsidy commitments under Article 3.3 of the *Agreement on Agriculture*. Furthermore, by acting inconsistently with Article 10.1, the United States has acted inconsistently with its obligation under Article 8 of the *Agreement on Agriculture* "not to provide export subsidies otherwise than in conformity with this Agreement…".

C. Foreign Articles/Labour Limitation

1. Claim under Article III:4 of the GATT 1994

8.123 We recall that, under the Act, certain extraterritorial income derived from the sale or lease of "qualifying foreign trade property" is excluded from taxation. "Qualifying foreign trade property" is property made within or outside the United States,

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223 Original Appellate Body Report, *supra*, note 1, para. 149.
224 Original Appellate Body Report, *supra*, note 1, paras. 144-147.
225 See *supra*, note 219.
226 See also original Appellate Body Report, *supra*, note 1, para. 149.
227 Original Appellate Body Report, *supra*, note 1, para. 152.

and sold for ultimate use outside the United States, no more than 50 per cent of the fair market value of which is attributable to "articles manufactured, produced, grown or extracted outside the United States" and "direct costs for labour ... performed outside the United States". Thus, the exclusion from taxation provided by the Act is not available in respect of income derived from the sale or lease of property more than 50 per cent of the fair market value of which is attributable to articles made, or costs of direct labour performed, outside the United States.

8.124 The European Communities submits that the foreign articles/labour limitation described above is inconsistent with Article III:4 of the *GATT 1994* as it is a requirement (contained in a law) that provides less favourable treatment to imported parts and materials than to like domestic goods with respect to their internal use in the production of goods within the United States.[228]

8.125 The United States contends, in general, that the European Communities mischaracterizes the Act, and emphasizes that the Act does not require the use of domestic rather than imported goods: goods can meet the foreign articles/labour limitation even if 100 per cent of the fair market value of their inputs is foreign.[229] The United States submits that the Act does not on its face violate Article III:4, and that the European Communities has failed to proffer adequate factual evidence in support of its claim.

8.126 Article III:4 of the *GATT 1994* provides in relevant part:

> "The products of the territory of any Member imported into the territory of any other Member shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use."

8.127 In our examination of the merits of the EC claim under Article III:4, we will examine the following issues: (a) whether the imported and domestic products at issue are "like products"; (b) whether the measure at issue is a "law, regulation, or requirement affecting their internal sale, offering for sale, purchase, transportation, distribution, or use"; and (c) whether the imported products are accorded "less favourable" treatment than that accorded to like domestic products."[230]

8.128 We recall the essence of the Article III:4 obligation that will guide our examination of the EC claim under Article III:4 of the *GATT 1994*, as follows[231]:

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[228] EC first written submission, Annex A-1, para. 188; EC response to Panel Question 30, Annex F-1, para. 75. The European Communities does not claim that the foreign articles/labour limitation is inconsistent with Article III:4 of the *GATT 1994* as it relates to the production of goods outside the United States (EC response to Panel Question 27, Annex F-1, para. 66).

[229] US first written submission, Annex A-2, paras. 213-215.

[230] We recall that the Appellate Body has recently held that: "For a violation of Article III:4 to be established, three elements must be satisfied: that the imported and domestic products at issue are "like products"; that the measure at issue is a "law, regulation, or requirement affecting their internal sale, offering for sale, purchase, transportation, distribution, or use"; and that the imported products are accorded "less favourable" treatment than that accorded to like domestic products." Appellate Body Report, *Korea - Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, ("*Korea - Beef*"), WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001, DSR 2001:I, 5, para. 133. We note that our approach is materially similar to that outlined by the Appellate Body.

[231] Panel Report, *Canada-Certain Measures Affecting the Automotive Industry ("Canada-Autos")*, WT/DS139/R, WT/DS142/R, DSR 2000:VII, 3043, para. 10.78, adopted 19 June 2000 as modified by Appellate Body Report, *supra*, note 118. The findings of that panel under Article III:4 of the *GATT 1994* were not appealed.

> "The "no less favourable treatment obligation" in Article III:4 has been consistently interpreted as a requirement to ensure effective equality of opportunities between imported products and domestic products. In this respect, it has been held that, since a fundamental objective of Article III is the protection of expectations on the competitive relationship between imported and domestic products, a measure can be found to be inconsistent with Article III:4 because of its potential discriminatory impact on imported products.[842] The requirement of Article III:4 is addressed to "relative competitive opportunities created by the government in the market, not to the actual choices made by enterprises in that market".[843] Both in relation to Article III:2 and Article III:4 it has been established that the actual trade effects of a disputed measure are not a decisive criterion in determining whether the requirements of these provisions are met in a given case.[844] Finally, as stated by the Appellate Body, a determination of whether there has been a violation of Article III:4 does not require a separate consideration of whether a measure affords protection to domestic production.[845]

[842] Panel Report on *US – Section 337* ... paras. 5.11 and 5.13.

[843] Panel Report on *US – Malt Beverages,* ... para. 5.31.

[844] See, e.g., Appellate Body Report on *Japan – Alcoholic Beverages,* ... p. 16; Panel Report on *EC – Bananas III (ECU)*, ... para. 7.179.

[845] Appellate Body Report on *EC – Bananas III*, ... para. 216.

8.129 With these considerations in mind, we turn to the first element of our examination of the EC claim under Article III:4 of the *GATT 1994*.

(i) Whether the Imported and Domestic Products at Issue are "like products"

8.130 The parties differ on the nature of the "like product" analysis required in this case. The European Communities asserts that the distinction operated by the foreign articles/labour limitation relates to the origin of the product and that the mere fact of having US origin is not, as such, apt to confer upon goods any quality that makes them, by definition, "unlike" any imported goods.[232] The European Communities cites the *European Communities – Parts and Component*s[233] panel report for the proposition that it need not, in respect of a measure of general application, compare a certain class of domestic products with the same class of imported products.[234]

8.131 The United States contends that there must be evidence that any particular class of imported goods will be accorded less favourable treatment than a class of domestic like products, and that, as this case involves a generally applicable measure, there is a greater evidentiary burden than in the case of a measure of specific application and evidence must be introduced to establish a "meaningful nexus" between the

[232] EC first written submission, Annex A-1, paras. 196-197.

[233] Panel Report, *EEC – Regulation on Imports of Parts and Components*, BISD 37S/132, adopted 16 May 1990.

[234] EC written rebuttal submission, Annex C-1, paras. 240-241.

measure and adverse effects on competitive conditions for a like class of imported goods.[235]

8.132 We view the principal purpose of the "like product" inquiry under Article III:4 of the *GATT 1994* as ascertaining whether any formal differentiation in treatment between an imported and a domestic product could be based upon the fact that the products are different - i.e. not like - rather than on the origin of the products involved. We find support for this view in the recent statement by the Appellate Body that under "Article III:4 of the *GATT 1994*, the term "like products" is concerned with competitive relationships between and among products."[236]

8.133 On this basis, we note that the distinction made between imported and domestic products in the Act's foreign articles/labour limitation concerning the limitation on fair market value attributable to "articles" is solely and explicitly based on origin. We do not believe that the mere fact that a good has US origin renders it "unlike" an imported good. We further note that the Act is a measure of general application. It applies horizontally to all possible products that can be used for the production of goods that might eventually be qualifying foreign trade property. Thus, in our view, there is no need to demonstrate the existence of actually traded like products in order to establish a violation of Article III:4.[237] Furthermore, where there are no like US goods, the issue of less favourable treatment of imported goods would not even arise.

8.134 Thus, we do not believe that it is necessary, as the United States argues, that there must be evidence that any particular class of imported goods will be accorded less favourable treatment than a class of like products of national origin. Nor - as far as the "like product" analysis is concerned - do we believe that evidence must be introduced to establish a "meaningful nexus" between the measure and adverse effects on competitive conditions for a like class of imported goods just because this case involves a generally applicable measure.[238] Nor do we endorse the US assertion that laws of general applicability have, at most, an indirect impact on imported products and thus engender a greater evidentiary burden than laws of specific application.[239]

8.135 For these reasons, we consider that the "like product" element of Article III:4 is satisfied in this case.

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[235] US first written submission, Annex A-2, paras. 216-219; US oral statement, Annex D-3, paras. 167, 171.

[236] See Appellate Body Report, *European Communities - Measures Affecting Asbestos and Asbestos-Containing Products*, WT/DS135/AB/R, adopted 6 April 2001, DSR 2001:VII, 3243, para. 103.

[237] We find support, for example, in Panel Report, *Indonesia - Measures Affecting the Automotive Industry*, WT/DS54/R, WST/DS55/R, WT/DS59/R, WT/DS64/R, adopted 23 July 1998, DSR 1998:VI, 2201, para. 14.113 ("…an origin-based distinction in respect of internal taxes suffices in itself to violate Article III:2, without the need to demonstrate the existence of actually traded like products"). *See also* Panel Report, *Canada-Autos*, *supra*, note 231, para. 10.74. That panel stated: "It has not been contested that the distinction made between domestic products and imported products in the definition of Canadian value-added is based solely on origin and that, consequently, there are imported products which must be considered to be like the domestic products the costs of which are included in the definition of Canadian value-added."

[238] US first written submission, Annex A-2, paras. 216-219; US oral statement, Annex D-3, para. 167.

[239] US oral statement, Annex D-3, para. 171.

(ii) Whether the Act is a "law, regulation or requirement affecting the internal ... use" of Imported and Like Domestic Products by Reason of the Foreign Articles/Labour Limitation

8.136 The parties disagree on whether or not, by reason of the foreign articles/labour limitation, the Act is a "law, regulation or requirement affecting the internal ... use" of imported and like domestic products within the meaning of Article III:4 of the *GATT 1994*.

8.137 The European Communities states that its claim under Article III:4 of *GATT 1994* is focusing on the "foreign content limitation, which affects the sale or use of products on the US market and discriminates against foreign products", and is not claiming that the "tax exemption" as such is a "requirement affecting internal sale" within the meaning of Article III:4.[240] With respect to the term "affecting", the European Communities argues that actual trade effects of the measure need not be established. Rather, according to the European Communities, it is sufficient that the limitation "affects" the competitive position of the imported product on the market.[241] The European Communities states that the Act provides an incentive to source inputs domestically because this will enhance the chances that a US producer will qualify for the tax benefit, and that this is sufficient to violate Article III:4 which guarantees equality of competitive opportunities.[242] For the European Communities, this is the case even if the measure allows for other means to obtain the advantage.[243]

8.138 For the United States, it is difficult to consider how imports could be "affected" by a generally applicable measure like the one at issue.[244] According to the United States, the Act does not affect competitive conditions between imported and like domestic products as it does not require the use of any US-origin goods for a transaction to earn excluded extraterritorial income; goods can meet this requirement even if 100 per cent of the fair market value of their inputs is foreign.[245]

8.139 In considering these issues, we first consider the *form* of the measure in question. We agree with the views expressed in previous GATT and WTO panel reports that Article III:4 applies also to measures in the form of conditions[246] that must be satisfied in order to obtain an "advantage"[247] from the government.

8.140 While we endorse the view of the European Communities that the measure at issue here falls within the scope of the phrase "laws, regulations and requirements" in

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[240] EC response to Panel Question 18, Annex F-1, paras. 47-48.

[241] EC first written submission, Annex A-1, paras. 198-205.

[242] EC written rebuttal submission, Annex C-1, para. 231.

[243] EC written rebuttal submission, Annex C-1, para. 237, citing Panel Report, *Canada - Autos*, *supra*, note 231, paragraph 10.82.

[244] e.g. US first written submission, Annex A-2, para. 218.

[245] US first written submission, Annex A-2, para. 214; also e.g. US oral statement, Annex D-3, para. 166 *ff*.

[246] See e.g. Panel Report, *Canada – Administration of the Foreign Investment Review Act*, BISD 30S/140, adopted 7 February 1984, paras. 5.4-5.6; Panel Report, *EC – Parts and Components*, *supra*, note 233, para. 5.21; and Panel Report, *Canada – Autos*, *supra*, note 231, para. 10.73.

[247] The term "advantage" has been used in this context in previous GATT and WTO dispute settlement reports: see Panel Report, *Canada – Autos*, *supra*, note 231, para. 10.73; Panel Report, *EC – Parts and Components*, *supra*, note 233, para. 5.21. The term "incentive" is used in the context of the Article III:4 examination by the Appellate Body in Appellate Body Report, *EC - Bananas*, *supra*, note 251, para. 213.

Article III:4, we are inclined to believe that the three separate elements identified in this phrase in Article III:4 deal with the *form* rather than the *content* of the measure under examination. We observe that the foreign articles/labour limitation is a statutory provision, that is, a requirement included in the Act, which is a generally applicable "law". At any rate, regardless of whether the measure at issue is a "law" or a "requirement", we agree with the view expressed by the European Communities that the "standard laid down in Article III:4 of GATT 1994 is the same both for "laws" and "requirements"".[248]

8.141 We recall the European Communities' statement that its claim under Article III:4 of *GATT 1994* is focusing on the "foreign content limitation, which affects the sale or use of products on the US market and discriminates against foreign products".[249] The European Communities clarifies that it is not claiming that the "tax exemption" as such is a "requirement affecting internal sale" within the meaning of Article III:4 of the *GATT 1994*.[250] In this regard, we note that the measure in question in an Article III:4 examination may condition access to an advantage or incentive bestowed by the government. We consider that the nature of the "advantage" ultimately sought from (or "incentive" ultimately bestowed by) the government when a certain "requirement" is voluntarily accepted in order to obtain the "advantage" or "incentive" is not relevant for the purposes of an enquiry under Article III:4 of the GATT 1994. In particular, it is not relevant that we are dealing here with a measure that conditions access to an income tax advantage to a "firm".

8.142 In this connection, we can see no specification or limitation in the text of Article III:4 concerning the type of advantage linked to the measure under examination under Article III:4 of the *GATT 1994*. Thus, nothing in the plain language of the provision specifically excludes requirements conditioning access to income tax measures from the scope of application of Article III, which deals with "national treatment on internal taxation and regulation".

8.143 In terms of context, we note that Article XIV(d) of the *General Agreement on Trade in Services* (the "*GATS*"), entitled "General Exceptions", stipulates that nothing in that Agreement shall be construed to prevent the adoption or enforcement by any Member of measures inconsistent with the "national treatment" obligations in Article XVII, "provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members." This implies to us that a direct income tax measure would generally be covered by Article XVII of the *GATS*. We base this view on the following reasoning: unless a direct income tax measure were within the ambit of that provision, the Uruguay Round negotiators would not have deemed it necessary to create such an explicit "exception" when drafting the relevant provisions of the *GATS*. Clearly, provisions relating to national treatment under the *GATS* were modelled after Article III of the *GATT* and reflect jurisprudence developed thereunder. This contextual element, therefore, supports our view that the obligation in Article III:4 of the *GATT 1994* is not so circumscribed.

8.144 Furthermore, the terms "law, regulation or requirement affecting…" in Article III:4 are general terms that have been interpreted as having a broad scope.[251] If meas-

[248] See EC response to Panel Question 31, Annex F-1, para. 79.

[249] EC response to Panel Question 18, Annex F-1, paras. 47-48.

[250] *Ibid.*

[251] Appellate Body Report, *European Communities - Measures Affecting the Importation, Sale and Distribution of Bananas*, adopted 25 September 1997, WT/DS27/AB/R, DSR 1997:II, 591, para. 220.

ures conditioning access to income tax advantages in respect of certain products were excluded from the scope of Article III:4, a wide range of trade-distortive measures with enormous economic and commercial implications would, in effect, be given a safe haven, while measures not linked to income tax advantages and perhaps associated with a lesser extent of trade distortion would be subject to the disciplines of Article III:4. It seems to us that such a interpretation runs counter to the object and purpose of the *GATT* and the *WTO Agreement* (including the "elimination of discriminatory treatment" in international trade[252]) and can hardly have been what the drafters intended. On the basis of the text and context of Article III:4 in light of the object and purpose of the *GATT* and the *WTO Agreement*, we therefore consider that Article III:4 of the *GATT 1994* applies to measures conditioning access to income tax advantages in respect of certain products.

8.145 We take note of the preparatory work for the Havana Charter referred to by the United States in these proceedings. In response to Panel questioning, the United States states that "there is support in the history of the GATT that Article III:4 was never intended to apply to income taxes". According to the United States, the Reports of the Havana Convention at which Article 18 of the Havana Charter[253] was drafted, specify that "neither income taxes nor import duties fall within the scope of Article 18 which is concerned solely with internal taxes on goods".[254] This statement in the preparatory work of the Havana Charter does not change our view that the scope of Article III:4 of the *GATT 1994* includes measures conditioning access to income tax advantages in respect of certain products. While seemingly framed in general terms, this statement appears[255] in a section containing comments on paragraphs 1, 2 and 3 of Article 18 and thus seems to relate to what would later become Article III:2 of the GATT. It therefore would not be decisive concerning the scope of Article III:4, in any event. Moreover, the statement was made in relation to the withdrawal of a specific proposal by Peru dealing with a situation materially different than the one currently before us (not deeming as "in opposition to" Article 18 the exemption of import duties on equipment or materials and exemption from income taxes granted for a limited time to enterprises created for the establishment of "economically sound industries").[256] However, even if the statement was meant to refer more generally to what would later become Article III as a whole (including Article III:4), if taken literally, it would entirely exclude an area that was explicitly covered by Article 18 of the Havana Charter, and now Article III:4 of the GATT: i.e., internal regulation (it suffices here to recall that Article III of the GATT 1994 is entitled: "National Treatment on Internal Taxation and Regulation"), which would amount to a result that clearly runs counter to the object and purpose of Article III and of the *GATT 1994* in general. Therefore, the statement in the preparatory work of the Havana Charter does

See also Panel Report, *Canada-Autos*, *supra*, note 231, para. 10.80; Panel Report, *Italian Agricultural Machinery*, BISD 7S/60, adopted 23 October 1958, para. 12.

[252] See preamble to the *GATT 1947* and the *Marrakesh Agreement Establishing the World Trade Organization*.

[253] *Final Act of the United Nations Conference on Trade and Employment*, March 24, 1948.

[254] In its response to Panel Question 18, the United States cites to the Interim Committee for the International Trade Organization, *Report of Committees and Principal Sub-Committees,* Report of Sub-Committee A of the Third Committee on Articles 16, 17, 18 and 19, E/CONF.2/C.3/59, para 44, page 63, Geneva, 1948.

[255] See *ibid.*

[256] See Third Committee: Commercial Policy, Revised Annotated Agenda for Chapter IV, Proposed Amendment by Peru, E/Conf.2/C.3/6/Add. 2, 17 December 1947.

not change our view that Article III:4 of the GATT 1994 applies to measures conditioning access to income tax advantages in respect of certain products.[257]

8.146 Finally, we observe that previous panels have been of the view that the scope of Article III:4 extended to measures conditioning access to income tax advantages in respect of certain products. Indeed, one WTO panel has observed that, "subsidies granted in respect of direct taxes are generally not covered by Article III:2, but may infringe Article III:4 to the extent that they are linked to other conditions which favour the use, purchase, etc. of domestic products."[258] We also note that provisions relating to eligibility for an import duty exemption (an area also referred to in the preparatory work cited by the United States as not falling within the scope of Article 18 of the Havana Charter) were at issue in the Article III:4 inquiry by the panel in *Canada-Autos*.[259]

8.147 We next examine whether the measure at issue is one "affecting" the internal sale or use of the products concerned. We recall here the Appellate Body's observation that the ordinary meaning of the word "affecting" implies a measure that has "an effect on" and thus indicates a broad scope of application.[260] Further, we observe that the term "affecting" in Article III:4 of the *GATT 1994* has been interpreted to cover not only laws and regulations which directly govern the conditions of sale or purchase but also any laws or regulations which might adversely modify the conditions of competition between domestic and imported products.[261]

8.148 We consider that a measure pursuant to which the use of domestic - but not imported - products contributes to obtaining an advantage has an impact on the conditions of competition between domestic and imported products and thus "affects" the internal "use" of imported products, *even if* the measure allows for other means to obtain the advantage, such as the use of domestic inputs other than products.[262] Under the Act, by reason of the foreign articles/labour limitation, the use of US-origin products contributes to obtaining the exclusion while the use of imported products does not. Thus, we consider that it is a measure which "affects" the internal use of imported products even if ways - other than the use of goods - exist to impute permissible fair market value.

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[257] Furthermore, we note that in accordance with the customary rules of interpretation of public international law as codified in Articles 31 and 32 of the *Vienna Convention on the Law of Treaties*,

> "Recourse may be had to supplementary means of interpretation, including the preparatory work of a treaty ... in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:
> (a) leaves the meaning ambiguous or obscure; or
> (b) leads to a result which is manifestly absurd or unreasonable."

Here, we do not consider that the ordinary meaning of the text of Article III:4, in its context and in light of the object and purpose of the *GATT 1994* and the *WTO Agreement* to be "ambiguous or obscure" or that our interpretation of that provision "leads to a result which is manifestly absurd or unreasonable". We are therefore of the view that it is not even necessary to refer at all to the preparatory work.

[258] Panel Report, *Indonesia - Certain Measures Affecting the Automobile Industry,* WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, adopted 23 July 1998, DSR 1998:VI, 2201, para. 14.38.

[259] *Supra*, note 231.

[260] Appellate Body Report*, European Communities - Bananas*, *supra*, note 251 ,para. 220. See also Panel Report, *Canada-Autos*, *supra*, note 231, para. 10.80.

[261] Panel Report, *Italian Agricultural Machinery*, *supra*, note 251, para. 12; see also Panel Report, *Canada-Autos*, *supra*, note 231, para. 10.80.

[262] See Panel Report, *Canada-Autos*, *supra*, note 231, para. 10.82.

8.149 For these reasons, we find that, by reason of the "foreign articles/labour limitation", the Act is a "law, regulation or requirement" that affects the internal "use" in the United States of imported goods and like domestic products for use in the production of qualifying foreign trade property.

(iii) Whether the Act Accords Imported Products "less favourable" Treatment than that Accorded to Like Domestic Products by Reason of the Foreign Articles/Labour Limitation

8.150 The parties disagree as to whether or not the Act accords less favourable treatment than that accorded to like domestic products by reason of the foreign articles/labour limitation.

8.151 The European Communities argues that in all cases, the "foreign articles/labour limitation" will act as an incentive to source inputs domestically because this will enhance the chances of a US producer intending to export its goods to qualify for the tax benefit.[263] According to the European Communities, this is sufficient to violate Article III:4, which guarantees equality of competitive opportunities. While the European Communities recognizes that the Act does not oblige a US producer to use US inputs, the European Communities argues that this is in many cases one of the necessary conditions for obtaining the advantage, and in all other cases the scheme encourages the use of US goods over foreign goods.[264] Thus, the Act gives "less favourable treatment" to imported goods. In any event, the European Communities considers that, under Article III:4, "[a]ny individual product must be treated no less favourably than a like domestic product - and this in all cases, for all transactions".[265]

8.152 The core of the US response to this claim hinges on its argument that no less favourable treatment is afforded to imported goods because the foreign articles/labour limitation does not change or affect the conditions of competition. According to the United States, taxpayers are under no obligation to use domestic content.[266] The United States contends that the Act does not require the use of any US-origin goods for a transaction to earn excluded extraterritorial income[267], but rather provides that up to 50 per cent of the fair market value of the goods involved in a transaction may be attributable to articles produced outside the United States and direct labour costs incurred outside the United States. The US underlines, and deems it fundamental, that goods can meet this requirement even if 100 per cent of the fair market value of their inputs is foreign.[268]

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[263] EC first written submission, Annex A-1, paras. 205, 207, 208; EC written rebuttal submission, Annex C-1, para. 231.

[264] EC first written submission, Annex A-1, paras. 191-195; EC second written submission, Annex C-1 para. 231; EC oral statement, Annex D-1, para. 82; EC closing oral statement, Annex D-2, paras. 32-34.

[265] EC first written submission, Annex A-1, para. 211.

[266] US oral statement, Annex D-3, para. 166.

[267] US first written submission, Annex A-2, para. 214.

[268] The United States submits that the foreign articles/labour limitation takes into account only the value of foreign articles and direct labour costs in producing a finished product, but does not limit other foreign value. Thus, the United States submits, the remaining 50 per cent of fair market value of the finished product can be attributed to non-tangible elements, including intellectual property

8.153 With these considerations in mind, we examine the text of the foreign articles/labour limitation in the Act to see whether it adversely affects the equality of competitive opportunities of imported products in relation to like domestic products and thus affords less favourable treatment to imported products than to like domestic products within the meaning of Article III:4 of the *GATT 1994*.

8.154 We observe that we are dealing here with a statutory requirement that is expressly and explicitly origin-based: there is an explicit reference in the Act to articles manufactured or produced "outside", as opposed to within, the United States. We are well aware, however, that any distinction that is based exclusively on criteria relating to the nationality or origin of the product will not necessarily be incompatible with Article III.[269] Article III:4 requires rather that a measure accord treatment to imported products that is "no less favourable than" that accorded to like domestic products. Therefore, we do not halt our examination here.

8.155 We further observe that the foreign articles/labour limitation explicitly places a limit on the proportion of the fair market value of a product that can be derived from imported products (and foreign labour) only, and places no similar constraint on the proportion of the fair market value of a product that can be derived from domestic products (and labour).

8.156 We note that the use of imported products by a manufacturer in the US cannot contribute to the fulfilment of the foreign articles/labour limitation - a condition necessary to obtain the advantage in the form of the exclusion from tax of the portion of extraterritorial income that is qualifying foreign trade income available under the Act - whereas the use of domestic products can. Thus, an advantage is conferred upon the use of domestic products that is not conferred upon the use of imported products. This constitutes a formal differentiation of treatment between imported and like domestic products which, in our view, affords less favourable treatment to imported products than to like domestic products.

8.157 At the heart of the US argument in response to this claim is its assertion that the foreign articles/labour limitation does not necessarily require the use of US-origin goods. Thus, more than 50 per cent of the fair market value of "qualifying foreign trade property" could be attributable to US or foreign intellectual property, goodwill, capital, marketing, distribution or other services. However, we are of the view that the existence of other ways to impute value does not change the fundamental fact that, as far as goods are concerned, the foreign articles/labour limitation creates an incentive to use domestic rather than imported goods. That there may exist other ways to impute permissible fair market value in order to obtain qualifying foreign trade property does not vitiate the fact that this incentive inherently advantages domestic goods and that less favourable treatment is thereby accorded to imported goods than to domestic goods.

8.158 In light of these considerations, we consider that, by reason of the foreign articles/labour limitation, the Act accords less favourable treatment within the meaning of Article III:4 of the *GATT 1994* to imported products than to like products of US origin because, by conferring an advantage upon the use of products of US origin but not upon the use of imported products, it adversely affects the equality of com-

rights, goodwill, capital, marketing, distribution and other services, which may be of either US or foreign origin. According to the United States, the articles used in manufacturing, whatever their origin, account for only part of the total value. See e.g. United States first written submission, Annex A-2, para. 201.

[269] See Appellate Body Report, *Korea-Beef*, *supra*, note 230, paras. 137-138.

petitive opportunities of imported products in relation to like products of United States origin.

8.159 We wish to point out that the United States argument that the European Communities has presented insufficient factual evidence in support of its claim of inconsistency of the Act, by reason of the foreign articles/labour limitation, with Article III:4 of the *GATT 1994* is not germane to our examination. In order to reach our finding of *de jure* violation of Article III:4, we take note of, but need not rely on, the evidence submitted by the European Communities indicating that in certain cases, the foreign articles/labour limitation would appear to *require* the use of a certain amount of US articles. The "less favourable treatment" we have found arises by necessary implication from the words actually used in the text of the foreign articles/labour limitation in the Act. We recall that Article III:4 of the *GATT 1994* is an obligation addressed to governments requiring that they ensure equality of competitive opportunities to domestic and like imported products. It does not require a demonstration of trade effects, nor proof that the sourcing decisions of private firms have actually been impacted by the requirement in question.[270]

2. *Other Claims*

8.160 We note that the European Communities has also alleged that the "extended" subsidy, in respect of goods produced outside the United States, is prohibited because it will often be necessary to use US articles (and therefore exports) in order to satisfy the "foreign articles/labour limitation"[271], and that "[t]he foreign content limitation in the FSC Replacement scheme renders the basic FSC Replacement subsidy (and the extended FSC Replacement subsidy, if this is not contrary to Article 3.1(a)) contingent upon the use of US over imported goods contrary to Article 3.1(b) of the *SCM Agreement*."[272]

8.161 We recall that we need not examine all legal claims before us. Rather, we need only address those claims that must be addressed in order to resolve the matter in issue in the dispute[273], provided that we address those claims on which a finding is necessary in order to enable the DSB to make sufficiently precise recommendations and rulings so as to allow for prompt compliance by a Member in order to ensure effective resolution of disputes to the benefit of all Members.[274]

8.162 In light of our finding that the Act is inconsistent with Article III:4 of the *GATT 1994* by reason of the "foreign articles/labour limitation" in respect of US-produced goods[275], we do not consider it necessary to also address the EC claim that the Act is inconsistent with Article 3.1(b) of the *SCM Agreement* by reason of the foreign articles/labour limitation in respect of US-produced goods.

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[270] We find support for this view in Panel Report, *Canada-Autos*, *supra*, note 231, para. 10.84 and para. 10.78, Appellate Body Report, *Japan – Alcoholic Beverages, supra*, note 197, pp. 16-17.

[271] EC response to Panel Question 1, Annex F-1, paras. 1-4.

[272] EC first written submission, Annex A-1, para. 259.

[273] Appellate Body Report, *United States - Measure Affecting Imports of Woven Wool Shirts and Blouses from India*, WT/DS33/AB/R, adopted 23 May 1997, p. 19, DSR 1997:I, 323, at 340. See also e.g. Appellate Body Report, *Canada - Autos, supra,* note 118, paras. 112-117, where the Appellate Body refers to and endorses that panel's exercise of the "discretion" implicit in the principle of judicial economy.

[274] Appellate Body Report, *Australia-Measures Affecting Importation of Salmon*, WT/DS18/AB/R, adopted 6 November 1998, DSR 1998:VIII, 3327, para. 223.

[275] *supra*, para. 0.

8.163 With respect to the elements of the Act challenged by the European Communities in its claim under Article 3.1(a) of the *SCM Agreement* in respect of foreign-produced goods, we understand the European Communities to allege, in effect, that US-produced inputs that are used to produce qualifying foreign trade property outside the United States receive a subsidy contingent upon export performance. Under the current scheme, to the extent that a supplier of such inputs may be seen as receiving a "subsidy", it would be entitled to receive that subsidy irrespective of whether the inputs were used to produce qualifying foreign trade property within the United States *or* outside the United States. In order to decide the EC claim, we would be required to assume a different scheme, that is, where an input supplier might be seen as entitled to a "subsidy" *only* where the inputs were supplied for use in production of qualifying foreign trade property *outside* the United States (i.e. a scheme devoid of a foreign articles/labour limitation in respect of qualifying foreign trade property produced *within* the United States, which currently constitutes an integral part of the measure). However, such a significantly transformed measure would be manifestly different from the measure that is currently before us, and, as such, we consider that it would be neither necessary or appropriate to rule on it. With respect to the European Communities' alternative claim under Article 3.1(b) of the *SCM Agreement*, the European Communities asks us "to consider the application of the foreign content limitation in the case of non-US producers only if [we are] of the view that this limitation does not make the extended FSC Replacement subsidy contingent upon export performance contrary to Article 3.1(a)."[276] As we have not ruled on the EC claim under Article 3.1(a), it would therefore be inappropriate for us to rule on the *alternative* EC claim under Article 3.1(b) of the *SCM Agreement*.

D. Transitional Issues

8.164 In our Report in the original dispute, we recommended "that the DSB request the United States to withdraw the FSC subsidies without delay"[277], and specified that "FSC subsidies must be withdrawn at the latest with effect from 1 October 2000".[278] These elements formed part of the DSB recommendations and rulings arising upon adoption, on 20 March 2000, of the original Panel and Appellate Body Reports. On 12 October 2000, the DSB acceded to the United States' request "that the DSB modify the time-period in this dispute so as to expire on 1 November 2000".[279]

8.165 The European Communities argues that by maintaining the availability of FSC subsidies after 30 September 2000, for transactions effected by existing FSCs until 31 December 2001 (and, under certain circumstances, for an indefinite period), the United States has failed to withdraw the FSC subsidies as required by Article 4.7 *SCM Agreement* and the recommendations and rulings of the DSB and has also failed to comply with its obligations under Article 21 *DSU*.[280]

8.166 In the US view, the "limited transition relief" available under the Act provides foreign and domestic businesses with an opportunity to adjust and protect people who might have altered their conduct in reliance on the tax treatment provided by the earlier law, and is reasonable in the particular circumstances of this case. The United

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[276] EC first written submission, Annex A-1, para. 184.
[277] Original Panel Report, *supra*, note 2, para. 8.3.
[278] Original Panel Report, *supra*, note 2, para. 8.8.
[279] WT/DS108/11, 2 October 2000. See *supra*, para. 1.3 and WT/DSB/M/90, paras. 6-7.
[280] EC first written submission, Annex A-1, para. 241.

States contends that WTO panels have excused procedural violations in the absence of prejudice to the complaining party, essentially taking into account equitable considerations in issuing their decisions. According to the United States, a limited adjustment period is particularly appropriate given the EC's 13-year delay in challenging the FSC and the United States' reasonable reliance on the 1981 decision and understanding of the GATT 1947 Council.[281] Thus, the United States argues that the Act's limited transition rules constitute "reasonable implementation of the DSB's recommendations".[282]

8.167 We recall that the Act provides that "amendments made by this Act shall apply to transactions after 30 September 2000"[283], and that no new FSCs may be created after 30 September 2000.[284] However, in the case of a FSC in existence on 30 September 2000, the amendments made by the Act shall not apply to any transaction in the ordinary course of trade or business involving a FSC which occurs: (A) before 1 January 2002; or (B) after 31 December 2001, pursuant to a binding contract between the FSC (or any related person) and any unrelated person that is in effect on 30 September 2000.[285]

8.168 Thus, for FSCs in existence as of 30 September 2000, the FSC subsidies continue in operation for one year and, with respect to FSCs that entered into long-term, binding contracts with unrelated parties before 30 September 2000 the Act does not alter the tax treatment of those contracts for an indefinite period of time. We recall the statement of the Appellate Body in *Brazil - Export Financing Programme for Aircraft, Recourse by Canada to Article 21.5 of the DSU* 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"."[286]

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 dispute.[287]

8.170 In light of these considerations, we find that the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies inconsistent with Article 3.1(a) of the *SCM Agreement* and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 *SCM Agreement*.

8.171 Having found that the United States has not fully withdrawn the FSC subsidies as required by the recommendations and rulings of the DSB made pursuant to Article 4.7 *SCM Agreement*, we do not believe that it is necessary to also determine whether the United States "failed to comply with the DSB recommendations and rulings within the period of time specified by the DSB and has therefore also failed to

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[281] *Tax Legislation*, BISD 28S/114, 7-8 December 1981.

[282] US first written submission, Annex A-2, paras. 223-229.

[283] Act, section 5(a).

[284] Act, section 5(b)(1).

[285] Act, section 5(c)(1). The Act specifies that 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.

[286] Appellate Body Article 21.5 Report, *Brazil - Export Financing Programme for Aircraft, Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/AB/RW, adopted 4 August 2000, DSR 2000:VIII, 4067, para. 45.

[287] See US first written submission, Annex A-2, para. 224.

comply with Article 21 *DSU*"[288] due to its enactment of the Act repealing the FSC on 15 November 2000. We therefore exercise judicial economy with respect to this claim.

IX. CONCLUSION

9.1 In light of the findings contained in Section VIII above, we therefore conclude that:

(a) the Act is inconsistent with Article 3.1(a) of the *SCM Agreement* as it involves subsidies "contingent… upon export performance" within the meaning of 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* by applying the export subsidies, with respect to both scheduled and unscheduled agricultural products, in a manner that, at the very least, threatens to circumvent its export subsidy commitments under Article 3.3 of the *Agreement on Agriculture* and, by acting inconsistently with Article 10.1, the United States has acted inconsistently with its obligation under Article 8 of the *Agreement on Agriculture*;

(d) the Act is inconsistent with Article III:4 of the *GATT 1994* by reason of the foreign articles/labour limitation as it accords less favourable treatment within the meaning of that provision to imported products than to like products of US origin; and

(e) the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies inconsistent with Article 3.1(a) of the *SCM Agreement* and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 *SCM Agreement*.

[288] EC first written submission, Annex A-1, paras. 242-246.

9.2 Since Article 3.8 of the *DSU* provides that "[i]n cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment", we conclude that to the extent the United States has acted inconsistently with the *SCM Agreement*, the *Agreement on Agriculture* and the *GATT 1994* it has nullified or impaired the benefits accruing to the European Communities under those agreements.

ANNEX A

First Submission by the Parties

ANNEX A-1

FIRST WRITTEN SUBMISSION OF THE EUROPEAN COMMUNITIES

(17 January 2001)

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1. INTRODUCTION

1. The *FSC Repeal and Extraterritorial Income Exclusion Act of 2000* (the "FSC Replacement Act"), adopted on 15 November 2000 as US Public Law No 106-519, is the measure taken by the US ostensibly to comply with the recommendations and rulings of the DSB following the earlier proceedings before the Panel.[1] It does not however bring the US into compliance with those recommendations and rulings for the reasons the EC will explain in detail below. Although the FSC Replacement Act states that it repeals the FSC scheme, this scheme will continue to be available to all existing FSC scheme until 1 January 2002 and to apply to certain of their transactions for an indefinite period. Also, for those transactions where the FSC scheme no longer applies, the FSC Replacement Act makes available an alternative scheme that increases and extends the subsidies that were available under the FSC scheme without removing the contingency on export performance or on the use of domestic over imported goods.

[1] *United States – Tax Treatment for "Foreign Sales Corporations."* Reports of the Panel (WT/DS108/R, 8 October 1999, DSR 2000:IV, 1675) and by the Appellate Body on (AB-1999-9, WT/DS108/AB/R, 24 February 2000, DSR 2000:III, 1619) adopted by the DSB on 20 March 2000.

2. The description of the factual background (Section 2) is limited to the essential information. More detail about the US measure is provided as and when needed during the legal analysis (Section 3). Before concluding, the EC will ask the Panel to clarify the rights of third parties in this proceeding by means of a request for a preliminary ruling (Section 4).

2. FACTUAL BACKGROUND

3. The Panel is well aware of the background of this dispute through its work on the original Panel Report, which was upheld by the Appellate Body in virtually all respects except for a change in the reasoning relating to the violation of the *Agreement on Agriculture*. The recommendations of the Panel were adopted by the Dispute Settlement Body on 20 March 2000.[2]

4. Initial US proposals for complying with the recommendations of the DSB, for example by reducing the level of the tax deductions, were rejected by US business groups that lobbied vigorously to maintain their benefits. According to *Inside US Trade* of 24 March 2000:

> Large companies that stand to lose billions of dollars in tax benefits if the FSC were changed have taken a very hard line on rolling back FSC benefits. They hope the EU will agree to a cosmetic change of the FSC …[3]

5. Accordingly, the US decided to attempt to comply with the DSB recommendations by replacing the FSC scheme with other tax provisions that would maintain the same benefits.

6. The first official communication of US intentions came on 2 May 2000 when the US Deputy Secretary of the Treasury, Mr Eizenstat, came to Brussels to outline a proposal to the EC Commission.

7. This initial US proposal would have involved a repeal of the current FSC scheme and its replacement by an elective tax regime that would tax the "qualifying foreign income" of "eligible corporations" at a rate of 12.17 per cent or 24.5 per cent. The text of this proposal is Exhibit EC-2.

8. This new elective tax regime would have been very similar in effect to the FSC scheme. The tax rate of 12.17 per cent applied only if the "safe haven method" for calculating "qualifying foreign income" was used and corresponded to the FSC benefit using administrative pricing rules (12.17 per cent being equivalent to 8/23 of 35 per cent) and the rate of 24.5 per cent, applied in other cases (24.5 per cent being about double 12.17 per cent).

9. Also, an "eligible corporation" would have been defined as a foreign corporation that

(i) is managed outside the United States, and

(ii) conducts economic activity outside the United States with respect to its "qualifying foreign income."[4]

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[2] Doc. WT/DS108/10 of 24 March 2000.

[3] The relevant extract is Exhibit EC-1.

[4] See page 2 of the US proposal in Exhibit EC-1.

and "qualifying foreign income" would have had to be earned by an "eligible corporation," from the sale, lease, or rental of goods

(i) manufactured by an "eligible manufacturing corporation,"

(ii) sold, leased, or rented for use, consumption, or disposition outside the United States, and

(iii) not more than 50 per cent of the fair market value of which is attributable to foreign content. [5]

10. The main change compared with the FSC scheme was that the benefit of the new scheme would also have become available to foreign sales of certain foreign manufactured goods (of which not more than 50 per cent of the fair market value was attributable to foreign content).

11. In the view of the US, the enlarged application of the elective regime to both export foreign sales (involving US manufacturing) and non-export foreign sales (involving foreign manufacturing) would have rendered this scheme non export contingent.

12. On 26 May 2000, by a letter of Commissioner Lamy to Mr Eizenstat, the EC made clear its view that this proposal was unacceptable as it did not fulfil the conditions for WTO compatibility (Exhibit EC-3).

13. On 28 July 2000, US Deputy Secretary of State Eizenstat wrote to Commissioner Lamy to inform him about the passage by the House Ways and Means Committee on 27 July of the legislation to replace the FSC scheme. The bill submitted to Congress removed some of the ancillary elements of the 2 May proposal, like the need to create a foreign corporation to channel sales, but the US nonetheless persisted with the same basic scheme, developing its form to make it, in the US view, more easily defendable within the WTO, while still maintaining equivalent benefits for FSC beneficiaries.

14. Commissioner Lamy wrote to US Deputy Secretary of State Eizenstat on 31 August 2000 to express his concerns about the content of the bill as according to him it failed to remove the WTO violations that were present in the FSC scheme (Exhibit EC-4).

15. The bill was ultimately signed into law on 15 November 2000 as an Act of the US Congress entitled *FSC Repeal and Extraterritorial Income Exclusion Act of 2000*. The text of this Act is attached as Exhibit EC-5. An explanation of its provisions is contained in the US Congress Joint Committee on Taxation, *Technical Explanation of the Senate Amendment to H.R. 4986, the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000* (JCX-111-00) of 1 November 2000 (Exhibit EC-5A).

16. The intent to continue the effect of the FSC scheme is apparent in particular through the statement[6] in the Joint Committee on Taxation explanation that during the "gap period" pending the issuance of administrative guidance on the application of the new scheme, taxpayers may apply the principles of present law regulations and other administrative guidance under the FSC scheme.

17. The title of this law is misleading in a number of ways. First, it does not entirely repeal the FSC scheme, but allows it to continue for an indefinite period, as the EC will explain in more detail in Section 3.9 below. Second, it does not concern "ex-

[5] See page 2 of the US proposal in Exhibit EC-1.

[6] Exhibit EC-5A, p. 20.

traterritorial" income in any real of that word. The income to which it relates can be earned entirely in the US. It seems that the US is using the word "extraterritorial" to mean "export" or "derived from sales for foreign consumption". Finally, the word "exclusion" is confusing because the Act does nothing other than exempt a certain amount of income from tax, in a manner that is different in form but not in substance from the FSC scheme. For these reasons the EC will refer to the Act as the "FSC Replacement Act".

18. The nature of the new scheme introduced by the FSC Replacement Act (and which the EC will refer to as the "FSC Replacement scheme" to distinguish it from its predecessor) is well summarized in a Congressional Research Service Report on *Foreign Sales Corporation Tax Benefit for Exporting and the World Trade Organization* as follows:[7]

> H.R 4986 begins by exempting "extraterritorial income" from US tax, and continues by defining "extraterritorial income" and a chain of other concepts in a way that confines its exemption to a firm's US exports and a matching amount of income from foreign operations. The initial link in the chain of definitions is "qualifying foreign trade property", which is generally products manufactured, produced, grown, or extracted within or outside the United States. Generally, this is the full range of US exports, but the bill explicitly excludes the same items as FSC: certain intangibles, oil and gas, raw timber, prohibited exports, and property in short supply. Unlike FSC, however, military products would apparently qualify for the same benefit as other exports. And unlike the parallel FSC concept of export property, qualifying foreign trade property can be partly manufactured outside the United States. However, not more that 50 per cent of the value of qualified property can be added outside the United States.
>
> The next link in the chain is "foreign trade gross receipts", which the bill defines as income from sale or lease of qualifying trade property, and which parallels the FSC concept of gross receipts. As with FSC, a firm would only be treated as earning foreign trading gross receipts if it conducts economic processes abroad. However, FSC's foreign management requirements (see page 4, above) would be dropped.
>
> The bill next defines "foreign trade income" as taxable income attributable to foreign trading gross receipts. The bill terms a specified part of this foreign trade income "qualifying foreign trade income", and grants such income a tax exemption. The bill sets qualifying foreign trade income (and thus the exclusion) equal to either 1.2 per cent of foreign trading gross receipts, 15 per cent of foreign trade income, or 30 per cent of the income attributable to the foreign economic processes undertaken under the foreign trading gross receipts requirements. (The rule exempting 30 per cent of income is similar in its effect to the FSC rule that applies to firms that use arm's length pricing.) As with FSC and the May proposal before it, the arithmetic result of

[7] Congressional Research Service Report on Foreign Sales Corporation Tax Benefit for Exporting and World Trade Organization *The Foreign Sales Corporation FSC Tax Benefit for Exporting and the WTO* David L. Brumbaugh Specialist in Public Finance. Government and Finance Division (Updated 22 September 2000) - Exhibit EC-6.

the rules is that a firm can exempt somewhere between 15 per cent and 30 per cent of qualified income from US tax.

19. The main features of the FSC Replacement scheme compared with the FSC scheme to which the EC would draw attention at this point are:[8]

- The FSC Replacement scheme preserves the tax benefits available under the FSC scheme and envisaged in the initial US proposal in May 2000, that is an exemption of between 15 per cent and 30 per cent of export income. The formulae for calculating the exclusion from income are arithmetically equivalent to those available under the FSC scheme (as the EC will explain below).
- The FSC Replacement scheme is however simpler and easier to use than the FSC scheme. The need for a separate foreign corporation to earn the exempted income has been removed and the maximization of tax benefits by using the most favourable method for calculating qualifying foreign trade income can now be conducted by the US tax authorities;
- The FSC Replacement scheme is available under certain circumstances for income earned from the sale of goods by foreign corporations that elect to be treated as domestic US corporations;
- The 50 per cent foreign content limitation that exists under the FSC scheme has been adapted to the features of the new law so as to include foreign direct labour costs.

20. The FSC Replacement Act therefore does nothing to meet the concerns of the EC, the Panel, the Appellate Body or the DSB about the export subsides granted by the US tax system. It is an attempt to disguise them. Indeed its purpose is, as US Deputy Secretary of State Eizenstat intimated when urging the US Senate to pass the bill, to prevent immediate retaliation and to give the US "a chance to 're-litigate' the dispute".[9]

21. The Congressional Budget Office estimated that the FSC Replacement Act would increase tax expenditures compared to the existing FSC scheme by the following amounts:[10]

Estimated Budget Effects of H.R. 4986, The "FSC Repeal And Extraterritorial Income Exclusion Act of 2000," as Reported by the Committee on Finance

[Fiscal Years 2001– 2010, in millions of dollars]

Provision	Effective	2001	2002	2003	2004	2005	2006
Extra-territorial income	Generally	-141	-305	-340	-378	423	-466

[8] For a fuller explanation of the differences between the FSC scheme and the FSC Replacement scheme, the Panel is referred to the annexed documents. The EC will describe the provisions of the Act in more detail as and when necessary below.

[9] US Deputy Secretary of State Eizenstat speaking during the Senate Finance Committee passing of the bill on 19 September 2000 and reported in Inside US Trade, 22 September 2000, page 26 (Exhibit EC-7).

[10] Taken from the Senate Report of 20 September 2000. The Congressional Budget Office Cost Estimate of 13 September 2000 (Exhibit EC-8) contained slightly higher estimates.

Provision	Effective	2007	2008	2009	2010	2001-05	2001-10
Extra-territorial income	Generally	-514	-566	-623	-687	-1,587	-4,443

Exclusion: FSC Repeal 9/30/00

Legend for "Effective" column: ta = transaction after.

Note: Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

22. Despite its disappointment with the fact that the US has refused to comply with the recommendations of the DSB, the EC has endeavoured to de-escalate this dispute in the hope that a calm political environment would facilitate the task of the US in ultimately coming into compliance. For this reason, it has entered into a procedural agreement with the US, which it has notified to the WTO[11] and which underlines the importance that the EC attaches to the multilateral character of the WTO dispute settlement system.

23. On 17 November 2000 the EC initiated the procedures under Article 21.5 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ("*DSU*") by requesting the US to enter into consultations.[12]

24. Consultations were held with the US on FSC Replacement scheme in Geneva on 4 December 2000 Act. They allowed a better understanding of the respective positions of the parties but failed to resolve the dispute.

25. Accordingly, the EC requested that the Panel be reconvened to examine this issue under Article 21.5 *DSU*.[13] The Panel was established on 20 December 2000.

3. LEGAL ANALYSIS

3.1. Introduction

26. In the view of the EC, the FSC Replacement Act fails to bring the US into compliance with the DSB recommendations and rulings and is inconsistent with the covered agreements. The FSC Replacement scheme provides equally prohibited subsidies to US exporters as does the FSC scheme and introduces further prohibited subsidies to certain foreign corporations.

27. There is disagreement both as to the existence and the consistency with covered agreements of measures taken to comply with the recommendations and rulings of the DSB within the meaning of Article 21.5 *DSU*. The US has even refused at the consultations to accept that no measures taken to comply with the recommendations and rulings of the DSB "existed" on the date by which the DSB had fixed for them to be taken.

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[11] *Understanding between the European Communities and the United States Regarding Procedures* under *Articles 21 and 22 of the DSU and Article 4 of the SCM Agreement,* WT/DS108/12, 5 October 2000.

[12] The request was circulated in document WT/DS108/14 of 21 November 2000.

[13] WT/DS108/16, 8 December 2000.

28. Accordingly, the mandate of the Panel pursuant to Article 21.5 of the *DSU* and in the light of Article 4 of the Agreement on Subsidies and Countervailing Measures ("*SCM Agreement*") is to determine whether the US has withdrawn the subsidy and complied with the recommendations and rulings of the DSB by the due dates and whether the US measures (the FSC Replacement Act and its related provisions) are consistent with the covered agreements.

29. The EC will set out in the following order the reasons why it considers that the FSC Replacement Act is inconsistent with the obligations of the US under the covered agreements and that by failing to withdraw the subsidies found to be inconsistent with the *SCM Agreement* and to bring its law into conformity with its obligations under the *SCM Agreement* and the *Agreement on Agriculture*, the US has also failed to comply with the DSB recommendations and rulings in this dispute:

- that the FSC Replacement scheme results in the foregoing of tax revenue that is otherwise due, thereby conferring a benefit upon recipients. Therefore, the FSC Replacement Act provides subsidies within the meaning of Article 1 of the SCM Agreement and under the Agreement on Agriculture;
- that the FSC Replacement scheme provides subsidies which are contingent upon export performance contrary to Article 3.1(a) of the SCM Agreement and specifically related to export contrary to item (e) of Annex 1 of the SCM Agreement;
- that the FSC Replacement scheme provides subsidies which are contingent upon the use of domestic over imported goods contrary to Article 3.1(b) of the SCM Agreement;
- that consequently, the FSC Replacement scheme grants and maintains subsidies contrary to Article 3.2 of the SCM Agreement;
- that the FSC Replacement scheme provides treatment less favourable to products imported into the US that is accorded to like US products, contrary to Article III:4 of GATT 1994;
- that the subsidies provided by the FSC Replacement scheme are contrary to Articles 10.1 and 8 of the Agreement on Agriculture, or in, the alternative, Articles 3.3 and 8 in conjunction with Article 9.1 of the Agreement on Agriculture;
- that the FSC Replacement Act contains transitional provisions which allow companies to continue to benefit from the WTO incompatible FSC scheme beyond 30 September 2000;
- that the US has failed to comply with the DSB recommendations and rulings in United States - Tax Treatment for "Foreign Sales Corporations", WT/DS108 by 1 November 2000, as specified by the DSB on 12 October 2000.

3.2. The FSC Replacement Scheme Continues to Provide Subsidies

3.2.1. The Findings of the Panel and the Appellate Body on the FSC Scheme

30. The Panel will recall that the FSC scheme was held to involve a financial contribution by government that confers a benefit and therefore to give rise to a sub-

sidy because it involved the forgoing of revenue that would otherwise be due. As the Appellate Body stated in upholding the finding of the Panel:[14]

> In our view, the "*foregoing*" of revenue "*otherwise* due" implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, "otherwise". Moreover, the word "foregone" suggests that the government has given up an entitlement to raise revenue that it could "otherwise" have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues. There must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised "otherwise". We, therefore, agree with the Panel that the term "otherwise due" implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question.

31. The only point on which the Appellate Body's reasoning on Article 1 of the *SCM Agreement* differed from that of the Panel related to the question of whether:[15]

> … the term "otherwise due" establishes a "but for" test, in terms of which the appropriate basis of comparison for determining whether revenues are "otherwise due" is "the situation that would prevail but for the measures in question…"

32. The Appellate Body's difficulty with this test was that it was not treaty language and would imply that changing an exception from taxation into an exclusion from taxation would imply that there was no subsidy. In the Appellate Body's words:[16]

> It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be *no* general rule that applied formally to the revenues in question, absent the contested measures.

33. The Panel and the Appellate Body also stressed that there the *WTO Agreement* did not restrict the right (indeed "the sovereign authority") of WTO Members to tax, or not to tax, particular categories of revenue,[17] so long as it respects its WTO obligations. It appears that the US will attempt to argue that the FSC Replacement Act does not give rise to a subsidy because the US has simply exercised this right and has chosen not to tax a category of income that it terms "extraterritorial" (or "qualifying foreign trade income").

3.2.2. The Changes Introduced by the FSC Replacement Act

34. The FSC Replacement Act abolishes, subject to various transitional arrangements, the FSC exemptions and replaces them with a scheme whereby certain "qualifying foreign trade income" is said to be "excluded" from taxation.

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[14] Appellate Body Report, para. 90.
[15] Appellate Body Report, para. 91 referring to Panel Report, paragraph 7.45.
[16] Appellate Body Report, para. 91.
[17] Panel Report, para. 7.122 and Appellate Body Report, para. 90.

35. This "excluded" qualifying foreign trade income corresponds arithmetically to the exempt foreign trade income of FSC scheme. The text of the new Section 941(a) of the IRC, which defines this concept, merits quoting in full:

> (1) IN GENERAL. The term `qualifying foreign trade income' means, with respect to any transaction, the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest of
>
> (A) 30 per cent of the foreign sale and leasing income derived by the taxpayer from such transaction,
>
> (B) 1.2 per cent of the foreign trading gross receipts derived by the taxpayer from the transaction, or
>
> (C) 15 per cent of the foreign trade income derived by the taxpayer from the transaction.

36. Thus, the new Section 941(a)(1)(A) provides an exclusion equal to 30 per cent of foreign sale and leasing income which corresponds to the 30 per cent exclusion available under in the FSC scheme applicable when the administrative pricing rules are not applied (Section 923(a)(2)). The new Section 941(a)(1)(B) provides an exclusion equal to 1.2 per cent of foreign trading gross receipts is equal to that available under the FSC scheme[18] (multiplying 15/23 by 1.83 per cent yields 1.2 per cent.). The new Section 941(a)(1)(C) provides an exclusion equal to 15 per cent of foreign trade income, which is equal to that available under FSC scheme[19] (multiplying 15/23 by 23 per cent yields 15 per cent).

37. The FSC Replacement Act also simplifies the availability of the benefit by removing the need for a foreign subsidiary (the FSC), removing other formalities and placing on the US Internal Revenue Service the task of identifying the formula that maximizes the benefit to the taxpayer for each transaction.

38. The first basic question is therefore whether the fact that the FSC Replacement Act is expressed in terms of *excluding* certain income from taxation, whereas the FSC scheme used the term "*exempt"* (as well as the term "excluded"), means that there is no longer any subsidy (because WTO Members are allowed to choose what categories of income they will tax).

39. The EC will show below that the FSC Replacement scheme is just as much a subsidy as was (and is) the FSC scheme. The EC will first explain why the US is playing with words when it claims that the scheme is different from the FSC scheme by *excluding* income from tax rather than *exempting* it. The EC will then return to the terms of Article 1.1 *SCM Agreement* as interpreted by the Panel and the Appellate Body to demonstrate that the cosmetic changes which the US has made have not changed the fact that revenue that is otherwise due is forgone.

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[18] Sections 923(a)(3) (as modified by Section 291(a)(4) IRC) and 925(a)(1) of the IRC.

[19] Sections 923(a)(3) (as modified by Section 291(a)(4) IRC) and 925(a)(2) of the IRC.

3.2.3. It is Irrelevant and Misleading to Refer to the FSC Replacement Scheme as an "exclusion from tax" Rather than an Exemption

40. The EC has already noted above[20] the Appellate Body's observation that a formalistic approach based on a distinction between an "exclusion" from tax and an exemption could provide an easy but inappropriate means of circumventing the *SCM Agreement* prohibition on export contingent subsidies. Already for this reason the US device is doomed to fail. The EC will explain why the change in terminology is irrelevant and misleading.

41. Indeed, the words "exemption" and "exclusion" can and are used fairly interchangeably in tax legislation. Already the basic FSC provision, Section 921 of the IRC has as its first heading "Exempt Foreign Trade Income" and as its second "Exclusion." It operated formally as an exclusion, since income was deemed to be "foreign source income which is not effectively connected with the conduct of a trade or business within the United States" and thus not taxable. In reality everyone recognized, and the Panel and the Appellate Body held, that the FSC scheme exempted income from tax. The confusion of terminology is nothing new, and the EC will now explain why the true nature of the FSC Replacement scheme is that of an exemption from tax.

42. The new Section 114(a) of the IRC inserted by the FSC Replacement Act provides that:

> (a) EXCLUSION. Gross income does not include extraterritorial income.

43. But Section 114(b) then immediately states that:

> (b) EXCEPTION. Subsection (a) shall not apply to extraterritorial income which is not qualifying foreign trade income as determined under subpart E of part III of subchapter N.

44. Thus, it is immediately apparent that it is only "qualifying foreign trade income" that is "excluded." The invention of an additional category of "extraterritorial income" is largely unnecessary, misleading and irrelevant. Read together, paragraphs (a) and (b) do nothing other than provide for a limited exemption from tax of an amount of income that is later defined as qualifying foreign trade income. Reference to the definition of "qualifying foreign trade income" in Section 941(a) further shows that this amount of income is defined in terms of "the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to …" This is exactly equivalent to an exemption of the amounts that are then listed.

45. As explained in Section 3.2.2 above, the amounts exempted are arithmetically equivalent to the amounts exempted under the FSC scheme.

46. Thus, the first reason why the FSC Replacement scheme is not really an exclusion of income from the tax base but rather a new exemption of income from taxation is that the "excluded income" is expressly defined in terms of "the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to" a defined amount.

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[20] Paragraph 31.

47. Clearly, any exemption can be presented as an exclusion in this way. If a WTO Member wanted to give a 1 per cent bounty for the value of goods exported it could simply exclude from taxation "the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to 1 per cent of the value of goods exported."

48. A second reason why the new scheme creates an exception and not an exclusion from tax liability is that it is subject to a large number of *special conditions.* These will be discussed in more detail below, and it is sufficient to note here that they are not only conditions related to export (i.e. sale for consumption outside the US) but also require, for example, that qualifying property must have less than 50 per cent foreign content. There are also numerous exceptions (for example, the scheme does not apply to the income from the export of lumber or of goods deemed to be in short supply).

49. A third reason why there is an exception and not an exclusion is that only part of the income from a given taxable event (that part which is qualifying foreign trade income) is "excluded" from tax. Indeed the US does subject the major part of what it calls "extraterritorial income" to tax. It is only that variable part of it that is designated qualifying foreign trade income and that the taxpayer chooses to bring within the exclusion that escapes tax. It is not therefore in any event possible to speak of a "category of income" being excluded from tax.

50. The US seeks to turn this argument around[21] by saying that the *taxation* of the part of extraterritorial income which is not qualifying foreign trade income is the exception to the general rule of not taxing extraterritorial income and that, if it is allowed to exclude all the income, then surely it can exclude some of it.

51. The EC submits that this is merely playing with words. The "exception", by its very nature, is the decision not to tax a part of such income. The fact that the majority of "extraterritorial income" (the part that is not qualifying foreign trade income) is subject to the normal rate of tax is simply evidence that there is no general rule excluding such income from taxation – this reinforces the argument that the non-taxation of qualifying foreign trade income is the exception.

52. Fourthly, the FSC Replacement scheme is *elective*. Firms can choose to avail of the FSC Replacement scheme or use the normal US tax rules until 1 January 2002,[22] or, in some circumstances during the indefinite transitional period, the FSC scheme.[23]

3.2.4. The FSC Replacement Scheme Gives Rise to Revenue Forgone that is Otherwise Due

53. The EC submits that the factor that determines whether the FSC Replacement scheme gives rise to a financial contribution and therefore a subsidy is not whether the legislative provisions on which it is based use the word "exclude" or the word "exempt" or neither, but whether there is revenue forgone that is otherwise due within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement.*

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[21] [In the House Ways and Means Report of 12.9.2000 (P.10)]

[22] See Section 942(a)(3) of the IRC.

[23] See Section 5 of the FSC Replacement Act and the explanation in Section 3.9 below.

54. Both the Panel[24] and the Appellate Body[25] made clear that this requires comparison of the revenue actually raised following application of the measure in question and that raised under a "benchmark" situation which would otherwise prevail under the law of the Member in question.

55. The FSC Replacement Act provides that income is partially "excluded" from taxation if all the conditions laid down by the FSC Replacement scheme are satisfied, that is, in particular:

- The income must derive from the sale of "qualifying foreign trade property" and must therefore:
  - be held for ultimate use outside the US;[26]and
  - have foreign content of not more than 50 per cent of the fair market value;[27]
- The income must be "qualifying foreign trade income" (in particular, the property must not be sold for final consumption in the US);[28]
- Elections must have been made or not made as required;[29]
- None of the various exclusions from the benefit of the FSC Replacement scheme must apply, such as those:
  - for agricultural and horticultural cooperatives;[30]
  - for members of groups of companies including DISCs;[31]
  - for FSCs;[32]
  - for categories of foreign corporations designated by the Secretary;[33]
  - exclusion of income by the Secretary as a consequence of participation by taxpayers in an "international boycott" and corrupt practices.[34]

56. If these conditions are met, the income is "excluded" from taxation. If they are not met, it is not excluded (i.e. is included) and tax is due on it. Consequently, if the conditions are met, the tax revenue that would otherwise be due from this income is not raised – that is, it is forgone.

57. Thus, the "exclusion" from taxation that is effected through the operation of the FSC Replacement scheme cannot at all be assimilated to the non taxation of categories or classes of income that are not subject to taxation. The FSC Replacement Act does not *qualitatively* define a *class or category of income* that is excluded from the tax base – it lays down *conditions* for the partial non-taxation of income that otherwise would be fully taxed. The income is of the same nature whether or not the

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24 Panel Report, paras. 7.42-7.43.
25 Appellate Body Report, para. 90.
26 Section 943(a)(1)(B) of the IRC.
27 Section 943(a)(1)(C) of the IRC.
28 Section 941(a) of the IRC.
29 E.g. under Sections 942(a)(3),943(e).
30 Section 943(g) of the IRC.
31 Section 943(h) of the IRC.
32 Section 5(c) of the FSC Replacement Act.
33 Section 943(e)(4)(C) of the IRC.
34 Sections 941(a)(5) of the IRC.

conditions are met. Part of the income from a single taxable event is taxed and part is not.

58. It is true that WTO Members are free not to tax a *general category* of income and that foreign source income may be one such general category.

59. "Extraterritorial income" is not however foreign source income. As noted in Section 2 above it may be earned entirely in the US and the only "extraterritorial" characteristic is that it is revenue from sales for final consumption outside the US. Although new Section 942(b) IRC establishes a number of foreign economic process requirements, there is no relationship between the value of these processes and the extent to which they are performed outside the US and the amount of income exempted.

60. "Extraterritorial income" (and even less so, qualifying foreign trade income) is not a general category of income that a WTO Member may choose not to tax in conformity with the *SCM Agreement.* It is no more than an artificial device designed to replicate FSC benefits in the guise of a general exclusion.

61. As explained above, what is excluded from tax is a *quantity* of income - "the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to" a predetermined amount.[35]

3.2.5. There are Two Distinguishable Subsidies

62. The novel feature of the FSC Replacement scheme is that it also applies to transactions involving certain foreign produced goods (provided they contain no more than 50 per cent foreign content).

63. The conditions applying to each are not the same and nor, as will be shown, is the analysis under the *SCM Agreement*. The main formal difference is that the subsidy relating to transactions involving certain foreign produced goods only applies if the producing company has volunteered to be subject to US taxation as a domestic company. In addition, there are many other differences of treatment arising from the fact that *formally* identical treatment is applied to differing situations, notably production outside the US rather than inside and by a foreign person rather than by a US person.

64. The EC will refer to the subsidy granted in respect of the export of US produced goods as the "basic FSC Replacement subsidy" and that accorded to transactions involving foreign produced goods as the "extended FSC Replacement subsidy" in order to distinguish them. When there is no need to distinguish the two cases, the EC will refer to them generally as the "FSC Replacement subsidy" or the "FSC Replacement subsidies".

65. The fact that subsidies paid to foreigners may also fall under the *SCM Agreement* has already been recognized in *Brazil – Export Financing Programme for Aircraft,*[36] where the subsidies were paid to non-Brazilian airlines purchasing Brazilian aircraft.

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[35] See the definition of qualifying foreign trade income in Section 941(a) of the IRC.

[36] *Brazil – Export Financing Programme for Aircraft*, Panel Report, WT/DS46/R, 14 April 1999, DSR 1999:III, 1221 and *Brazil – Export Financing Programme for Aircraft*, Appellate Body Report, AB-1999-1, WT/DS46/AB/R, 2 August 1999, DSR 1999:III, 1161.

66. The availability of the FSC Replacement scheme to transactions involving foreign produced goods gives rise to revenue forgone and confers a benefit in the same way as the application of the scheme to the export of US produced goods. Indeed, it is arguably even clearer, since foreign produced goods will only be qualifying foreign trade property where the foreign producer affirmatively elects to be treated as a US domestic corporation and benefit from the scheme, whereas the scheme is supposed to apply automatically in the case of exports of US produced goods (unless the taxpayer elects to exclude receipts under Section 943(a)(3)). It is clear that the FSC Replacement scheme will not be invoked in the case of foreign produced goods unless this gives rise to a tax saving under US law.

3.2.6. The FSC Replacement Scheme Also Provides Subsidies within the Meaning of the Agreement on Agriculture

67. In the earlier proceedings, the Panel found that a measure falling within the definition of subsidy under the *SCM Agreement* would also be a subsidy for the purposes of the *Agreement on Agriculture* when applied to agricultural products unless there were provisions of the *Agreement on Agriculture* which suggested a different conclusion.[37] The Appellate Body found no reason to disagree with this finding. Nothing in the FSC Replacement Act suggests that a different conclusion is called for in respect of the FSC Replacement scheme.

3.2.7. Conclusion

68. The EC therefore concludes that the FSC Replacement scheme created by the FSC Replacement Act gives rise to subsidies within the meaning of the *SCM Agreement* and the *Agreement on Agriculture*.

3.3. The FSC Replacement Subsidy is Contingent upon Export Performance

3.3.1. Introduction – the FSC Replacement Scheme as an Export Subsidy

69. The US has signalled that its defence of the FSC Replacement scheme will concentrate on its contention that it has eliminated export contingency by making the FSC Replacement scheme available also for transactions involving goods produced outside the US (so long as the foreign content does not exceed 50 per cent).

70. This is in fact a rather extraordinary claim. It defies common sense to suggest that a measure will cease to be an export subsidy if an additional export promoting feature is added to it!

71. The US has replaced the requirement of export with a requirement that goods not be sold "for ultimate use in the United States".[38] As regards US goods, this is of course simply another way of saying that they must be exported (and indeed similar language has already been considered by the Panel because it is used in the FSC scheme[39]). The saving grace of the FSC Replacement scheme, according to the US, is that its scope is wider and also regulates the (probably very rare) case of foreign pro-

[37] Panel Report, paras. 7.149 – 7.151.
[38] Section 942(a)(2)(A)(i) of the IRC.
[39] Section 927(a)(1)(B) of the IRC.

ducers who are subject to US taxation as domestic companies but who produce abroad and whose goods are sold abroad. If the prohibition on export subsidies in the *SCM Agreement* ceases to apply for such a reason, it is a very poorly designed provision indeed.

72. The EC will set out in Sections 3.3.2 to 3.3.5 below a number of detailed legal reasons why the US is wrong. First and most fundamentally, the point of comparison for considering whether a subsidy is contingent upon export performance is the treatment accorded to domestic sales, not the treatment accorded to sales of foreign produced goods. Second, the alleged alternative means of obtaining the subsidy is also export contingent, that is the extended FSC Replacement subsidy is also prohibited. Third, Article 3.1(a) expressly states that a subsidy is prohibited whether export performance is *the sole or one of several* conditions. Fourth, the consequences of an election by a foreign producer to be subject to US tax are such that it cannot be expected that the election will be used in practice.

73. The EC will also argue in Section 3.4 below that the FSC Replacement scheme is also a prohibited export subsidy because it is specifically related to exports.

3.3.2. The Tax Treatment of Domestic Sales of Domestic Goods, not that of Foreign Sales of Foreign Goods, is the Proper Basis for Comparison

3.3.2.1. Introduction – the US Argument

74. Article 3.1(a) of the *SCM Agreement* prohibits:

> subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I (footnotes omitted)

75. As noted above, the US appears to be arguing that since it is possible to obtain the FSC Replacement subsidy without exporting, it is not export contingent.

76. Since the subsidy is in fact the exemption (or exclusion) of certain income from tax, the US could in fact be arguing that since it is possible to earn tax free income without exporting, exempting (or excluding) income from tax is not an export subsidy.

77. There are a number of categories of income that are not subject to tax in the US. The FSC Replacement Act operates by inserting a new Section 114 into the IRC that deems certain income to be excluded from "gross income" for US tax purposes. There are many other provisions that do exactly the same. Like the exclusion from gross income that is the starting point of the FSC Replacement scheme, they are contained in Subtitle A, Chapter 1, Subchapter B, Part III of the IRC and include certain rental income, certain interest on State bonds and compensation for sickness.[40]

78. It is immediately apparent that the simple fact that tax free income – or even income that is given the name "extraterritorial" – can be earned without exporting cannot suffice to prevent an export subsidy from being present if such income can be earned contingent upon export performance. Otherwise, it would have been sufficient

[40] A list of some of the provisions is contained in Exhibit EC-9.

to include in the exemption any other category of income which is already exempted, or which it is thought desirable to exempt from tax.

79. In order to assess whether an exemption is contingent upon export or specifically related to export, there must be a comparison with some relevant benchmark.

80. The US seems to be arguing that the relevant benchmark for the tax treatment of sales of US produced goods sold outside the US can be taken to be the tax treatment of foreign produced goods sold outside the US and then argues that the tax exemption for income from such sales of the US produced goods is not export contingent because the same treatment is given to foreign produced goods.

81. The argument is mistaken because the wrong benchmark is being used. For the reasons that will be examined in the next Section, the correct benchmark in the case of the US produced goods is the treatment accorded to domestic sales.

3.3.2.2. The Correct Benchmark for US Produced Goods

82. The EC submits that the correct benchmark must be determined by examining the terms of Article 3.1(a) in context.

Contingent

83. It is the term "contingent" that has been subject of most attention in export subsidy cases so far. The Appellate Body has explained, for the first time in *Canada – Measures Affecting the Export of Civilian Aircraft ("Canada - Aircraft")*, that "contingent" is the key word in Article 3.1(a). It stated that[41]:

> …the ordinary connotation of "contingent" is "conditional" or "dependent for its existence on something else". This common understanding of the word "contingent" is borne out by the text of Article 3.1(a), which makes an explicit link between "contingency" and "conditionality" in stating that export contingency can be the sole or "one of several other *conditions*".

84. The Appellate Body has also made clear that "the legal standard expressed by the word 'contingent' is the same for both *de jure* or *de facto* contingency"[42] and that it is only the evidence that differs.[43] In *Canada – Certain Measures Affecting the Automotive Industry ("Canada – Automobiles")*,[44] it went on to say that:

> A subsidy is contingent "in law" upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure. The simplest, and hence, perhaps, the uncommon, case is one in which the condition of exportation is set out expressly, in so many words, on the face of the law, regulation or other legal instrument. We believe, however, that a subsidy is also properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the

[41] *Canada – Measures Affecting the Export of Civilian Aircraft*, Appellate Body Report, AB-1999-2, WT/DS70/AB/R, 2 August 1999, DSR 1999:III, 1377, para. 166.
[42] *Ibid*., para. 167.
[43] *Ibid.*
[44] *Canada – Certain Measures Affecting the Automotive Industry*, Appellate Body Report, AB-2000-2, WT/DS139/AB/R, WT/DS142/AB/R, 31 May 2000, DSR 2000:VI, 2985, para. 100.

measure. Thus, for a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfilment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.

Export

85. The term "export" is not defined in the *SCM Agreement* despite its fundamental importance. The dictionary definition of the noun "export" is

An article that is exported[45]

and the verb "export" means:

Send (esp. goods) to another country[46]

86. As usual, this dictionary definition is not of much help. Guidance is available however from the context in which this word is used, that is the rest of the *SCM Agreement* and indeed the rest of the *WTO Agreement*.

87. The importance of the context is also evident when one considers that if the term "export" were taken literally to refer to any export in the abstract independently of its context then any autonomous reduction of import duties on a product by a country would be a prohibited export subsidy since there would be revenue forgone and a benefit conferred and the amount would depend, literally, on export performance (of the third country exporters). It may be assumed that this was not the intention of the WTO Members when they concluded the *SCM Agreement*. It is necessary therefore to examine the meaning of the term in its context.

88. The immediate context is of course the Illustrative List, which is expressly stated to illustrate, that is to shed light on, the meaning of Article 3.1(a). In many places in the Illustrative List it is made clear that the term "export" refers to products *destined for the market* of another country, or *for consumption in* that other country. Thus, items (d), (f), (g) and (h) all require a comparison of the conditions applicable to exports with those applying in the case of goods for domestic consumption. Item (l) includes in the Illustrative List export subsidies identified in Article XVI of *GATT 1994*, paragraph 4 of which refers to export subsidies as giving rise to bi-level pricing between markets.[47]

89. Looking to the rest of the *SCM Agreement*, it may be noted that the first mention of the word "export" occurs in its footnote 1, which contrasts "exports" with "the like product when destined for domestic consumption." [48]

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[45] *New Shorter Oxford English Dictionary* CD-ROM version (1997).

[46] *New Shorter Oxford English Dictionary* CD-ROM version (1997).

[47] Article XVI:4 of the *GATT 1994* provides as follows:

Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. Until 31 December 1957 no contracting party shall extend the scope of any such subsidization beyond that existing on 1 January 1955 by the introduction of new, or the extension of existing, subsidies.*

[48] The full text of footnote 1 is:

In accordance with the provisions of Article XVI of *GATT 1994* (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the exemption of an exported product from

90. The fact that the term "exports" describes goods *destined* for the markets of (that is, consumption in) other countries is also clearly expressed in *GATT 1994*. Thus, Article I of *GATT 1994* associates the concepts of importation/exportation and imports/exports with the phrase "products originating in or destined for any other country" [49] and similar language is found elsewhere in *GATT 1994*. That the use of the term "destined for" in relation to exports is not accidental is shown by Article V of *GATT 1994* which does not refer to exports but defines the contrasting concept of "transit".[50]

91. Thus, the EC submits that the term "export" in Article 3.1(a) of the *SCM Agreement* refers to the sale of:

- Goods;
- Originating in the country providing the subsidy;
- Destined for the market of, that is for final consumption in, another country.

92. The EC considers that this examination of the term "export" as used in Article 3.1(a) demonstrates that the provisions are written from the perspective of goods located in the country providing the subsidy and that accordingly the basis for comparison for the treatment accorded to export transactions is that accorded to domestic transactions.

Performance

93. The fact that the perspective of the Article 3.1(a) is that of producers in the territory of the country granting the subsidy is also clear from the use of the word "performance".

94. The primary dictionary definition of "performance" in this context is

> The execution or accomplishment of an action, operation, or process undertaken or ordered; the doing of any action or work; the quality of this, esp. as observable under particular conditions;[51]

95. Used with the word "export", this word implies that the link or dependency need not exist for every single transaction but that exports in general (that is the *process* of export) should be determined by the availability of the subsidy. Thus a

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duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy.

[49] The full text of Article I:1 of the *GATT 1994* reads:

With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III,* any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

[50] Article V:1 provides that:

Goods (including baggage), and also vessels and other means of transport, shall be deemed to be in transit across the territory of a contracting party when the passage across such territory, with or without trans-shipment, warehousing, breaking bulk, or change in the mode of transport, is only a portion of a complete journey beginning and terminating beyond the frontier of the contracting party across whose territory the traffic passes. Traffic of this nature is termed in this article "traffic in transit".

[51] *New Shorter Oxford English Dictionary* CD-ROM version (1997).

commitment to export 50 per cent of the output resulting from a subsidized production facility would be contingent upon export performance, even though there is no requirement to export every product produced by the facility.

Conclusion

96. Accordingly, the EC considers that it does not need to show that *all* subsidies granted under the FSC Replacement scheme are export dependent. It is sufficient if some of the beneficiaries receive the benefit conditional upon exporting from the US rather than selling domestically. If there are circumstances in which exportation is obligatory in order to obtain the subsidy, then the subsidy is dependent or contingent upon export in these circumstances, and must therefore be an export subsidy.

97. Thus, the notion of contingency does not exist in the abstract but must be understood in the light of the actual circumstances of a recipient and compared with the relevant alternative (in the case of export contingency sale for consumption abroad rather than sale for domestic consumption). In particular, producers (or more exactly owners) of US goods have no choice but to export in order to obtain the subsidy in respect of those goods.

98. It is true that where a subsidy is made available, for example, to all producers of shoes, some producers may in fact qualify by producing shoes which they export, but this does not make the subsidy export contingent. Each producer is free to sell on the domestic market or to export and this does not affect entitlement to the subsidy. However, in the case of the FSC Replacement scheme, the situation is different. Owners of US goods for sale in the US do not have a choice in how to obtain the subsidy. They cannot, unlike the shoe manufacturers in the above example, satisfy the conditions by selling domestically. They have to export. Thus they obtain the subsidy by performing one function, export, in preference to another, selling on the domestic market.

3.3.2.3. Application to the FSC Replacement Scheme

99. The FSC Replacement Act avoids any mention of the word "export". It uses other words to achieve the same result. (It is not uncommon for export subsidies to avoid the word "export" as the Appellate Body remarked in *Canada – Automobiles*.[52]) The FSC Replacement scheme is only available in respect of sales of "qualifying foreign trade property." Part of the definition of this concept limits it to goods for use or consumption outside the US. Section 943(a)(1)(B) of the IRC provides that it must be:

> held primarily for sale, lease, or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States,

100. Further, the sale of qualifying foreign trade property for ultimate use in the US will prevent foreign trading gross receipts from arising. Section 942(a)(2)(A)(i) of the IRC provides that

> The term `foreign trading gross receipts' shall not include receipts of a taxpayer from a transaction if the qualifying foreign trade property or services are for ultimate use in the United States

[52] See the quotation from the Appellate Body in the discussion of the word "contingent" in Section 3.3.2.2 above.

101. The phrase "for ultimate use within the US" is for US goods obviously simply another way of saying "not exported". Thus, the key distinction for the availability of the FSC Replacement subsidy is whether such property is exported. A sale of goods for ultimate use outside the US (i.e. an export) has as its consequence the availability of the FSC Replacement subsidy; a sale of goods for ultimate use in the US is deprived of the same advantage. The EC submits that that makes the availability of the subsidy contingent upon export performance.

102. It is true that the same consequence (the availability of the FSC Replacement subsidy) can arise in other ways. One example is the provision of services outside the US. That does not diminish the fact that it is only available to US goods if they are exported, not if they are sold on the US market. It does not undermine the conclusion that this availability for export is a reward for export performance.

103. It is also true that the same consequence can arise through production and sales of certain goods outside of the US (although, as will be discussed below, this is not likely). Again, that is not the relevant point of comparison. Article 3.1(a) addresses export contingency relating to the goods of the country providing the subsidy (in this case the US) and prohibits making the availability of the subsidy contingent on export performance and therefore on whether the goods are exported.

3.3.3. The Alleged Alternative Means of Obtaining the Subsidy is also Export Contingent, that is, the Extended FSC Replacement Subsidy is Also Prohibited

104. Another reason why the US attempt to remove the export contingency from the FSC Replacement scheme fails is that the alleged alternative means of obtaining the subsidy (the EC will explain in Section [3.3.5] below that it is unlikely to be used) also involves export contingency. In other words, the extended FSC Replacement subsidy is also prohibited.

105. If both elements of the FSC Replacement subsidy are contingent upon export performance, so, whatever interpretation of Article 3.1(a) is adopted, is the whole.

106. The export contingency of the extended FSC Replacement subsidy arises out of the requirement that the foreign produced goods be sold outside the US in conjunction with the fact that they cannot be qualifying foreign trade property and therefore cannot benefit from the FSC Replacement scheme if they have a foreign content exceeding 50 per cent.

107. As already mentioned above, the FSC Replacement subsidy is only available for the sale of "qualifying foreign trade property". According to Section 943(a)(1) of the IRC:

The term 'qualifying foreign trade property' means property –

(A) manufactured, produced, grown or extracted within or outside the United States

(B) held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the Unites States, and

(C) no more than 50 per cent of the fair market value of which is attributable to -

(i) articles manufactured, produced, grown, or extracted outside the United States, and

(ii) direct costs for labour (determined under the principles of Section 263A)

performed outside the United States.[53]

108. In many cases, the requirement that no more than 50 per cent of the fair market value be attributable to articles manufactured, produced, grown, or extracted outside the United States, and direct labour costs will mean that inputs will have to be exported from the US, as the EC will now proceed to demonstrate.

109. The terms "articles" and "attributable" are not defined in the legislation. It may be that the US will clarify them during these panel proceedings and the EC may then be able to refine its argument on this point.

110. However, for present purposes, it is sufficient to note that fair market value of a product (FMV) can be considered to be made up of the sum of the following:

- The cost of "articles attributable" (hereinafter "articles") (A), which may again be split into:
  - US articles; (A1) and
  - Foreign articles (A2);
- The direct cost of labour (B);
- The cost of other inputs (which may include energy, royalties for intellectual property used, overheads etc) (C);
- Profit (D).

111. If these categories are considered to cover all costs (with any residual costs being included in (C), A1+A2+B+C+D must equal the sales price (SP). In normal cases SP will be equal to FMV.

112. Since A2 + B may not exceed 50 per cent of P, (i.e. A2 + B must be = or < SP/2), then mathematically,

A1+C+D must constitute at least 50 per cent of SP (i.e. A1+C+D must be = or > SP/2 which can be expressed as A1 = or > SP/2-C-D). This means that A1 will be positive whenever SP/2 > C+D

In other words, US articles must be used whenever the cost of other inputs (not articles or direct labour) (C) and profit (D) are less than 50 per cent of the selling price (or more exactly the US-assessed fair market value) of the goods.

113. This condition (and therefore the need for there to be exports of US articles) will not always be met but it will in many cases. Whether it is met or not will depend on the nature of the production process. There are a series of factors that render the condition more difficult to meet and others that render it easier to meet. Factors that will make the condition more difficult to meet include:

- A high cost of articles used in production;
- A high amount and therefore cost of foreign direct labour in production;
- A low intellectual property component;
- A low profit.

[53] Emphasis added.

114. Correspondingly, factors that will make the condition easier to meet include:

- A low cost of articles used in production;
- A low amount and therefore cost of foreign direct labour in production;
- A high intellectual property component;
- A high profit margin.

115. The EC's point is that the importance of these factors varies between sectors and companies and there will inevitably be companies who will have to use US products. That in the EC view is sufficient to establish contingency.

116. In order to illustrate this argument, the Annex to this submission gives a series of examples of where the requirement to use US articles must arise in practice. The Annex identifies cases where the cost of "articles" used to produce finished goods exceed 50 per cent of the value of the finished product. In all these cases, some US articles will have to be used in order to produce "qualifying foreign trade property". In fact, the approach followed in the Annex is conservative since foreign direct labour costs are not taken into account in the Annex but are included in the foreign content limitation, thus further reducing the ability of producers to fulfil the condition without using US articles. In other words, for every percentage increase in the value of foreign direct labour, there is a corresponding increase in the percentage in value of US articles that must be used.

117. Even in cases where the above foreign content limitation could be met without the need for US inputs, a foreign producer who wishes his goods to benefit from the FSC Replacement scheme will still have an incentive to purchase US goods in order to make it easier to comply with the requirement and to ensure that the benefit will be available.

118. The foreign content is expressed as a fraction of the price a company can obtain from the sale of the finished product. However, the price a company expects from the sale of such finished product may not materialize due to a number of unforeseen (or not entirely foreseen) circumstances: for example price trends may dramatically change downwards so that the fair market value also decreases (and a company can no longer obtain the prices based on which it had made its production calculations). In order to minimize such risk of not being able to qualify, companies will need to reduce the value of foreign articles and direct labour to a level that will always ensure that they account for no more than 50 per cent of the price, even in case of price decreases.

119. Accordingly, the fact that the extension of the FSC Replacement scheme to foreign produced goods is subject to a foreign content requirement creates in many cases a requirement for exports to be made from the US. This renders the extended FSC Replacement subsidy also export contingent and thus prohibited.

120. Since both elements of the FSC Replacement subsidy are contingent upon export performance, so is the whole. The FSC Replacement scheme is therefore a prohibited export subsidy contrary to Article 3.1(a) of the *SCM Agreement*.

3.3.4. Article 3.1(a) Expressly States that a Subsidy is Prohibited whether Export Performance is the Sole or one of Several Conditions.

121. The US approach to implementation of the Panel Report has been to endeavour to hide, what is essentially the same subsidy as that before the Panel in the original proceeding, within a slightly wider subsidy. It does this by adding to the basic FSC Replacement subsidy the extended FSC Replacement subsidy.

122. The drafters of the *SCM Agreement*, were aware of the potential for such devices and expressly provided that a subsidy shall be prohibited if it is contingent "contingent, ... *whether solely or as one of several other conditions*, upon export performance."

123. In other words, a subsidy that is export contingent in some situations does not cease to be so if it can also be obtained in other situations which do not require export. A subsidy that is available to exporters and to producers of certain categories of goods is still prohibited in those situations where export is required to obtain it.

124. To take an example: suppose a subsidy programme is available to all goods produced in a certain region of a WTO Member's territory, but only available to goods produced outside that region if exported from that WTO Member's territory. It is true that it is not in all circumstances necessary to export to obtain the subsidy, since goods from the eligible region can benefit if sold domestically. But goods from outside the eligible region can only qualify for the subsidy when exported. There are no "alternative" conditions in this case - the subsidy is export contingent. The same situation arises with the FSC Replacement scheme. Although there may be cases of production outside the US that may benefit in the absence of export, goods produced in the US can only obtain the benefit in one way – if exported. In these circumstances, the subsidy is export contingent.

125. It is true that a where a subsidy is made available, for example, to all producers of shoes, some producers may in fact qualify by producing shoes which they export, but this does not make the subsidy export contingent. Each producer is free to sell on the domestic market or to export and this does not affect entitlement to the subsidy. However, in the case of the FSC Replacement scheme, the situation is different. Owners of US goods produced in the US do not have a choice in how to obtain the subsidy. They cannot, unlike the shoe manufacturers in the above example, satisfy the conditions by selling domestically. They have to export. Thus they obtain the subsidy by performing one function, export, in preference to another, selling on the domestic market.

126. That this is the correct interpretation of Article 3.1(a) is confirmed by the panel and Appellate Body reports *Canada – Aircraft*. One of the subsidies involved in that case, the Technology Partnerships Canada programme, was available to non-export sectors such as environmental technologies and "enabling technologies."[54] The fact that the subsidy was available in some situations without any export contingency did not stop the payments under the programme to the regional aircraft industry being found export contingent.

127. Thus, even if the Panel were not to agree with the position set out in Section 3.3.2 above - that the extended FSC Replacement subsidy is also export contingent,

[54] See e.g. *Canada – Aircraft,* Panel Report, WT/DS70/R, DSR 1999:IV, 1443, para. 6.174.

this will not prevent a finding that the basic FSC Replacement subsidy is export contingent.

128. Indeed, the above view of alternative conditions is also that adopted by the US when it applies its own countervailing duty rules on export subsides to foreign producers. This rule (§351.514 of the US countervailing duty rules) is very similar to Article 3.1(a) of the *SCM Agreement*, read with its footnote, since it provides that:

> ….(a) *In general.* The Secretary will consider a subsidy to be an export subsidy if the Secretary determines that eligibility for, approval of, or the amount of, a subsidy is contingent upon export performance. In applying this section, the Secretary will consider a subsidy to be contingent upon export performance if the provision of the subsidy is, in law or in fact, tied to actual or anticipated exportation or export earnings, alone or as one of two or more conditions."

In the discussion section of its own countervailing duty rules, the US states that:[55]

> In situations where the government evaluates multiple criteria under a program, §351.514 would require an analysis different from that described in *Extruded Rubber Thread from Malaysia*, 57 FR 38472 (August 25, 1992). In that case, the Malaysian Government considered 12 criteria in evaluating whether a particular company should receive "pioneer" status. Two of these criteria addressed the export potential of a product or activity. In addition, in certain situations, companies were required to agree to export commitments. In analyzing the Pioneer program, the Department examined the criteria being applied with respect to a particular company. If one or more of the criteria applied by the Government included favorable prospects for export, but the export criteria did not carry preponderant weight, we did not consider the award of Pioneer status to constitute an export subsidy. *However, under the new standard contained in §351.514, if exportation or anticipated exportation was either the sole condition or one of several conditions for granting Pioneer status to a firm, we would consider any benefits provided under the program to the firm to be export subsidies unless the firm in question can clearly demonstrate that it had been approved to receive the benefits solely under non-export-related criteria.* In such situations, we would not treat the subsidy to that firm as an export subsidy. (Emphasis added in italics).

129. Thus it is clear that in its countervailing duty law, the US considers that export subsidies exist for some firms even in cases where certain other firms can demonstrate that they do not need to obtain the benefits. This situation is analogous to that of the FSC Replacement scheme.

130. Indeed, the contention of the US that the *SCM Agreement* should be interpreted so as to allow the FSC Replacement scheme to escape the disciplines of the *SCM Agreement* bring to mind the words used by the US in connection with an ex-

[55] US Department of Commerce (International Trade Administration) Countervailing duties : Final Rule 19 CFR Part 351 *(WTO Document G/ADP/N/1/USA/1/Suppl.4, G/SCM /N/1/USA Suppl.4 29.3.99 p.62)*

port subsidy of another Member, when it said of an argument made by that Member:[56]

> If adopted, this standard would enable governments to engage in the very sorts of manipulation and modifications of subsidy programmes that the drafters of the SCM Agreement sought to curtail.

3.3.5. The Consequences of an Election by a Foreign Producer to be Subject to US Tax Are such that it cannot be Expected that the Election will be Used in Practice

131. The EC further considers that the addition of the extended FSC Replacement subsidy to the FSC Replacement scheme is merely cosmetic (and an attempt to hide a prohibited export subsidy) because there are a number of reasons to believe that it will rarely be used.

132. The most important of these reasons is that the extended subsidy is only available where the foreign producer makes an election to be taxed as a domestic US corporation. Section 943(a)(2) of the IRC provides that:

> Property which (without regard to this paragraph) is qualifying foreign trade property and which is manufactured, produced, grown, or extracted outside the United States shall be treated as qualifying foreign trade property only if it is manufactured, produced, grown, or extracted by
>
> (A) a domestic corporation,
>
> (B) an individual who is a citizen or resident of the United States,
>
> (C) a foreign corporation with respect to which an election under subsection (e) (relating to foreign corporations electing to be subject to United States taxation) is in effect, or
>
> (D) a partnership or other pass-thru entity all of the partners or owners of which are described in subparagraph (A), (B) or (C);

133. The election required by Section 943(a)(2) would create additional tax liability, reporting requirements and administrative burdens on the corporation without reducing its liability, requirements and burdens in its own jurisdiction. Foreign corporations are only likely to elect to be treated as domestic companies in the US in such situations where such an election would entail an overall tax saving (or a benefit) and thus it is only likely to be contemplated in special circumstances.

134. In addition, Section 943 (e)(1) provides that:

> (e) ELECTION TO BE TREATED AS DOMESTIC CORPORATION. -
>
> (1) IN GENERAL. - An applicable foreign corporation may elect to be treated as a domestic corporation for all purposes of this title if such corporation waives all benefits to such corporation granted by the United States under any treaty. No election under section 1362(a) may be made with respect to such corporation.

135. Any benefit that might possibly arise from being treated as a US domestic corporation and benefiting from the FSC Replacement scheme would have to

[56] Panel Report, *Canada – Aircraft,* WT/DS70/R, DSR 1999:IV, 1443, paragraph 7.143.

weighed against the consequences of waiving *all* benefits granted by the US under *any* treaty!

136. It is true that elections under the FSC Replacement scheme can be revoked for subsequent tax years but this also brings with it serious disadvantages.

137. The additional tax consequences of elections and their revocations require some explanation. By virtue of Section 943 (e)(4)(B):

> (B) EFFECT OF ELECTION, REVOCATION, AND TERMINATION. -
>
> (i) ELECTION. - For purposes of section 367, a foreign corporation making an election under this subsection shall be treated as transferring (as of the first day of the first taxable year to which the election applies) all of its assets to a domestic corporation in connection with an exchange to which section 354 applies.
>
> (ii) REVOCATION AND TERMINATION. - For purposes of section 367, if -
>
> (I) an election is made by a corporation under paragraph (1) for any taxable year, and
>
> (II) such election ceases to apply for any subsequent taxable year,
>
> such corporation shall be treated as a domestic corporation transferring (as of the 1st day of the first such subsequent taxable year to which such election ceases to apply) all of its property to a foreign corporation in connection with an exchange to which section 354 applies.

138. This provision confirms that an election of a foreign corporation to be treated as a US domestic corporation gives rise to a deemed transfer of assets between corporation. One consequence of this is that non-distributed profits of a foreign corporation are immediately subject to US taxation when a foreign corporation elects to be treated as a US domestic corporation, which may not have been the case otherwise.[57] Another, and arguably more serious consequence, is that an election to *cease* being treated as a US domestic corporation gives rise to a deemed transfer of assets out of the US. This will give rise to US tax charge not only on all its non-distributed profits but also on unrealized capital gain in the value of its assets. This latter future and uncertain tax liability on the revocation of an election is likely to be the greater barrier to the making of an election to be treated as a US domestic corporation in the first place since its importance will not be known when that election is made.

139. Electing to be treated as US domestic corporations for US tax purposes may subject foreign corporations them to reporting and other requirements inconsistent with their domestic law and possibly impact in other ways on their business. The principle behind bilateral tax treaties is that a corporation will be resident in one jurisdiction or another (even though it may be subject to tax as a non-resident in the

[57] More precisely, the regulations under Section 367(b) will require US shareholders of the foreign corporation to take into income a deemed dividend based on the undistributed earnings of the corporation accumulated prior to its election. The FSC Replacement Act has a transition provision (Section 5(c)(3)) pursuant to which earnings and profits accumulated by the domesticating corporation in taxable years ended prior to 1 October 2000 will not be included in the income of the shareholders of the corporation. This transition provision is applicable only in those circumstances specified in the provision.

jurisdiction where it is not resident). Traditionally, the primary purpose of such treaties is to eliminate or reduce double taxation, with the ancillary goal of determining the taxing rights of the Contracting States. As regards business income, the OECD Model Tax Convention (on which most tax treaties concluded between industrialized countries are based) provides that it is only taxable in the Contracting State in which the taxable person is resident. A Contracting State may only impose tax on the business income of a resident of the other Contracting State in so far as this has a permanent establishment in the first mentioned Contracting State. An election under the FSC Replacement scheme will disrupt this assumption and mean that corporations will start to be resident for tax purposes in two jurisdictions, which can give rise to potential conflicts. To date the consequences of such conflicts remain unknown, which is why it is also reasonable to presume that any prudent economic operator (in this case a foreign corporation) might be reluctant to elect to be treated in the US as a domestic corporation. By doing so it would assume a risk of rather adverse effects of which the significance is unknown to it at the time of the election.

140. Indeed one example of a conflict is given in apparent from the FSC Replacement Act itself. New Section 941(a)(5) IRC, for example, denies the benefit of the scheme to firms that participate in "international boycotts etc.". Clearly, many other States may make participation in such boycotts obligatory.

141. More generally in the case of tax law, US law may require certain expenses to be written off over a period that conflicts with the period required by other jurisdictions.

142. It may also be expected that foreign governments will oppose (or refuse to acknowledge) their corporations becoming subject to all the obligations of the US tax code. The elections provided for in the FSC Replacement scheme disrupt the balance of rights and obligations, benefits and costs, on which bilateral tax treaties are concluded. Accordingly, as the treaty rights of a foreign government would be breached it might in its turn decline to respect its treaty obligations (for example, granting of double tax relief). Any prudent foreign corporation contemplating election to be treated in the US as a domestic corporation would certainly be mindful of this risk and assess its importance against any potential benefits from it could receive as a result of the election. Foreign governments may also object to corporations under their jurisdiction being required "to waive all benefits ... granted by the US under any treaty" and to way this provision may be interpreted by the US. Such objections by foreign governments could be based on the rights they have under bilateral tax treaties (which will limit the way in which the US can tax the foreign country's corporations) and on the basis of international law principles of jurisdiction which limit the extent to which States may assert jurisdiction over foreign corporations. There is no exception to these principles that would allow corporations to "elect" to be subject to a State's jurisdiction in return for some benefit.

143. It is clear that if a foreign government objected to corporations under its jurisdiction waiving their rights and electing to be subject to the US tax code, that election could not be made.

144. Additionally, as explained above, foreign corporations can in many cases only benefit from the FSC Replacement scheme if they use US articles. This is a further disincentive to using the scheme.

145. In view of these obstacles, the EC considers that even if the extension of the FSC Replacement scheme to foreign production had its intended effect of removing

the *de jure* export contingency of the scheme (*quod non*), that scheme would in any event remain *de facto* export contingent and still be contrary to Article 3.1(a) of the *SCM Agreement*.

3.3.6. Conclusion

146. For all these reasons the EC considers that the FSC Replacement scheme is a prohibited export subsidy contrary to Article 3.1(a) of the *SCM Agreement*.

3.4. The FSC Replacement Subsidies are Specifically Related to Exports within the Meaning of Item (e) of the Illustrative List

3.4.1. Introduction

147. In this Section the EC will explain that item (e) of the Illustrative List in Annex I to the *SCM Agreement* also renders the FSC Replacement subsides prohibited.

148. Item (e) defines as an export subsidy:

> The full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises (footnotes omitted)

149. This provision is specifically designed to deal with export subsidies granted through the tax system.

150. The Panel considered Item (e) in its report in the original proceeding[58] and considered it to be applicable to the FSC scheme – in particular that the provision applied to exemptions from corporation taxes and that the beneficiary taxpayers were "industrial or commercial enterprises".

151. Although the FSC Replacement scheme differs slightly from the FSC scheme in that part of the income is expressed as being "excluded" from tax rather than expressed as an "exemption," it has been demonstrated in Section 3.2 above that it is in substance an exemption. The term "exports" has already been discussed in detail above. It remains to examine the meaning of "specifically related to" exports.

152. The dictionary definition of "specifically" is:

(a) in respect of specific or distinctive qualities;

(b) peculiarly;

(c) in a clearly defined manner, definitely, precisely[59]

and the dictionary definition of "related" is:

> Having relation; having mutual relation; connected[60]

153. Accordingly, "specifically related to exports" means "having a special, precise or clearly defined relationship or connection to exports".

3.4.2. The FSC Replacement Subsidies are Caught by Item (e)

154. The EC has shown above that the FSC Replacement subsidies are *contingent* upon export performance because they are dependent upon exportation.

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[58] Panel Report, para. 7.110.

[59] *New Shorter Oxford English Dictionary* CD-ROM version (1997).

[60] *New Shorter Oxford English Dictionary* CD-ROM version (1997).

155. The "exports" referred to in item (e) must be understood in the same as "export" in Article 3.1(a), that is as referring to exports from the country granting the subsidy.

156. Contingency is a particular form of special relationship. Therefore any subsidy that is contingent upon export performance must, necessarily, also be "specifically related to exports" within the meaning of item (e)

157. However, the term "specific relation" is broader than the term "contingency." The former term covers any specific link and thus would include a simple *incentive*. Thus, since the Illustrative List illustrates the meaning of Article 3.1(a), the prohibition on export subsidies must, at least, as it applies to subsidies granted through the tax measures described in item (e), also cover measures that specifically encourage exports.

158. Accordingly item (e) supports and confirms the conclusion that the FSC Replacement subsidies are prohibited under Article 3.1(a) *SCM Agreement.*

3.5. The FSC Replacement Scheme Provides Subsidies which are Contingent upon the Use of Domestic Over Imported Goods Contrary to Article 3.1(b) of the SCM Agreement

3.5.1. Introduction – the US Rules

159. In the same way as the FSC scheme, the FSC Replacement scheme continues to require, as a condition for enjoying the tax benefit it provides, that the qualifying transactions concern goods produced with a foreign content not exceeding 50 per cent (which now includes direct labour costs). The EC submits that this requirement makes the FSC Replacement scheme contingent in law "upon the use of domestic over imported goods" within the meaning of Article 3.1(b) of the *SCM Agreement*. The EC submits, in the alternative, that even if the Panel considered that this requirement does not amount to contingency in law, it would still need to conclude that, for certain sectors, it *de facto* makes resort to US inputs necessary and the subsidy is therefore *de facto* contingent upon the use of domestic over imported goods.

160. The virtual identity of this requirement which with the one applicable to FSCs is immediately apparent:

IRC RULES APPLICABLE TO FSC SCHEME Sec. 927. OTHER DEFINITIONS AND SPECIAL RULES	FSC REPLACEMENT ACT SCHEME – NEW IRC RULES Sec. 943. OTHER DEFINITIONS AND SPECIAL RULES
(a) EXPORT PROPERTY - For purposes of this subpart – (1) IN GENERAL. –	(a) QUALIFYING FOREIGN TRADE PROPERTY - For purposes of this subpart – (1) IN GENERAL. –
The term "export property" means property -	The term 'qualifying foreign trade property' means property –
(A) manufactured, produced, grown, or extracted in the United States by a person other than a FSC, (B) held primarily for sale, lease, or rental, in the ordinary course of trade or business,	(A) manufactured, produced, grown or extracted within or outside the United States, (B) held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the

by, or to, a FSC, for direct use, consumption, or disposition outside the United States, and (C) not more than 50 per cent of the fair market value of which is attributable to articles imported into the United States.	Unites States, and (C) no more than 50 per cent of the fair market value of which is attributable to– (i) articles manufactured, produced, grown, or extracted outside the United States, and (ii) direct costs for labour (determined under the principles of Section 263A) performed outside the United States.(emphasis added)
For purposes of subparagraph (C), the fair market value of any article imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation.	For purposes of subparagraph (C), the fair market value of any article imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation, and the direct costs for labour under clause (ii) do not include costs that would be treated under the principles of section 263A as direct labour costs attributable to articles described in clause (i).

161. In addition, the rules relating to "excluded property" and other limitations to "export property" are carried over in the FSC Replacement scheme in relation to "qualifying foreign trade property".

162. Thus, apart from some adjustments to take account of the fact that a separate legal entity in the form of a FSC is no longer required, the only innovation appears to be the addition of foreign direct labour costs to the foreign content to which the 50 per cent limitation applies.[61] The EC will explain below that this difference does not appreciably change the situation which already gave rise to its claim under Article 3.1(b) of the *SCM Agreement* in respect of the FSC regime, and that its arguments developed in the original Panel and Appellate Body proceedings apply *mutatis mutandis*.

3.5.2. Article 3.1(b) of the SCM Agreement

163. The EC submits that, by providing for the requirement just described, the FSC Replacement scheme makes the granting of a subsidy contingent upon the use of US goods thereby violating Article 3.1(b) of the *SCM Agreement*.

164. Article 3.1(b) prohibits:

> subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods

165. The only appropriate meaning for the word "over" in this context given by the *New Shorter Oxford English Dictionary* is "in preference to".[62] Accordingly, the words "use of domestic *over* imported" mean "use of domestic *in preference to* imported" and render this provision very broad, so that it may include any form of "preference" or "incentive" or "boost" to domestic production by the Member conferring a subsidy at the expense of imported goods.

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[61] The EC of course assumes that identical words used in different parts of the IRC will have the same meaning unless otherwise specified.

[62] *New Shorter Oxford English Dictionary* CD-ROM version (1997).

166. The Appellate Body has had one recent occasion to interpret this provision. In doing so, it has notably:

- extended its interpretation of "contingent" developed with respect to Article 3.1(a) to Article 3.1(b);[63]
- extended its interpretation of *de iure* contingency developed under Article 3.1(a) of the *SCM Agreement* to Article 3.1(b);[64]
- clarified that Article 3.1(b) covers subsidy schemes which are *de iure* contingent upon use of domestic over imported goods, but also *de facto* ones;[65]
- clarified that the wording "use of domestic over imported goods" also covers value added requirements.[66]

3.5.3. The Basic FSC Replacement Subsidy is Contingent upon Use of Domestic Over Imported Goods

167. The FSC Replacement scheme does not impose explicitly an obligation to "use domestic over imported goods", but rather an obligation not to exceed a certain proportion of foreign articles or labour. Nevertheless, the cost of articles and labour are amongst production costs - indeed still the main ones in the production of many goods – that are reflected in the "fair market value" of the finished product.

168. Just as in the case of the FSC scheme, the foreign content limitation under the FSC Replacement scheme must in principle be satisfied for each transaction for which the benefit is sought. The difference with the FSC scheme lies in the fact that the foreign content limitation is also imposed on companies producing goods outside the US that make an election to be treated as a domestic US corporation pursuant to Section 943(e) of the IRC. In this respect, the FSC Replacement Act makes clear that the foreign content limitation applies not only to foreign articles but also to direct costs for labour performed outside the US. The inclusion of foreign direct costs for labour in the foreign content limitation appears to be of no practical significance to goods produced in the US since these will, by definition, not contain any "foreign direct costs for labour performed outside the US." In any event, if foreign direct labour costs were ever relevant in assessing the foreign content of *US produced* goods, this would further reduce the scope for using foreign articles and thus make it more difficult to respect the 50 per cent foreign content limitation. The foreign content limitation would therefore be more restrictive than is the case under the FSC scheme.

169. In Section 3.3.2 above, it was explained how the foreign content limitation applied to foreign produced goods would often require the use of US "articles" and in other cases would require that US articles be used in order to ensure that the foreign content limitation was not exceeded. For analogous reasons, the foreign content limitation applied to US produced goods will also often require the use of US articles and

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[63] *Canada – Aircraft*, Appellate Body Report, WT/DS70/AB/R, DSR 1999:III, 1377, para. 166; *Canada - Automobiles*, Appellate Body Report, para. 123.

[64] *Canada – Aircraft*, Appellate Body Report, WT/DS70/AB/R, DSR 1999:III, 1377, para. 100; *Canada - Automobiles*, Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R, DSR 2000:VI, 2985, para. 123.

[65] *Canada – Automobiles*, Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R, DSR 2000:VI, 2985, para. 143.

[66] *Ibid.*, para. 130.

in other cases would require that US articles be used in order to ensure that the foreign content limitation was not exceeded.

170. The use of US articles will be required whenever the cost of inputs other than articles, any foreign direct labour and profit amount to 50 per cent or less of the selling price (or more exactly the fair market value) of the finished goods. In such cases the cost as articles will exceed 50 per cent of the total value of the product and the FSC Replacement subsidy will not be available if the articles are all foreign.

171. This condition (and therefore the need for US articles to be used) will not always be met but it will in many cases. The EC listed in Section 3.2.2 some factors that affected whether this condition would be met.

172. Further, the foreign content is expressed as a fraction of the price a company can obtain from the sale of the finished product. However, the price a company expects from the sale of such good may not materialize due to a number of unforeseen (or not entirely foreseen) circumstances: for example price trends may dramatically change downwards so that the fair market value also decreases (and a company can no longer obtain the prices based on which it had made its production calculations). In order to minimize such risk of not being able to qualify, companies will be induced to reduce the cost of foreign articles and labour to a level that will always ensure that they account for no more than 50 per cent of the price, even in case of price decreases.

173. For reasons analogous to those set out in Section 3.3.2, the fact that some companies will have to use US articles is sufficient to establish contingency. The examples in the Annex (cases where materials exceed 50 per cent of the final value of the product) illustrate on a conservative basis the fact that such products exist.

174. Accordingly, the basic FSC Replacement subsidy is "contingent upon the use of domestic over imported goods" within the meaning of Article 3.1(b) of the *SCM Agreement* because using domestic US articles will often be necessary to ensure that the foreign content limitation is not exceeded, whereas using foreign articles (and foreign direct labour if possible) will often prevent this limitation from being respected and make the FSC Replacement scheme unavailable. In other cases the use of foreign articles will impair a company's chances of respecting this limitation and the company will still be required to use US articles in order to ensure that the subsidy will be available.

175. The US has suggested that FSC Replacement scheme is not contingent upon the use of domestic over imported goods because it does not "affirmatively require" the use of US articles. In the US view, companies can respect the foreign content limitation (and thus obtain the tax benefit if the other conditions are met) without using any domestic parts and materials at all.

176. In order to establish a violation of Article 3.1(b), however, it is not necessary to show that the subsidy requires the actual use of domestic over imported goods in every case. The mere fact that in some cases a beneficiary will be required to use domestic goods instead of imported goods in order to qualify for the subsidy, if it can be demonstrated "on the basis of the *words* of the relevant legislation, regulation or other legal instrument",[67] is sufficient to trigger the application of Article 3.1(b).

[67] *Canada – Automobiles*, Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R, DSR 2000:VI, 2985, para. 123.

177. At any rate, assuming *arguendo* that the actual use of domestic goods had to be a necessary condition for granting the subsidy, as explained above and in Annex to this submission, the foreign content ceiling requirements have been set at such a level in the FSC Replacement Act that at least in certain sectors the beneficiaries cannot possibly meet them without using some US articles.

178. Further, the fact that a US producer may have alternative means of avoiding a breach of the foreign content limitation (e.g. by using US labour) does not *per se* rule out a violation of Article 3.1(b) of the *SCM Agreement*. Just as Article 3.1(a), and for the same anti-circumvention concerns, Article 3.1(b) foresees that the "use of domestic over imported goods" may be an alternative condition and prohibits such use "whether solely or one of several other conditions".

3.5.4. The Extended FSC Replacement Subsidy

179. As explained above in Section 3.3.5 the EC has doubts as to whether the extended scheme *can* be used by companies located outside the US. The way in which the foreign content limitation is formulated in Section 943 of the IRC is one reason for this. As recalled above, that Section imposes the 50 per cent foreign content limitation, which is described in the following terms:

> (C) no more than 50 per cent of the fair market value of which is attributable to–
>
> (i) articles manufactured, produced, grown, or extracted outside the United States, and
>
> (ii) direct costs for labour (determined under the principles of Section 263A) performed outside the United States.

180. The EC has also argued above in Section 3.3.3 that, even if the extended FSC Replacement subsidy will ever be available, it will constitute a prohibited export subsidy within the meaning of Article 3.1(a) of the *SCM Agreement*.

181. Since in its view the foreign content limitation applied to foreign products leads to the extended subsidy being a prohibited export subsidy, the EC does not consider that it can also be a local-content contingent subsidy.

182. If, however, the Panel should not agree that the foreign content limitation applied to foreign producers has this effect, the EC argues in the alternative that Article 3.1(b) should be interpreted as also prohibiting the imposition of a foreign content limitation on foreign producers.

3.5.5. Conclusion

183. For the above reasons the EC submits that the foreign content limitation in the FSC Replacement scheme renders the basic FSC Replacement subsidy *de iure* or at least *de facto* contingent upon the use of US over imported goods contrary to Article 3.1(b) of the *SCM Agreement*.

184. The EC asks the Panel to consider the application of the foreign content limitation in the case of non-US producers only if it is of the view that this limitation does not make the extended FSC Replacement subsidy contingent upon export performance contrary to Article 3.1(a).

3.6. The FSC Replacement Scheme Grants and Maintains Subsidies Contrary to Article 3.2 of the SCM Agreement

185. Article 3.2 *SCM Agreement* confirms that:

> A Member shall neither grant nor maintain subsidies referred to in paragraph 1

186. It has been demonstrated above the FSC Replacement subsidies fall under paragraph 1 of Article 3. The US is therefore failing to comply with its obligations under Article 3.2 by granting and maintaining them.

3.7. The FSC Replacement Scheme Provides Treatment Less Favourable to Products Imported into the US that is Accorded to Like US Products, Contrary to Article III:4 of GATT 1994

187. Article III:4 of *GATT 1994* provides in relevant part that

> The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use […].

188. The EC considers that the foreign content limitation contained in the FSC Replacement scheme is inconsistent with Article III:4 of *GATT 1994* in that it provides less favourable treatment to imported parts and materials than to like domestic goods with respect to their internal use in the production of goods.

189. On the other hand, the EC is making no claim about more favourable treatment in respect of the export from the US of US finished goods than of like foreign goods present on the US market, nor about more favourable treatment of exported US finished goods than like foreign goods present on the same foreign market (situations which are not covered by Article III:4).

190. In view of the terms of Article III:4, in order to rule on this claim the Panel is required to address the following issues:

- first, whether the measures at issue are "laws, regulations or requirements";
- second, whether domestic products are "like" imported products;
- third, whether the measures "affect" the "internal use" of the products concerned; and
- fourth, whether the measures afford "less favourable treatment" to imported products than to domestic products.

3.7.1. The Foreign Content Limitation is a "requirement"

191. By now it is firmly established that a measure need not be compulsory in order to qualify as a "requirement" for the purposes of GATT Article III:4, and that

Article III:4 also applies to "measures" in the form of conditions to obtain an advantage.[68]

192. In *EEC – Parts and Components* the Panel concluded that the conditions accepted by a firm in order to obtain an "advantage" granted by the EC authorities also constituted "requirements".[69]

193. More recently, in *Canada – Automobiles* the Panel went even further by holding that the "letters of undertaking" submitted by certain firms at the request of the Canadian Government were "requirements", even though they were neither legally enforceable nor a condition to obtain an advantage.[70]

194. As discussed in Section 3.5 above, while the FSC Replacement scheme does not oblige US producers to use of US inputs, this is in many cases one of the necessary conditions for obtaining an advantage, the tax benefit, and in many other cases the scheme encourages the use of US goods over imported goods.

195. The EC submits that, in light of the precedents cited above, the fact that the limit on those foreign inputs is one of the conditions to obtain the tax benefit is sufficient to conclude that the foreign content limitation constitutes a "requirement" within the meaning of Article III:4 of *GATT 1994*.

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[68] For example, in *Canada – Administration of the Foreign Investment Review Act*, adopted on 7 February 1984, BISD 39S/140 ("*Canada – FIRA*"), para. 4.5 the Panel held that the legally enforceable undertakings given by some foreign investors to the Canadian Government constituted "requirements", even though the submission of such undertakings was voluntary.

[69] *EEC – Regulation on Imports of Parts and Components*, Panel Report, BISD 37S/132, adopted on 16 May 1990 ("*EEC- Parts and components"*), para. 5.21:

> "…. Article III:4 refers to 'all laws, regulations or requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use'. The Panel considered that the comprehensive coverage of 'all laws, regulations or requirements *affecting* (emphasis added) the internal sale, etc.' of imported products suggests that not only requirements which an enterprise is legally bound to carry out, such as those examined by the FIRA Panel (BISD 30S/140, 158), but also those which an enterprise voluntarily accepts in order to obtain an advantage from the government constitute 'requirements' within the meaning of that provision."

The same interpretation underlies the Report on *Italian Discrimination against Imported Agricultural Machinery*, adopted on 23 October 1958, BISD 7S/60 ("*Italian Agricultural Machinery*"), where the Panel concluded that an Italian law providing special credit terms to farmers for the purchase of agricultural machinery conditional upon the purchase by the farmers of Italian machinery was contrary to Article III:4 of GATT.

[70] *Canada – Automobiles*, Panel Report, WT/DS139/R, WT/DS142/R, DSR 2000:VII, 3043, para. 10.122. The Panel cited the following circumstances in order to conclude that the "letters of undertaking" were "requirements":

"(i) in making the undertakings contained in the Letters, the companies acted at the request of the Government of Canada; (ii) the anticipated conclusion of the Auto Pact was a key factor in the decision of the companies to submit these undertakings; (iii) the companies accepted responsibility *vis-à-vis* the Government of Canada with respect to the implementation of the undertakings contained in the Letters, which they described as 'obligations' and in respect of which they undertook to provide information to the Government of Canada and indicated their understanding that the Government of Canada would conduct yearly audits; and (iv) at least until model year 1996, the Government of Canada gathered information on an annual basis concerning the implementation of the conditions provided for in the Letters."

3.7.2. Domestic Parts and Materials are "like" the Imported Goods

196. The distinction operated by the foreign content limitation relates to the origin of the products: whereas goods of US origin contribute to satisfy the foreign content limitation, imported goods do not.

197. Clearly, however, the mere fact of having US origin is not, as such, apt to confer upon goods any characteristic, property or quality which makes them, by definition, "unlike" any imported good.[71]

3.7.3. The Foreign Content Limitation "affects" the Internal "use" of the Products Concerned

198. The term "affect" has been interpreted broadly since the early days of the GATT. According to the Panel Report in *Italian Agricultural Machinery*,

> The selection of the word 'affecting' would imply […] that the drafters of the Article intended to cover in [Article III:4] not only the laws and regulations which directly governed the conditions of sale and purchase but also any laws or regulations which might adversely modify the conditions of competition between the domestic and imported products on the internal market [72]

199. In the present case, the foreign content limitation "affects" directly the "internal use" of goods because it will in many cases determine which goods a producer will use. In order not to exceed it, US producers must, in many cases, incorporate into their products a certain amount of domestic goods.

200. In addition, as recalled above in Section [ ] there will e.g. be cases in which a firm will be induced to increase the value of US goods it uses to anticipate price decreases (and therefore the increase of foreign inputs value relative to price of the finished good). In other words, the content limitation will play a role on the sourcing decisions in those cases as well. In each and every case, it will be easier for a US producer to qualify for the tax benefit if it prefers domestic to foreign goods. Accordingly, the requirement "affects" the "sale ... or use" of goods within the meaning of Article III:4 of *GATT 1994*.

201. The word "affecting" must also be interpreted in the light of the object and purpose of Article III:4. As most recently recalled by the Panel in *Canada – Automobiles*,

> The "no less favourable treatment obligation" in Article III:4 has been consistently interpreted as a requirement to ensure effective equality of opportunities between imported products and domestic products. In

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[71] In *Indonesia – Measures affecting the Automotive Industry*, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, adopted 23 July 1998, DSR 1998:VI, 2201 (*Indonesia – Autos*), the Panel noted, at para 14.113, that an

> "… origin-based distinction in respect of internal taxes suffices in itself to violate Article III:2, without the need to demonstrate the existence of actually traded like products".

See also the Panel Report on *Canada – Automobiles*, WT/DS139/R, WT/DS142/R, DSR 2000:VII, 3043, para. 10.174.

[72] Panel Report on *Italian Agricultural Machinery*, para. 12. The Appellate Body confirmed that interpretation of the term "affect" in *EC – Bananas*, WT/DS27/AB/R, DSR 1997:II, 591, para. 220.

> this respect, it has been held that, since a fundamental objective of Article III is the protection of expectations on the competitive relationship between imported and domestic products, a measure can be found to be inconsistent with Article III:4 because of its potential discriminatory impact on imported products. The requirement of Article III:4 is addressed to "relative competitive opportunities created by the government in the market, not to the actual choices made by enterprises in that market." Both in relation to Article III:2 and Article III:4 it has been established that the actual trade effects of a disputed measure are not a decisive criterion in determining whether the requirements of these provisions are met in a given case. Finally, as stated by the Appellate Body, a determination of whether there has been a violation of Article III:4 does not require a separate consideration of whether a measure affords protection to domestic production. [73]

The Panel so ruled in respect of a requirement which it described as

> a measure which provides that an advantage can be obtained by using domestic products but not by using imported products [74]

202. This characterization clearly also applies to the foreign content limitation contained in the FSC Replacement scheme: whereas the use of US goods will always guarantee that the content requirement can be met, and thus will not impair the prospects of obtaining the benefit, the use of non-US inputs will in many cases impair the possibility of meeting the foreign content limitation.

203. The foreign content limitation is a legal requirement that the foreign inputs and labour not be used above a certain ceiling, if a taxpayer wants to obtain the tax benefit.

204. In view of the above, the Panel in *Canada – Automobiles* considered that the measure which it had just described

> has an impact on the conditions of competition between domestic and imported products and thus *affects the "internal sale,… or use" of imported products, even if* the measure *allows for other means to obtain the advantage*, such as the use of domestic services rather than products. [75]

Accordingly, it concluded that

> We also see no merit in Canada's argument that the CVA requirements do not in practice "affect" the internal sale or use of imported parts and materials because the CVA levels are so low that they can be easily met on the basis of labour costs alone. As discussed above, based on the ordinary meaning of the term "affecting", the CVA requirements must be considered to affect the internal sale or use of imported products because they have an effect on the competitive relationship

[73] *Canada - Automobiles*, Panel Report, para. 10.78 (footnotes omitted). In support of its statement the Panel refers, in footnotes 842-845, to Panel Report on *US – Section 337 of the Tariff Act of 1930* ("*United States - Section 337*"), BISD 36S/395, paras. 5.11 and 5.13; Panel Report on *US – Malt Beverages*, para. 5.31; Appellate Body Report on *Japan – Alcoholic Beverages,* p. 16, DSR 1996:I, 97, at 109-110; Appellate Body Report on *EC – Bananas*, DSR 1997:II, 591, paras. 179 and 216. The Panel's findings on Article III:4 were not appealed.

[74] *Canada - Automobiles*, Panel Report, DSR 2000:VII, 3043, para. 10.82.

[75] *Ibid*. (emphasis added).

> between imported and domestic products by conferring an advantage upon the use of domestic products while denying that advantage if imported products are used. Thus, we consider that the fact that it is easier to meet the CVA requirements and thus to obtain the benefit of the import duty exemption if domestic products are used than if imported products are used is sufficient to find that these requirements affect the internal sale or use of products, and we do not believe that we need to examine how important the CVA requirements are under present circumstances as a factor influencing the decisions of motor vehicle manufacturers in Canada regarding the choice between domestic parts, materials and non-permanent equipment, on the one hand, and imported parts, materials and non-permanent equipment, on the other. [76]

205. In the same way, since it will in many cases be easier to respect the foreign content limitation and thus obtain the benefit of the FSC Replacement subsidy if US products are used than if imported products are used, the competitive position of these products on the US market is "affected" and the limitation is contrary to Article III:4 of the GATT.

3.7.4. Imported Goods Are Afforded "less favourable treatment"

206. Finally, by requiring in some cases the use of a minimum amount of domestic parts and materials, the foreign content limitation precludes producers wishing to benefit from the FSC Replacement scheme from using an equivalent amount of imported parts and materials and, therefore, affords "less favourable treatment" to imported products.

207. Furthermore, using domestic parts and materials makes it easier for the beneficiaries not to exceed the foreign content limitation and hence to qualify for the tax benefit which it is conditional upon it, than using "like" non-US products.

208. As a consequence, prospective beneficiaries will always give preference, all other conditions being equal, to US "articles" over like imported goods. Thus, in all cases the foreign content limitation affords "less favourable treatment" to imported goods than like domestic goods in respect of their use.

209. The US may try to restate also in respect of this claim its argument that it is also possible to meet the foreign content limitation other than by using US articles and therefore that requirement is not WTO-incompatible.

210. However, Article III:4 of GATT must be respected in each and every case, for each and every transaction. The fact that an analysis transaction by transaction is necessary under Article III:4 is confirmed by the panel report in *United States - Standards for reformulated and conventional gasoline*. [77] In that report the panel rejected the argument that the US measures involved in that case could be justified because imported gasoline was treated "on the whole" no less favourably than domestic gasoline. The US did not appeal this element of the panel report. The panel in the *US – Gasoline* case rejected the "on the whole" reasoning because it would mean that less

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[76] *Canada - Automobiles*, Panel Report, DSR 2000:VII, 3043, para. 10.83.

[77] *United States - Standards for Reformulated and Conventional Gasoline* ("*US – Gasoline*"), Panel Report, WT/DS2/R, 29 January 1996, DSR 1996:I, 29.

favourable treatment in one instance could be offset by more favourable treatment in another instance and noted that such an approach had also been rejected under GATT 1947. [78]

211. It is therefore clear that under Article III:4 an analysis has to be carried out at the level of an individual product, not at the level of the application of the law to all possible products. Any individual product must be treated no less favourably than a like domestic product – and this in all cases, for all transactions.

3.7.5. Precedent and the TRIMs Agreement Confirm that the Foreign Content Limitation is Inconsistent with Article III:4

212. Local content requirements constitute a clear-cut violation of the national treatment requirements imposed by GATT Article III:4, which has already been condemned by GATT/WTO panels on several occasions.

213. In *Canada – FIRA*, the Panel found that the undertakings given to the Canadian Government by some foreign investors to, *inter alia*, purchase goods of Canadian origin in specified amounts or proportions was contrary to Article III:4.[79]

214. Similarly, in *EEC- Parts and Components*, the Panel concluded that, by making the suspension of anti-circumvention proceedings conditional upon an undertaking to limit the use of Japanese parts and materials, the EC acted inconsistently with Article III:4.[80]

215. In *Indonesia – Autos*, the Panel found that the grant of certain tax and import duty benefits to a so-called "National Car" manufacturer conditional upon meeting a certain local content percentage was in violation of Article III:4.[81]

216. Finally, in *Canada – Automobiles*, the Panel held that the grant of a customs duty exemption to certain manufacturers of motor vehicles subject to compliance with certain "Canadian Value Added" requirements was inconsistent with Article III:4.[82]

217. The *Agreement on Trade-Related Investment Measures* (the "TRIMs Agreement") has confirmed beyond doubt that local content requirements are inconsistent with Article III:4 of GATT. Item 1.a) of the Illustrative List of TRIMs includes, among the TRIMs that are inconsistent with Article III:4, those which require

> "a) the […] use by an enterprise of products of domestic origin […], whether specified in terms of […] value of products, or in terms of a proportion of […] value of its local production"

218. As the EC has explained above in Section [3.3.2], the foreign content limitation contained in the FSC Replacement scheme amounts in many cases to a requirement to use US goods rather than imported articles. Accordingly, it is equivalent to requirements described in item 1(a) of the Illustrative List. This further confirms that it is inconsistent with Article III:4 of *GATT 1994*.

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[78] The Panel referred to the Panel Report on *United States - Section 337*.
[79] *Canada – FIRA*, Panel Report, paras. 5.4-5.12.
[80] *EEC –Parts and Components*, Panel Report, paras. 1.19-5.21.
[81] *Indonesia – Autos*, Panel Report, DSR 1998:VI, 2201, para. 14.83 *et seq.*
[82] *Canada – Automobiles*, Panel Report, DSR 2000:VII, 3043, para. 10.58 *et seq.*

3.7.6. Conclusion

219. For the above reasons the EC submits that the Panel should find that the FSC Replacement scheme accords more favourable treatment to US than to like imported products in relation to the use of such products for the production of goods for export under the scheme, contrary to Article III:4 of *GATT 1994.*

3.8. The FSC Replacement Subsidies are Also Inconsistent with the Agreement on Agriculture

3.8.1. Introduction

220. The US appears to have ignored the *Agreement on Agriculture* in implementing the DSB recommendations in this case. Its main argument, that there is a possibility of benefiting from the FSC Replacement scheme by producing outside the US, has no relevance to agricultural products. As the US argued itself in the original Panel proceedings:[83]

> It has to be recognized that for important exporting industries, the 50 per cent requirement has little or no practical effect. For example, in the agricultural sector that the European Communities targets in this case, the notion of incorporating imported goods into export products is impractical and artificial. Thus, for the agricultural sector, the 50 per cent requirement is largely inapplicable.

221. The US therefore agrees that by their very nature agricultural products, in particular commodities, will not satisfy the test unless produced in the US. They are indeed "grown" outside of the United States for the purposes of the condition under C) i).

222. The Panel will recall that it found[84] that the US had

> acted inconsistently with its obligations under Article 3.3 of the Agreement on Agriculture (and consequently with its obligations under Article 8 of that Agreement):
>
> - by providing export subsidies listed in Article 9.1(d) of the Agreement on Agriculture in excess of the quantity commitment levels specified in the United States' Schedule in respect of wheat;
> - by providing export subsidies listed in Article 9.1(d) of the Agreement on Agriculture in respect of all unscheduled products.

223. The Appellate Body however disagreed that the FSC scheme involved a reduction in the costs of marketing exports within the meaning of Article 9.1(d) of the *Agreement on Agriculture*. This was because it adopted a slightly different interpretation of the word "marketing" than had the Panel.[85]

224. The Appellate Body therefore addressed the EC's alternative claim under the *Agreement on Agriculture* and held that:[86]

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[83] Panel Report, para. 4.1211.
[84] Panel Report, para. 8.1(b).
[85] Appellate Body Report, paras. 131 and 132.
[86] Appellate Body Report, para. 171(d).

> the United States acts inconsistently with its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture* by applying export subsidies, through the FSC measure, in a manner which results in, or which threatens to lead to, circumvention of its export subsidy commitments with respect to both scheduled and unscheduled agricultural products;

225. One consequence of the Appellate Body adoption of the alternative claim is that the distinction between scheduled and unscheduled agricultural products becomes unimportant, since Article 10.1 of the *Agreement on Agriculture* applies to both equally.

226. The EC will show in [Section 3.7.2] below that nothing has changed with the introduction of the FSC Replacement scheme and that the US still acts inconsistently with its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture* by applying export subsidies, through the FSC Replacement scheme, in a manner which results in, or which threatens to lead to, circumvention of its export subsidy commitments with respect to both scheduled and unscheduled agricultural products.

227. For the case that the US should argue or the Panel consider that the FSC Replacement scheme escapes being prohibited under Article 10.1 of the *Agreement on Agriculture* by virtue of being a subsidy within the meaning of Article 9.1 of the *Agreement on Agriculture*, the EC will also argue in the alternative in [Section 3.7.3] below that the FSC Replacement scheme will in any event be inconsistent with the obligations of the US under the *Agreement on Agriculture* for similar reasons to those given by the Panel in respect of the FSC scheme.

3.8.2. The FSC Replacement Scheme is Inconsistent with Articles 10.1 and 8 of the Agreement on Agriculture

228. The Appellate Body's reasoning under the *Agreement on Agriculture* can be summarized as follows:

- The Appellate Body concluded that the FSC scheme involved a "subsidy contingent upon export performance" under the *Agreement on Agriculture*, for essentially the same reasons as underlay its and the Panel's corresponding conclusion with respect to the *SCM Agreement;*[87]
- The Appellate Body then reasoned that the term "export subsidy commitments", in Article 10.1 must, when read in the light of Articles 3, 8 and 9 of the *Agreement on Agriculture,* be considered to relate to both *scheduled* and *unscheduled* agricultural products;[88]
- Article 10.1 of the *Agreement on Agriculture* prohibits export subsides being "applied in a manner which *results in*, or which *threatens to lead to*, *circumvention* of export subsidy commitments." Since the FSC scheme creates *legal entitlements* to receive unlimited amounts of export subsidies not listed in Article 9.1, both for scheduled and unscheduled products, the Appellate Body concluded that they "at the very least" threaten to lead to circumvention of the export subsidy

[87] Appellate Body Report, paras. 136 to 142.
[88] Appellate Body Report, paras. 145 to 147.

commitments in the first and second clauses of Article 3.3 of the *Agreement on Agriculture;*[89]

- Consequently, the FSC subsidies are also inconsistent with Article 8 of the *Agreement on Agriculture,* in which Members undertook not to provide export subsidies otherwise than in conformity with the *Agreement on Agriculture*.[90]

229. Exactly the same reasoning applies in respect of the FSC Replacement scheme. Indeed, a circumvention of a circumvention is surely still a circumvention!

230. The EC has demonstrated above that the FSC Replacement scheme involves export subsidies. The FSC Replacement scheme also creates a legal entitlement for companies to receive these subsidies. They must therefore "at the very least" *threaten* to lead to circumvention of export subsidy commitments, that is the commitment in the first clause of Article 3.3 of the *Agreement on Agriculture* not to provide export subsides listed in Article 9.1 on scheduled products in excess of its the budgetary outlay and quantity commitments specified in the relevant part of its Schedule and the commitment in the second clause of Article 3.3 of the *Agreement on Agriculture* not to provide export subsides listed in Article 9.1 at all on unscheduled products. The FSC Replacement scheme is therefore also inconsistent with Articles 10.1 and 8 of the *Agreement on Agriculture*.

3.8.3. In the Alternative, the FSC Replacement Subsidies are Inconsistent with Article 3.3 and 8 of the Agreement on Agriculture Read in Conjunction with Article 9.1 of the Agreement on Agriculture

231. Apart from maintaining that the FSC Replacement scheme does not give rise to subsidies or that they are not export contingent, it would seem that the only way in which the US could argue that the FSC Replacement subsidies escape prohibition under Article 10.1 of the *Agreement on Agriculture* would be to claim that they are export subsidies but fall under one of the categories in Article 9.1 of the *Agreement on Agriculture*.

232. Apart from Article 9.1(d) of the *Agreement on Agriculture*, which the Appellate Body has held is not applicable to the forgoing of tax receipts indirectly linked to the marketing of agricultural products, the only other provision of Article 9.1 of the *Agreement on Agriculture* that has ever been mentioned as being possibly relevant to this kind of subsidy[91] is paragraph (a).

233. For the case that the US makes such an argument, the EC maintains an alternative claim that the FSC Replacement subsidies are inconsistent with Articles 3.3 and 8 of the *Agreement on Agriculture* in conjunction with whichever paragraph of Article 9.1 is considered applicable, for the same reasons, *mutatis mutandis*, given by the Panel in paragraphs 7.144 to 7.151 and 7.160 to 7.177 of the original Panel Report. There is no need for the EC to examine here the applicability of whatever para-

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[89] Appellate Body Report, paras. 150 and 153.

[90] *Ibid.*, at para. 154.

[91] The Panel mentioned that Article 9.1(a) might be relevant in footnote 700 to paragraph 7.159 of the Panel Report. The US also frequently referred to it in argument to support its view that paragraph (d) was not applicable to the FSC scheme.

graph of Article 9.1 is considered applicable because this is what will be established or admitted before the alternative claim can be considered at all.

3.9. The Transitional Provisions of the FSC Replacement Act Allow Companies to Continue to Benefit from the WTO Incompatible FSC Scheme Beyond 30 September 2000

234. Section 2 of the FSC Replacement Act formally provides for the repeal of the FSC scheme. It states that:

> Subpart C of part III of subchapter N of chapter 1 (relating to taxation of foreign sales corporations) is hereby repealed.

235. However, this repeal is something of an illusion, because FSC transactions can continue for an indefinite period.

236. While Section 5(c)(1) of the FSC Replacement Act provides in general terms that the Act applies to transactions entered into after 30 September 2000 and that no new FSC may be created after the same date, for FSC "in existence on September 30, 2000 and at all times thereafter" the amendments laid down in the FSC Replacement Act shall not apply to any transaction occurring

- before 1 January 2002, or
- after 31 December 2001, pursuant to a binding contract
  - with unrelated parties and
  - in effect on 30 September 2000.

237. Binding contracts include contract renewal options, purchase options and replacement options included in a contract. This only applies if such options are binding against the seller or lessor or equivalent.

238. There is no legal limit whatsoever to the duration of the FSC scheme through these contracts and options.

239. The EC submits that the above provision allow companies to continue to benefit from the WTO incompatible FSC scheme for an indefinite period, and thus perpetuates the violations found to result from the FSC scheme beyond the period provided for in the Panel Report and confirmed by the Appellate Body. Accordingly, the US has failed to implement the relevant DSB recommendations and rulings.

240. Furthermore, pursuant to Section 5(c)(2) of the FSC Replacement Act, FSCs can refuse this benefit by requesting immediate subjection to the new rules, if applicable, by making an "election" to this effect. This election can be made in respect of a single transaction, so that for the rest the new rules will apply. This of course offers old FSCs still an additional option to maximize their tax benefits according to the most suitable formula.

241. Accordingly, by maintaining the availability of FSC subsidies after 30 September 2000, for transactions effected by existing FSCs until 31 December 2001 (and, under certain conditions, for an indefinite period) the US has failed to withdraw the FSC subsidies as required by Article 4.7 *SCM Agreement* and the recommendations and rulings of the DSB and has also failed to comply with its obligations under Article 21 *DSU*.

3.10. The US Failed to Comply with the DSB Recommendations and Rulings within the Time Period Specified by the DSB

242. When adopting the Panel and the Appellate Body Reports on 20 March 2000, the DSB formulated recommendations and rulings also in respect of the compliance "with effect from 1 October 2000", that is the deadline laid down in the Panel Report and confirmed by the Appellate Body.[92]

243. Failure of the United States to comply with the DSB recommendations and ruling within such mandatory deadline would have of course placed the US in a position of non-compliance as from 1 October 2000. It would thus have exposed the US to the risk of countermeasures and suspension of concessions or other obligations by the EC.

244. Given that it had become clear that the United States would not be able to comply within this mandatory deadline, the US requested the DSB a modification of the time period for compliance, to which the DSB acceded on 12 October 2000.[93]

245. The EC points out that the FSC Replacement Act became law when signed by the President of the United States on 15 November 2000, that is 15 days after the deadline as extended by the DSB.

246. Accordingly, the EC submits that the US failed to comply with the DSB recommendations and rulings within the period of time specified by the DSB and has therefore also failed to comply with Article 21 *DSU*.

4. PRELIMINARY OBJECTION: THIRD PARTIES' RIGHTS UNDER THE PANEL WORKING PROCEDURES

247. Before concluding the EC would like to bring to the attention of the Panel a difficulty concerning third parties that arises, no doubt inadvertently, out of its Working Procedures.

248. Amongst the additional Working Procedures adopted by the Panel pursuant to Article 12.1 of the DSU (and item 11 of Appendix 3 to the DSU), rule 9 regulates third parties' access to the main parties' submissions. It provides in relevant part that

> Third parties shall receive copies of the parties' first written submissions. Any party may decide to provide the third parties with a copy of its rebuttal or other submissions.

249. A clear distinction is therefore between access to the first submissions and to other submissions. Whereas third parties have a fully-fledged right to obtain a copy of the main parties' first written submissions, their access to the other submissions is left to the discretion of such main parties.

250. The EC considers that the interests of third parties recognized in the DSU are not adequately protected in this case as these parties are denied a legal right to receive a copy of the parties' submissions to the first meeting of the Panel other than the first submissions.

251. In the EC's view this part of the Working Procedures conflicts with Article 10.3 of the DSU, which reads as follows

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[92] Panel Report, para. 8.8.

[93] WT/DS108/11, 2 October 2000; WT/DSB/M/90, 31 October 2000, para. 6.

> Third parties *shall receive the submissions* of the parties to the dispute to the first meeting of the panel (emphasis added).

252. This provision is binding on the parties and the Panel; it is unambiguous and does not provide for exceptions or derogations. Panels are not free to derogate in their Working Procedures from binding provisions of the DSU that grant procedural rights to the parties or to third parties. Nor is it in the interest of a fair and objective procedure to prevent third parties from having access to some of the written submissions that are made in preparation of the first (and only) substantive meeting of the Panel with the parties and the third parties.

253. The EC would like to stress that the panel process might seriously suffer from this way of proceeding. Preventing third parties from usefully participating in the procedure will obviously not further the Panel's task of making an objective assessment of the facts and the legal issues before it. Third parties should not be forced to base their contribution to a dispute settlement procedure on guesswork or hearsay information about the arguments submitted by the parties. The Working Procedures prevent third parties from being fully informed about the arguments exchanged before this Panel by the time of the substantive meeting with the parties and the third parties. As a consequence, the limitation of the access to documents that are before the Panel at the time of the meeting with the parties and the third parties is also likely to prevent the Panel from the benefit of useful contributions by third parties which could help the Panel to make the objective assessment that it is required to make under Article 11 of the DSU.

254. The EC is aware that some other panels have adopted similar working procedures, and this is no doubt the origin of the adoption of the above provision in this proceeding. But a practice which is in conflict with the express provisions and the objectives of the DSU cannot be considered as being justified because it has also been followed in some other procedures. A procedural error cannot be healed by repeating it. As in all the other cases of a similar nature in which it was involved, the EC therefore maintains that this way of proceeding is incompatible with fundamental guarantees of procedural fairness which are implicit in the DSU and must be respected by this Panel, whatever the practice of other panels may have been.[94]

255. A previous panel report under Article 21.5 of the DSU (*Australia – Salmon)*[95] has addressed this issue but has taken a different view from that set out by the EC above. The EC would make the following comments on the reasoning in the *Australia – Salmon* report.

256. The panel in that case expressly recognized that the fact of sending third parties only copies of what is - normally - the first round of submissions is a mere "practice" under Article 10.3.[96] This rather confirms that there is no legal requirement to this effect in the DSU.

257. The panel further recalled the expedited nature of proceedings under Article 21.5. The EC would however insist again that supplying third parties with all the submissions available to the panel ahead of the third party session would in no way

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[94] Cf. para. 3.7 to 3.10 of the Panel report on "*Australia – Subsidies Provided to Producers and Exporters of Automotive Leather – Recourse to Article 21.5 of the DSU by the United States*", doc. WT/DS126/RW, 21 January 2000, DSR 2000:III, 1189.

[95] *Australia – Measures Affecting Importation of Salmon – Recourse to Article 21.5 by Canada*, Panel Report WT/DS18/RW, 18 February 2000, DSR 2000:IV, 2031.

[96] *Ibid*., para. 7.

make this process more burdensome or slower. It would be incumbent upon third parties to avail themselves of the opportunity to make a fully informed intervention before the panel within the deadline that the panel has already established.

258. In view of the foregoing, the EC requests that the Panel rule that third parties be allowed to receive all the main parties' submissions preceding the single Panel meeting. In order for this ruling to be effective, the EC requests that the Panel make its ruling, and communicate it to the parties and the third parties as soon as possible after the US has had an opportunity to comment, that is after receipt of the US first written submission and before the date for the presentation of the second written submissions.

5. CONCLUSION

259. For the above reasons the EC requests the Panel to find that:

- The FSC Replacement scheme created by the FSC Replacement Act gives rise to subsidies within the meaning of the *SCM Agreement* and the *Agreement on Agriculture*.
- The FSC Replacement scheme provides subsidies contingent upon export performance contrary to Article 3.1(a) of the *SCM Agreement.* This prohibition is supported and confirmed by the fact that these subsidies are specifically related to exports within the meaning of item (e) to the Illustrative List in Annex I to the *SCM Agreement*.
- The foreign content limitation in the FSC Replacement scheme renders the basic FSC Replacement subsidy (and the extended FSC Replacement subsidy, if this is not contrary to Article 3.1(a)) contingent upon the use of US over imported goods contrary to Article 3.1(b) of the *SCM Agreement*.
- The FSC Replacement scheme accords more favourable treatment to US than to like imported products in relation to the use of such products for the production of goods for export under the scheme, contrary to Article III:4 of *GATT 1994.*
- The FSC Replacement scheme is inconsistent with Articles 10.1 and 8 of the *Agreement on Agriculture* or, in the alternative, with Articles 3.3 and 8 of the *Agreement on Agriculture* in conjunction with Article 9.1 of the *Agreement on Agriculture*.
- By maintaining the availability of FSC subsidies after 30 September 2000, for transactions effected by existing FSCs until 31 December 2001 (and, under certain conditions, for an indefinite period) the US has failed to withdraw the FSC subsidies as required by Article 4.7 *SCM Agreement* and the recommendations and rulings of the DSB and has also failed to comply with its obligations under Article 21 *DSU*.
- By failing to withdraw the FSC subsidies and to comply with the rulings and recommendations of the DSB by the end of the period of time allowed by the DSB, the US has also failed to comply with its obligations under Article 21 *DSU*

260. In addition, the EC requests the Panel to make a preliminary ruling to the effect that third parties are entitled to receive all written submissions of the parties submitted prior to the meeting of the Panel and to make this preliminary ruling and communicate it to the parties and the third parties as soon as possible after receipt of the US first written submission and before the date for the presentation of the second written submissions.

ANNEX

The cost of materials a percentage of the fair market value of products

Section 943(1)(C) of the IRC, introduced by the *FSC Repeal and Extraterritorial Income Exclusion Act*, defines qualifying foreign trade property to be, *inter alia*,

property—

(C) not more than 50 per cent of the fair market value of which is attributable to—

(i) articles manufactured, produced, grown, or extracted outside the United States, and

(ii) direct costs for labour (determined under the principles of section 263A) performed outside the United States.

The cost of materials as a percentage of the final price of any product varies according to a number of factors, e.g. the market price of the materials, the relative cost of other factors of production (e.g. labour, overheads, depreciation), the level of integration of the producer concerned, and the expected level of profit.

Nevertheless, there are some products, produced or assembled in certain ways, for which the materials are so important an input that it is difficult to believe that their contribution to fair market value could ever be below 50 per cent.

The EC's main legal argumentation in respect of this requirement is developed in the text of its submission to the Panel. In addition, and for purely illustrative purposes of that general argumentation, the EC gathered some data relating to the production in certain sectors (and has cross-checked them with information obtained from certain European industries and in the course of various trade investigations).

The most obvious examples will be fairly basic products, with little or no brand value, having a low level of processing and attracting a low profit margin. Some examples are as follows.

1. The Steel industry

(a) Hot-rolled coils

Hot-rolled coils are manufacturing in steel mills and are the pre-material for many types of steel products e.g. wide and narrow strips, cold-rolled products, tubes. The normal cost of production (including SGA expenses) of hot-rolled coils is around 207 Euro per tonne; on this basis fair market value is around 220 Euro per tonne.

The cost of materials involved in production is:

Iron	109 Euro per tonne
Steel scrap	15 Euro per tonne
Others	8 Euro per tonne
Total	132 Euro per tonne

The contribution of materials to the fair market value of hot rolled coils is 60 per cent.

(b) Heavy Steel Plate

The normal cost of production (including SGA expenses) of heavy plate is 290 Euro per tonne ; on this basis the fair market value is around 310 Euro per tonne.

The cost of materials involved in production:

Steel slab	200 Euro per tonne
Steel scrap	-10 Euro per tonne (recovered)
Total	190 Euro per tonne

The contribution of materials to the fair market value of steel plate is 61 per cent.

(c) Stainless Steel Fasteners

The raw material for making stainless steel fasteners is stainless steel wire rod. The cost of the raw material accounts for between 55 and 61 per cent of the fair market value (normal selling price) of the final product.

2. Other metal products

(a) Aluminium household foil

The main raw material for aluminium household foil is aluminium slabs. The cost of the raw material accounts for between 58 and 63 per cent of the fair market value (normal selling price) of the final product.

3. Woven glass fibre fabrics

The raw material for producing woven glass fibre fabrics is glass fibre yarn. The cost of the raw material accounts for between 55 and 60 per cent of the fair market value (normal selling price) of the final product.

4. Chemicals and synthetic fibres

(a) Polyethylene Terephthalate Bottle Resin

The raw materials for producing this product, which is used for the production of plastic bottles, are purified terephthalic acid, mono ethylene glycol, diethylene glycol and isophthalic acid. Together these account for up to 70 per cent of the fair market value (normal selling price) of the final product.

5. Aircraft

The engines of an aircraft can account for 30 per cent of the final price of the finished product. Similarly, the avionics on a modern aircraft can also cost 30 per cent of the final value.

Engines and avionics are typically purchased from outside suppliers. Together they can account for 60 per cent of the final price.

NOTE

Assembly always involves direct labour costs which can be quite high. This means that, to take the example of aircraft where bought-in engines and avionics account for 60 per cent of the final value, the 10 per cent that must be sourced in or from the US in order not to exceed the 50 per cent limitation is increased by the amount of the foreign direct labour costs also incurred by the producer.

LIST OF EXHIBITS

EC-1 Extract from Inside US Trade, 24 March 2000 (page 9).

EC-2 The initial US proposal to replace the FSC scheme.

EC-3 Letter of Commissioner Lamy to US Deputy Secretary of State Eizenstat of 26 May 2000.

EC-4 Letter of Commissioner Lamy to US Deputy Secretary of State Eizenstat of 31 August 2000.

EC-5 *FSC Repeal and Extraterritorial Income Exclusion Act of 2000* (the "FSC Replacement Act").

EC-5A *Technical Explanation of the Senate Amendment to H.R. 4986, the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000* (JCX-111-00) of 1 November 2000.

EC-6 Congressional Research Service Report on Foreign Sales Corporation Tax Benefit for Exporting and World Trade Organization *The Foreign Sales Corporation FSC Tax Benefit for Exporting and the WTO* David L. Brumbaugh Specialist in Public Finance. Government and Finance Division.

EC-7 Report of US Deputy Secretary of State Eizenstat speaking during the Senate Finance Committee passing of the FSC Replacement Bill on 19 September 2000, Inside US Trade, 3 November 2000 (Article starts on page 26 and continues on pages 24 and 25. The quoted text is on page 25).

EC-8 The Congressional Budget Office Cost Estimate of 13 September 2000.

EC-9 List of provisions in Subtitle A, Chapter 1, Subchapter B, Part III of the IRC excluding certain income from US tax.

ANNEX A-2

FIRST WRITTEN SUBMISSION OF THE UNITED STATES

(7 February 2001)

TABLE OF CONTENTS

I. INTRODUCTION

1. The European Communities ("EC") has initiated these proceedings to challenge the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 ("the Act").[1] In doing so, the EC claims that the new law is essentially the same as the former US Foreign Sales Corporation (or "FSC") tax provisions it replaced, and the EC proposes novel interpretations of WTO rules. The United States presents the Panel with this submission to explain how the new law works and why it is consistent with WTO rules.

2. The EC's efforts to paint the Act with the same brush it used on the FSC is inappropriate given that the Act was specifically designed to remedy defects found by the *FSC* Panel and the Appellate Body. The Act differs from the FSC in many ways, but two are particularly significant. First, unlike the FSC, the Act changes the United States' general rule – or normative benchmark – for taxation of foreign income and does not create a tax-saving exception to an otherwise applicable revenue-raising general rule. Thus, the Act does not confer a subsidy. Second, because the Act applies to a broad category of income, it is not export-contingent. Thus, the Act does not – as the Panel and Appellate Body found in the case of the FSC – create a situation in which a WTO Member, "having decided to tax a particular category of income ... carve[s] out an export contingent exemption from ... its other rules of taxation."[2] In fact, the Act has no such export contingency, and it does not "carve out" any income that would be "taxed ... under other rules" at all.

3. Instead, the Act represents a major change in the way the United States approaches the taxation of income derived from the sale, lease and rental of goods outside its borders and the method by which the United States avoids double taxation of such income. Previously, the United States relied on a worldwide approach, taxing all income of US individuals and corporations wherever earned. In the context of this

[1] Public Law 106-519, 114 Stat. 2423 (2000), copy attached as Exhibit US-1.

[2] *United States - Tax Treatment for "Foreign Sales Corporations" ("FSC (AB)")*, WT/DS108/AB/R, Report of the Appellate Body adopted 20 March 2000, DSR 2000:III, 1619, para. 99; and *United States - Tax Treatment for "Foreign Sales Corporations" ("FSC (Panel)")*, WT/DS108/R, Report of the Panel, as modified by the Appellate Body, adopted 20 March 2000, DSR 2000:IV, 1675, para. 7.108.

worldwide approach to taxation, the United States relied principally on tax credits to offset foreign taxes paid in order to avoid taxation of the same income by two taxing authorities. With the Act, the United States has moved away from a system that relies principally on tax credits to relieve double taxation. The Act avoids double taxation by virtue of the fact that income is not subject to US tax in the first place. By excluding income from US taxation rather than employing tax credits to relieve double taxation, the Act in many respects adopts an approach to relieving double taxation that is similar to territorial exemptions for foreign-income provided by a number of countries around the world.

4. As troubling as the EC's mischaracterization of the Act may be, its recasting of WTO rules is even worse. With regard to the definition of "subsidy", the EC ignores what the Appellate Body said about the meaning of a "defined, normative benchmark" against which to compare "the contested measure and revenues that would be due in some other situation."[3] Rather than adhering to these words, the EC asks the Panel to reverse the Appellate Body's analysis by treating the *revenue-raising exception* in the Act as the "defined, normative benchmark" and to compare it against the new US *general rule* of excluding extraterritorial income from US taxation.

5. In addition, the EC proposes a new standard for defining an export subsidy. The EC claims that the test is not whether a subsidy is conditioned or dependent for its existence on export performance, as the Appellate Body has said, but rather whether exports are treated differently than like domestic transactions. Such a test is not grounded in the language of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement") or in panel or Appellate Body reports interpreting that agreement. The EC even goes so far as to argue that the Illustrative List of Export Subsidies – which merely provides examples of prohibited export subsidies – broadens the prohibition beyond subsidies that are "contingent ... upon export performance".

6. The EC's attempts to ignore the significant ways in which the Act differs from the FSC, to transform the Act into something it is not, and to reshape WTO provisions in ways they do not bend, suggests that the EC cannot quite fit the Act neatly into any pre-existing paradigm for establishing a WTO inconsistency, and that it cannot explain why the Act is an export subsidy but comparable measures of its own member states are not. In effect, the EC is saying that while it might not be able to define what a subsidy or export subsidy is, it knows one when it sees one.

7. For this reason, the EC not only attacks the 50 per cent limitation on certain foreign value in the Act (the "50 per cent rule"), but also attempts to rely on its own erroneous interpretation of that limitation to infect all other provisions of the Act. Specifically, the EC argues that, even if the other provisions of the Act do not constitute subsidies or export subsidies in and of themselves, the 50 per cent rule taints the whole Act and causes it to be an export subsidy. The 50 per cent rule, however, limits only certain kinds of foreign value, and does not disadvantage imported products as the EC contends. It certainly does not taint the rest of the Act in the way the EC claims.

8. The EC's pliable approach to adjudication is inappropriate. Interpretation and application of treaties under public international law require a strict adherence to the language of an agreement, as well as a clear explanation of the reasons why a con-

[3] *FSC (AB)*, DSR 2000:III, 1619, para. 90.

tested measure does or does not conform to that language. The United States respectfully requests the Panel to resist the EC's outcome-determinative approach and instead to apply a principled mode of analysis that is faithful to the language of the relevant WTO provisions. The United States submits that such an analysis will lead to the conclusion that the Act is consistent with these provisions.

II. PROCEDURAL BACKGROUND

9. This proceeding concerns measures taken by the United States to comply with the recommendations and rulings of the DSB in WT/DS108.

10. The procedural history of this dispute up through the initial panel phase is set forth in paragraphs 1.1-1.7 of *FSC (Panel)*. On 8 October 1999, the Panel circulated its final report. The Panel found that the FSC tax exemption constituted a prohibited export subsidy that was inconsistent with US obligations under Article 3.1(a) of the SCM Agreement.[4] The Panel also found that the FSC tax exemption constituted an export subsidy within the meaning of Article 9.1(d) of the Agreement on Agriculture and that the United States had acted inconsistently with its obligations under Articles 3.3 and 8 of that Agreement.[5] Pursuant to Article 4.7 of the SCM Agreement, the Panel specified that "FSC subsidies must be withdrawn at the latest with effect from 1 October 2000."[6]

11. Both the United States and the EC appealed certain of the Panel's findings. The Appellate Body circulated its report on 24 February 2000. The Appellate Body affirmed the Panel's findings under the SCM Agreement, but modified the Panel's reasoning somewhat. The Appellate Body reversed the Panel's findings under the Agreement on Agriculture, finding instead that the United States had acted inconsistently with its obligations under Articles 10.1 and 8 of that Agreement.[7]

12. On 20 March 2000, the DSB adopted the reports of the Panel and the Appellate Body. On 7 April 2000, the United States informed the DSB of its intention to implement the recommendations and rulings of the DSB in a manner consistent with its WTO obligations.

13. Notwithstanding its best efforts, for a variety of reasons the enactment of corrective legislation took longer than anticipated.[8] Accordingly, on 29 September 2000, the United States requested that the DSB extend the time period for withdrawing the FSC to 1 November 2000.[9] On 12 October 2000, the DSB granted this request. Also on 29 September, the United States and the EC entered into a procedural agreement applicable to the follow-up to the *FSC* dispute.[10] Essentially, this agreement provides for panel and Appellate Body review of the WTO-consistency of the

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4 *FSC (Panel)*, DSR 2000:IV, 1675, para. 8.1(a).

5 *Ibid.*, para. 8.1(b).

6 *Ibid.*, para. 8.8.

7 *FSC (AB)*, DSR 2000:III, 1619, para. 177(b)-(d).

8 The United States notes that the EC has referred to discussions between U.S. and EC officials regarding initial legislative proposals to comply with the DSB's recommendations and rulings. *EC First 21.5 Submission*, paras. 4-14. The legislation ultimately passed by the United States, the Act, differs substantially from these initial proposals and, in fact, addresses certain concerns raised by the EC. Considering these differences, these initial legislative proposals, while reflecting the United States' extensive efforts and good faith in attempting to address the EC's concerns and honor U.S. WTO obligations, are irrelevant to the issues before the Panel.

9 WT/DS108/11 (2 October 2000).

10 WT/DS108/12 (5 October 2000).

Act before any consideration of the appropriate amount, if any, of countermeasures or suspension of concessions under Article 22.6 of the DSU.

14. On 15 November 2000, the Act was signed into law. The provisions of the Act were made effective with respect to transactions after 30 September 2000.

15. On 17 November 2000, the EC initiated proceedings under Article 21.5 of the DSU by requesting consultations with the United States regarding the Act.[11] On the same day, the EC requested authorization from the DSB to take appropriate countermeasures and suspend concessions pursuant to Article 4.10 of the SCM Agreement and Article 22.2 of the DSU.[12] On 27 November 2000, pursuant to Article 4.11 of the SCM Agreement and Article 22.6 of the DSU, the United States objected to the appropriateness of the countermeasures and the level of suspension of concessions proposed by the EC, thereby resulting in a referral of the matter to arbitration.[13]

16. The United States and the EC consulted on 4 December 2000, but were unable to resolve the matter. On 7 December 2000, the EC requested the establishment of a panel under Article 21.5.[14] On 20 December 2000, the DSB established a panel.[15]

17. In accordance with the 29 September procedural agreement, on 21 December 2000, the United States and the EC submitted a joint request that the arbitration proceeding under Article 4.11 and Article 22.6 be suspended until the adoption of the Article 21.5 panel report or, in the event of an appeal, the adoption of the Appellate Body report.[16] As a result, the arbitration was suspended.[17]

18. Following the establishment and composition of the Panel, on 21 December 2000, the Panel held an organizational meeting with the parties and presented the parties with a draft schedule and Working Procedures. The draft schedule called for the simultaneous filing of written rebuttal submissions by both parties. At the organizational meeting, the United States observed that if written rebuttals were simultaneous, the United States essentially would have nothing to say, given that in its first submission it already would have responded to the EC's first submission. The EC, on other hand, would be able to respond in its rebuttal to the first US submission. Effectively, the EC would be given the opportunity to file two written submissions, while the United States would be limited to one. Accordingly, the United States requested that rebuttal submissions be staggered, so that the EC would file its rebuttal submission first, followed by the US rebuttal submission.

III. FACTUAL BACKGROUND

19. In this section, the United States describes the Act and the territorial limitation on US taxing authority that it creates. This section then compares the Act to European systems that provide a territorial exemption for income earned in export transactions. Finally, this section distinguishes the Act from the former FSC regime.

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[11] WT/DS108/14 (21 November 2000).
[12] WT/DS108/13 (17 November 2000).
[13] WT/DS108/15 (27 November 2000).
[14] WT/DS108/16 (8 December 2000).
[15] *See* WT/DS108/19 (5 January 2001).
[16] WT/DS108/19 (5 January 2001).
[17] WT/DS108/18 (21 December 2000).

A. Description of the Act

20. The Act accomplishes two primary objectives. First, to comply with the DSB's recommendations, section 2 of the Act repeals the FSC provisions in sections 921 through 927 of the US Internal Revenue Code ("IRC").[18] Second, section 3 of the Act establishes a new regime for the treatment of extraterritorial income.[19] Under the new regime, extraterritorial income is excluded from gross income for US tax purposes, and, as explained below, is thereby placed outside the taxing jurisdiction of the United States. The rationale for, and details of, this exclusion are explained below.

1. Objectives of the Act and Its Effect on the US Tax System

21. Reports of the relevant committees of the US Congress form essential parts of the legislative history of the Act, and explain the underlying intent of Congress.[20]

(a) Compliance with the Panel and Appellate Body Reports

22. The legislative history makes clear that one of the objectives of the Act was to comply with the findings contained in the *FSC* Panel and Appellate Body reports.[21] The Act accomplishes this objective in two ways. First, the Act repeals the FSC provisions with effect from 1 October 2000. From that date, no corporation may elect to be treated as a FSC.[22] In addition, subject to reasonable and customary transition rules, the FSC provisions cease to have any application with respect to post-effective date transactions through existing FSCs.

23. Second, the Act also remedies the defect in the FSC found by both the Panel and the Appellate Body – namely, that the FSC tax exemption was an exception to otherwise applicable tax rules that applied only to exports. Rather than providing unique or special treatment for export-related income, the Act treats all foreign sales and all taxpayers alike. Under the Act, as under many EC and other tax systems, the income that is outside the US tax jurisdiction is in no way limited to income earned through exporting. Thus, taxpayers receive the same US tax treatment with respect to income derived from foreign transactions regardless of whether exports are involved. Moreover, the Act's exclusion of income applies without regard to whether the income is earned by a US or foreign individual, a US or foreign corporation, or a partnership or other pass-through entity.

(b) A New US Approach to Taxation of Foreign Income

24. In addition to implementing the DSB's recommendations, the Act also was intended to rationalize the treatment of foreign income under the US system of taxation. Wholly apart from the *FSC* dispute, the United States Senate had begun a process of reviewing the international provisions of the IRC with hearings early in 1999.

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[18] The Act § 2.
[19] The Act § 3.
[20] S. Rep. No. 106-416 (2000) ("*Senate Report*") (Exhibit US-2); and H.R. Rep. No. 106-845 (2000) ("*House Report*") (Exhibit US-3).
[21] *Senate Report*, page 5; *House Report*, page 3.
[22] The Act § 5(b)(1).

Among the issues identified was the need to re-examine the US tax treatment of foreign income.[23]

25. Although the timing of the Act certainly was affected by the *FSC* dispute, the substance of the Act was influenced by ongoing congressional review. By excluding extraterritorial income from the definition of "gross income", the Act fundamentally changes the way the United States taxes foreign income.[24] As the legislative history of the Act makes clear, the definition of "gross income," as modified by the Act, defines the outer limits of US tax jurisdiction.[25] Whereas the United States previously operated under the principle that all income of US persons is within the US taxing jurisdiction, the Act creates a new general rule under which excluded extraterritorial income earned by US taxpayers is outside US taxing jurisdiction. In recognition of this, a congressional report states that the territorial limitations created by the Act "parallels the exclusions under most territorial tax systems, particularly those employed by European Union member states."[26]

(c) A Measure to Avoid Double Taxation

26. Finally, the Act provides a method for avoiding double taxation.[27] The legislative history makes clear that Congress intended that the Act's exclusion serve as a means of avoiding double taxation of excluded income.[28] Because the exclusion avoids double taxation, the Act disallows foreign tax credits and deductions that otherwise might be allocable to excluded extraterritorial income.[29] By excluding certain foreign income, the Act adopts an internationally-accepted method for avoiding double taxation, a method employed by a number of EC member states and other countries.

2. *Description of Excluded Extraterritorial Income*

27. Turning to the details of the Act, under section 114(a) of the IRC, as added by the Act, extraterritorial income is excluded from "gross income." Thus, extraterritorial income is placed outside the limits of US taxing jurisdiction.

28. The Act provides a detailed definition of the term "extraterritorial income." The definition is contained primarily in new sections 114, 941, 942, and 943 of the IRC. These sections are included in Exhibit US-1 and are summarized here.

29. There are three main aspects to the definition of extraterritorial income. Extraterritorial income generally is defined as (1) qualifying foreign trade income (2) attributable to foreign trading gross receipts (3) with respect to which the taxpayer has performed certain foreign economic processes.[30] This definition contains both a qualitative and a quantitative component. The qualitative component relates to the

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[23] *Senate Report*, page 5; *House Report*, page 18.
[24] *Senate Report*, page 17.
[25] *Ibid.*, page 16.
[26] *Ibid.*, page 5.
[27] *Ibid.*, pages 2, 6.
[28] *House Report*, page 18 ("the extraterritorial income excluded by this legislation from the scope of US income taxation is parallel to the foreign-source income excluded from tax under most territorial tax systems").
[29] The Act § 3, amending IRC § 114(c)-(d).
[30] The Act § 3, amending IRC §§ 114(b)- (e) and 942(b)(1).

type of transactions subject to an exclusion, while the quantitative component relates to the amount of the exclusion. Each of these components is described below.

(a) The Qualitative Component of Excluded Income: Its Extraterritorial Nature

30. The first and perhaps most basic element of extraterritorial income is that it arises from extraterritorial transactions – *i.e.*, foreign – sales, leases and rentals. The Act provides that extraterritorial income must derive from one of five categories of foreign transactions.[31] These five categories include:

(1) the sale of qualifying property for its use or disposition outside the United States,

(2) the lease of qualifying property for use by the lessee outside the United States,

(3) the provision of services related and subsidiary to the first two categories,

(4) the provision of managerial services performed for unrelated persons in connection with the first three categories, and

(5) the provision of engineering or architectural services for projects located outside the United States.[32]

The Act makes the extraterritorial nature of excluded income clear by providing that the goods or services sold or leased are ultimately not to be used or performed in the United States, and may not be for the use of the United States itself or any instrumentality thereof.[33]

31. In addition, the Act requires that the gross receipts from which excluded extraterritorial income arises must have a nexus with activity occurring in a foreign jurisdiction. Excluded extraterritorial income can be derived only from transactions with respect to which the taxpayer (or a related person) engages in solicitation, negotiation, or contracting activities in a foreign jurisdiction, and incurs a certain threshold amount of costs associated with economic activities in a foreign jurisdiction.[34] These foreign economic activities (or "processes") may consist of one or more of the following five categories:

(1) advertising and sales promotion,

(2) processing of customer orders and arranging for delivery,

(3) transportation outside the United States in connection with delivery to the customer,

(4) billing activities, and

(5) the assumption of credit risk.[35]

The threshold amount of costs is 50 per cent of the aggregate total costs incurred in all five categories or 85 per cent of the total costs incurred in any two of the five

[31] To be precise, under section 114(e), extraterritorial income is defined as gross income attributable to "foreign trading gross receipts." "Foreign trading gross receipts", in turn, is defined by section 942(a) as gross receipts derived from one of five categories of foreign transactions listed here. *See Ibid.*

[32] The Act § 3, amending IRC § 941(a)(1).

[33] The Act § 3, amending IRC § 942(a)(2).

[34] The Act § 3, amending IRC §§ 942(b)(1), 942(b)(2)(A).

[35] The Act § 3, amending IRC § 942(b)(3).

categories.[36] These foreign economic processes must be performed, and the threshold requirements met, with respect to every foreign transaction giving rise to excluded extraterritorial income.

32. The Act also provides that no more than 50 per cent of the fair market value of any goods involved may be attributable to articles produced outside the United States and direct labour costs incurred outside the United States.[37] Goods can meet this requirement even if 100 per cent of the fair market value of their inputs or content is foreign.

(b) The Quantitative Component of Excluded Foreign Trade Income

33. In addition to the qualitative component of excluded income described above, the Act provides three different methods for identifying "excluded income". Specifically, "qualifying foreign trade income" is the amount of income from covered transactions, which, if excluded, would reduce the taxpayer's taxable income by the greatest of: 15 per cent of foreign trade income, 1.2 per cent of total gross receipts, or 30 per cent of foreign sale and leasing income.[38] Different methods are needed because different taxpayers use different business models, and the use of only one method could lead to disparate results among businesses engaged in similar foreign business activities. Accordingly, taxpayers may choose the method for quantifying excluded income that is most appropriate to their business circumstances.[39]

3. Evenhanded Treatment of Taxpayers

34. The Act applies equally to individuals, partnerships, and corporations that earn excluded extraterritorial income. The Act applies to these taxpayers irrespective of whether they are located in the United States or abroad, the only requirement being that these persons be subject to US taxation.[40] As explained by the legislative history,

> the bill requires that property manufactured outside of the United States be manufactured by (1) a domestic corporation, (2) an individual who is a citizen or resident of the United States, (3) a foreign corporation that elects to be subject to US taxation in the same manner as a US corporation, or (4) a partnership or other pass-through entity all of the partners or owners of which are described in (1), (2), or (3) above.[41]

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[36] The Act § 3, amending IRC § 942(b)(2)(A)(ii) and (B).

[37] The Act § 3, amending IRC § 943(a)(1)(C).

[38] The Act § 3, amending IRC § 941(a)(1).

[39] The Act § 3, amending IRC § 941(a)(2). Of the three calculations used to determine "qualifying foreign trade income", one is a percentage of overall "foreign trade income", one is a percentage of total receipts, and the third – involving "foreign sales and leasing income" – is a percentage of a subset of "foreign trade income". In other words, "foreign sales and leasing income" is a type of foreign trade income. "Foreign sales and leasing income" is "foreign trade income" that is attributable to the lease or sale of certain types of property, and that is directly tied to the performance of the prescribed foreign economic processes described above. The Act § 3, amending IRC § 941(c).

[40] The Act § 3, amending IRC § 942(a)(2).

[41] *Senate Report*, page 10.

This requirement is intended to equalize treatment of US taxpayers operating abroad in branch form with the treatment of US taxpayers operating abroad in corporate subsidiary form.[42] To reinforce this evenhanded treatment, the Act provides that property may be the subject of a qualifying transaction even if it is produced outside of the United States.[43]

35. In addition, the Act permits a foreign corporation to elect to be treated as a domestic corporation to ensure that property produced outside the United States need not be produced by a US person (*e.g.*, a US corporation).[44] This election is similar to other elections given to taxpayers that would not otherwise be subject to US tax jurisdiction.[45]

4. The Act's Effective Date

36. The Act is effective for transactions after 30 September 2000.[46] All provisions of the Act have effect from this date. Thus, no FSCs may be created after 30 September 2000.[47] A foreign corporation created after 30 September 2000, will be treated under general rules applicable to all foreign corporations. None of the rules under the former FSC provisions, including the special "dividends-received deduction", will be available to such a corporation or its US parent. In addition, subject to reasonable and customary transition rules, described below, the FSC provisions cease to have any application with respect to post-effective date transactions.

5. The Act's Transition Rules

37. Transition relief is common under US tax law in order to avoid undue hardship or confusion with respect to pre-existing business arrangements entered into under pre-existing law. Section 5(c) of the Act provides that the Act's amendments do not apply to a transaction in the ordinary course of a trade or business of a FSC already in existence as of 30 September 2000, which occurs: (1) before 1 January 2002,[48] or (2) after 31 December 2001, pursuant to certain binding contracts.[49] The only binding contracts to which the transition rules may apply are transactions between a FSC (or a related person) and an unrelated person that are already in effect on 30 September 2000.[50]

38. At any time during the transition period, a taxpayer may elect to apply the Act to a transaction that would otherwise be eligible for transition relief.[51] Such an election would be effective for the taxable year for which it was made and for all subse-

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[42] *Senate Report*, page 10.

[43] The Act § 3, amending IRC § 943(a)(1)(A).

[44] The Act § 3, amending IRC § 943(e)(1).

[45] For example, a foreign corporation may elect to be treated as a US corporation under IRC § 953(d) (relating to foreign insurance companies), IRC § 897(i) (relating to foreign corporations with US real property interests), and IRC § 1504 (relating to foreign corporations formed solely for foreign law purposes). *See* Exhibit US-4.

[46] The Act § 5(a).

[47] The Act § 5(b)(1).

[48] The Act § 5(c)(1)(A).

[49] The Act § 5(c)(1)(B).

[50] The Act § 5(c)(1)(B)(i)-(ii). A binding contract for this purpose includes "a purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor." The Act § 5(c)(1).

[51] The Act § 5(c)(2).

quent taxable years.[52] Under no circumstances is a taxpayer permitted to apply the FSC provisions and the Act to the same transaction or transactions.[53] The Act automatically applies (without any election or other notification) to transactions not covered by the transition rules.[54]

B. The Act Moves the US Approach to Taxation of Foreign Income Close to the European Model

39. The US Congress recognized that by excluding extraterritorial income from gross income, the Act "parallels the foreign-source income excluded under most territorial tax systems, particularly those employed by European Union member states."[55] In this regard, many European countries impose income taxes on a territorial basis, at least in part. Subject to numerous exceptions, European governments applying a territorial approach do not tax income earned outside their borders. European territorial exemptions extend not only to income earned by resident corporations and offshore branches, but also to income earned by foreign subsidiaries and dividends paid to domestic parents by foreign subsidiaries.

40. European tax exemptions for offshore income apply to three types of transactions: imports, wholly foreign transactions, and exports. In most cases, European countries do not require the foreign tax rate to be equal to or greater than the home country rate and, in some instances, no minimum foreign rate is required at all. Thus, European companies with overseas operations in low tax jurisdictions can receive a tax benefit from a territorial exemption. Insofar as the sale of goods is concerned, European manufacturers operating in these types of tax regimes may obtain the benefits of a territorial exemption only by exporting.

41. As indicated above, no EC member state now provides a blanket exemption for foreign-source income. In fact, as the EC explained to the Panel in the initial proceeding, EC member states providing an exemption for foreign-source income do so only partially, and most generally treat foreign-source income as an exception to the general rule that the worldwide income of a domestic corporation is subject to taxation in its country of residence.[56] Thus, just as the Act has introduced an element of territoriality into the US system of taxation, European systems themselves are a mix of worldwide and territorial principles.

42. This confluence of worldwide and territorial approaches is perhaps most striking in the Dutch tax system. As the Panel may recall from the initial proceeding, as a general matter, Dutch resident companies are liable for corporate income tax on a worldwide basis. However, the income of foreign branches of Dutch resident companies generally is not taxed. Even in the absence of a treaty, income earned by a foreign branch of a Dutch company that is subject to *any* income tax in a foreign country is also exempt from Dutch tax.[57]

43. In addition, the income of a foreign subsidiary of a Dutch company is not subject to Dutch income tax, even in the case of income from export activities, so

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[52] The Act § 5(c)(2).
[53] *Senate Report*, page 21.
[54] The Act § 5(a).
[55] *Senate Report*, page 5.
[56] EC Second Written Submission to the *FSC* Panel, Annex EC-2, para. 2, attached as Exhibit US 5.
[57] *FSC (Panel)*, DSR 2000:IV, 1675, para. 4.809.

long as the subsidiary does not have substantial activities in the Netherlands. Moreover, any Dutch shareholder that owns 5 per cent or more of a foreign corporation may generally exempt from tax 100 per cent of the dividends paid by the foreign corporation to that shareholder.

44. As with a foreign branch, income from a foreign subsidiary will qualify for the exemption so long as the subsidiary is subject to *any* national-level income tax in its country of residence. Thus, a subsidiary that is resident in a low-tax jurisdiction such as the Netherlands Antilles is generally exempt from Dutch tax on income earned outside the Netherlands. Moreover, a Dutch parent corporation will, subject to certain requirements, receive a 100 per cent participation exemption (dividends-received deduction) on dividends from that subsidiary, even though the income may be subject to tax in the Netherlands Antilles at a very low rate of tax (two or three per cent).

45. To appreciate how the Dutch system operates, assume that a Dutch manufacturing company and its Netherlands Antilles sales subsidiary engage in an export transaction in which the subsidiary acts on the parent company's behalf to sell items exported from the Netherlands, and the companies together earn a total of $100,000.[58] Further assume that each company earns the equivalent of $50,000 under arm's-length transfer pricing principles. The Netherlands Antilles subsidiary's income from the transaction – that is, $50,000 – would be fully exempt from taxation by the Netherlands and, at a 3 per cent rate, would owe tax of only $1,500 to the Netherlands Antilles.

46. Due to the 100 per cent participation exemption, the Dutch parent corporation would not pay taxes upon the repatriation of the exempt income earned by the foreign subsidiary. On the other hand, the Dutch parent company would be liable for taxes in the Netherlands, at a rate of 35 per cent, on the income it earned from the transaction; *i.e.,* the other $50,000. The taxes on this income would amount to $17,500. The overall taxes on the total export income of $100,000 would be $19,000 – or an effective tax rate of 19 per cent – resulting in a tax savings of $16,000 ($35,000-$19,000) as compared to the tax that would have been incurred if the same transaction had involved a domestic sale.

C. The Act is Fundamentally Different from the FSC

47. Throughout its First Submission, the EC portrays the Act as "essentially the same subsidy" as the FSC.[59] This portrayal is erroneous, because it ignores the fundamental ways in which the Act differs from the FSC, as described below.

1. The FSC Was a Relatively Narrow Exception to US General Rules of Worldwide Taxation for Export-Related Income

48. Prior to adoption of the Act, the US tax system operated principally on a worldwide basis. The United States asserted the right to tax all income earned by US citizens and residents (including US corporations), as well as income earned by non-residents conducting activity within US borders. The US system treated all income

[58] For a more detailed discussion of this example, see *FSC (Panel)*, DSR 2000:IV, 1675, paras. 4.809 and 4.1042.

[59] *See, e.g.*, First EC 21.5 Submission, para. 121.

earned by US persons as taxable, even if earned outside the United States. The United States generally exempted from direct taxation, however, all income earned outside the United States by foreign corporations.

49. This exemption applied even if the foreign corporation was owned by a US person. Subject to certain antideferral rules, the United States generally taxed the US shareholders of foreign corporations at the time income was distributed to the US shareholder. Thus, as a general matter, US shareholders of foreign corporations benefitted from the deferral of US tax on income earned through a foreign corporation.

50. Notwithstanding this general rule, the United States has adopted a series of "anti-deferral" regimes that constitute limited exceptions to the general norm of deferral and that, in general, respond to specific concerns about potential tax avoidance by US corporations through foreign affiliates. One of these regimes is found in subpart F of the IRC. Subpart F limits the availability of deferral for certain types of income earned by certain controlled foreign subsidiaries of US companies.[60] Pursuant to subpart F, a US shareholder that controls a foreign corporation must pay US tax on certain types of income earned by the foreign corporation at the time the income is earned by such foreign corporation, and without regard to whether the income is distributed to the shareholder.

51. As the Panel and Appellate Body found in *FSC*, the FSC operated as an exception to these general rules of US corporate taxation. It subjected the income of a foreign corporation directly to US taxation. It provided a dividends received deduction for income repatriated by a foreign subsidiary to a domestic parent. It created an exception to subpart F for income of a controlled foreign corporation that otherwise might have been deemed to be immediately taxable to the foreign corporation's parent. And, of course, the FSC applied only to income from "export property"; *i.e.*, property manufactured in the United States and sold abroad.

2. *The Act Makes a Fundamental Shift in US Tax Treatment of Extraterritorial Income*

52. The Act modified the general rule of US taxation by fundamentally amending the definition of "gross income", the term which, under US tax law, defines the boundaries of US taxing jurisdiction. In contrast to the former US worldwide approach, the Act excludes income earned in qualifying foreign transactions from the definition of gross income and, thus, modifies the extent to which the United States seeks to tax such income.

53. This new general rule applies to a substantially broader category of income than that which was exempted from tax under the FSC provisions. It applies to foreign transaction income irrespective of whether the goods in question were produced in the United States. It requires no related foreign company to be involved in the transactions in question, and it is applicable to a broader group of taxpayers, including foreign corporations.

54. Thus, unlike the FSC, the Act's exclusion of income from US taxation is automatic. It does not result from the creation of an exception to US general rules for taxing foreign corporations, an exception to the subpart F rules, or an exception to the rules governing the dividends received deduction. Instead, the Act's exclusion is part of the US general rules of taxation.

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[60] IRC § 951 (US-4).

3. The Act does not Require Exportation

55. Not only is the Act broader than the FSC in terms of the rules it establishes for the US tax system and with respect to the taxpayers that may use it, it also is broader with respect to the transactions it covers. Unlike the FSC, the Act is not limited to "export property". Instead, the Act applies to income involving property produced within or without the United States. Indeed, unlike the FSC, excluded income under the Act can arise from transactions involving property that is manufactured and sold outside the United States, and all of the value of which is comprised of 100 per cent foreign content. As in the case of European tax regimes, exporters are eligible for the exclusion, but the Act nowhere requires a taxpayer to export in order to earn excluded extraterritorial income.

IV. ISSUES RAISED IN THIS PROCEEDING

56. The following issues are raised in this proceeding for resolution by the Panel:

(a) Whether the Act's exclusion of extraterritorial income from US taxation confers a subsidy within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.

(b) Whether the Act's exclusion of extraterritorial income from US taxation is contingent upon export performance within the meaning of Article 3.1(a) of the SCM Agreement.

(c) Whether the Act's exclusion of extraterritorial income from US taxation constitutes a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59 of the SCM Agreement and whether, for that reason, the exclusion does not constitute a prohibited export subsidy under Article 3.1(a) of the SCM Agreement.

(d) Whether, if the Act's exclusion of extraterritorial income from US taxation does not constitute a prohibited export subsidy by virtue of the fifth sentence of footnote 59, the exclusion is not prohibited by any other provision of the SCM Agreement by virtue of footnote 5 of that Agreement.

(e) Whether the Act's 50 per cent rule on certain foreign value renders the Act's exclusion of extraterritorial income from US taxation contingent upon the use of domestic goods over imported goods within the meaning of Article 3.1(b) of the SCM Agreement.

(f) Whether the Act's 50 per cent limitation on certain foreign value provides less favourable treatment to imported goods in comparison to the treatment afforded to like domestic goods so as to be inconsistent with Article III:4 of GATT 1994.

(g) Whether the Act's exclusion of extraterritorial income from US taxation is inconsistent with US obligations under Articles 10.1 and 8, or Article 3.3 and 8, of the Agreement on Agriculture.

(h) Whether the DSB's recommendation that the FSC subsidy be withdrawn with effect from 1 November 2000 precludes a reasonable transition period.

(i) Whether third parties to this proceeding have a right to the parties' rebuttal submissions.

V. ARGUMENT

A. General Considerations

57. Although this principle is now well-established in WTO jurisprudence, it is nonetheless worth recalling that the EC, as the complainant, bears the burden of proof both in terms of presenting a *prima facie* case and in the sense of the ultimate burden of persuasion. Thus, if the balance of evidence is inconclusive, the EC will have failed to have established its claims.[61]

58. It also is worthwhile to recall the principles of treaty interpretation that govern this proceeding. Article 3.2 of the DSU states that provisions of WTO agreements are to be read in accordance with "the customary rules of interpretation of public international law." The Appellate Body has frequently explained that the "general rule of interpretation" under public international law is set forth in Article 31(1) of the *Vienna Convention on the Law of Treaties* ("*VCLT*"), which provides that "[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose." As the United States demonstrates in the sections that follow, when the relevant provisions of the WTO agreements are considered in light of their ordinary meaning, context and object and purpose, it becomes clear that the Act is consistent with US WTO obligations.

B. The Exclusion of Extraterritorial Income Under the Act Does Not Constitute a Subsidy under Article 1 of the SCM Agreement

59. The first issue before the Panel is whether the exclusion of extraterritorial income under the Act constitutes a "subsidy" within the meaning of Article 1 of the SCM Agreement. If it does not, it cannot be a prohibited subsidy under either Article 3.1(a) or Article 3.1(b), and the Panel need not reach any of the issues raised by Article 3 at all.[62] In this section, the United States explains why the exclusion of extraterritorial income under the Act does not constitute a "subsidy" as that term is defined in Article 1, as construed by the *FSC* Panel and the Appellate Body.

1. Under Article 1, the Normative Benchmark Is the Member's "Prevailing Domestic Standard"

60. Article 1 of the SCM Agreement provides that "a subsidy shall be deemed to exist if ... there is a financial contribution by a government ... and a benefit is thereby conferred." With respect to tax measures, Article 1.1(a)(1)(ii) provides that a "financial contribution" exists where "government revenue that is otherwise due is foregone or not collected". The determinative Article 1 issue in this case is thus whether, by excluding extraterritorial income from gross income – and, thus, excluding extraterri-

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[61] *See, e.g., India - Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*, WT/DS90/R, Report of the Panel, as affirmed by the Appellate Body, adopted 22 September 1999, DSR 1999:V, 1799, para. 5.120.

[62] *FSC (AB)*, DSR 2000:III, 1619, 93 ("This definition [of subsidy] ... applies wherever the word "subsidy" occurs throughout the *SCM Agre*ement and conditions the application of the provisions of that Agreement regarding *prohibited* subsidies in Part II ... .") (emphasis in original); *see also FSC (Panel)*, DSR 2000:IV, 1675, para. 7.39 ("in order for a measure to be an export subsidy within the meaning of Article 3.1(a) of the SCM Agreement, it must be a subsidy within the meaning of Article 1 of that Agreement").

torial income from US taxing jurisdiction – the United States has "foregone or not collected" revenue that is "otherwise due".

61. With respect to the ordinary meaning of the critical terms used in subparagraph (ii), the meaning of "revenue" most applicable to this case is "the annual income of a government or State, from all sources, out of which the public expenses are met".[63] The definition of "forego" is "to abstain or refrain from" or "go without; deny to oneself".[64] "Otherwise" is defined as "by other means; differently; in another case; in other circumstances",[65] and "due" is defined as "an obligatory payment; a fee, a tribute, a toll; a legal charge".[66] Taking the ordinary meaning of these terms together, the foregoing of revenue otherwise due means that a government has refrained from collecting income that in another circumstance would be legally owed to the government.

62. The classic case to which this language applies is a situation in which a company or group of companies has a legal tax obligation that the government forgives or fails to enforce. Selectively rebating a company's taxes or failing to enforce its existing tax obligations or giving the company preferential treatment under a generally applicable law are all situations that readily fit the ordinary meaning of subparagraph (ii). Each would be an example of a government's foregoing or not collecting taxes that are otherwise due.

63. Where the tax laws of a country themselves create a special exception from general tax obligations, that, too, may come within the language of subparagraph (ii). In the case of a statutory exception, the inquiry is again whether the income expressly excepted from tax would be "otherwise due" under other provisions of the country's tax law. Both the *FSC* Panel and the Appellate Body found that to determine whether taxes on statutorily excepted income would be "otherwise due," it is necessary to compare the challenged statutory measure with a "normative benchmark". As the Appellate Body stated, under subparagraph (ii), determining whether taxes are "otherwise due" requires a "defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised otherwise".[67]

64. Moreover, both the *FSC* Panel and the Appellate Body made clear that the normative benchmark must be found in the tax regime of the Member whose measure is being challenged. As the *FSC* Panel explained, "there is in the WTO Agreement no theoretical 'correct' benchmark for taxes that would represent the norm for taxes and duties 'otherwise due.'"[68] Rather, "the determination whether revenue foregone is 'otherwise due' must involve a comparison between the fiscal treatment being provided by a Member in a particular situation and the tax regime otherwise applied by that Member ... ."[69] As explained by the Appellate Body, "the word 'foregone' suggests that the government has given up an entitlement to raise revenue that it could 'otherwise' have raised. This cannot, however, be an entitlement in the abstract, be-

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[63] The New Shorter Oxford English Dictionary (1993).
[64] *Ibid.*
[65] *Ibid.*
[66] *Ibid.*
[67] *FSC (AB)*, DSR 2000:III, 1619, para. 90 ("the basis of comparison must be the tax rules applied by the Member in question").
[68] *FSC (Panel)*, DSR 2000:IV, 1675, para. 7.42.
[69] *Ibid.*, para. 7.43.

cause governments, in theory, could tax *all* revenues."[70] Instead, it must be an entitlement established in a government's own tax laws.

65. The *FSC* Panel applied this concept by asking whether taxes would have been collected "but for" the measure in question.[71] Applying this "but for" test, the Panel considered "whether, if the FSC scheme did not exist, revenue would be due which is foregone by reason of that scheme."[72] While noting that it might not be appropriate in all cases, the Appellate Body agreed that the panel's "but for" test was appropriate for the *FSC* case. Stressing that WTO obligations do not compel any particular kind of tax system, and that Members have the sovereign authority to tax or not to tax particular categories of revenue, the Appellate Body concluded that the comparison must be with the "prevailing domestic standard" of the Member in question.[73]

66. Thus, the standard of subparagraph (ii), by its own terms and as construed by the *FSC* Panel and the Appellate Body, looks to whether, by virtue of a challenged measure, a government foregoes tax revenues that would otherwise be due under the normative benchmark that is the Member's "prevailing domestic standard." It was with reference to this WTO legal standard that the United States developed the Act.

2. *By Excluding Extraterritorial Income from "Gross Income", the Act does not Forego Revenue that Is Otherwise Due*

67. In determining how to revise the US tax system, Congress relied on and sought to incorporate the principles articulated by the *FSC* Panel and the Appellate Body. In particular, it designed the Act to meet the articulated standard of Article 1 of the SCM Agreement. Congress achieved this result by altering the general jurisdictional rule of US taxing authority; *i.e.*, the "outer boundary" of US taxing authority.

68. Incorporating limitations similar to those found in many European countries that place territorial limits on their own taxing authority, the United States restricted the statutory scope of its own taxing authority. Not unlike European countries that decline to tax certain categories of foreign income, the United States placed new limits on its own taxing authority with respect to "extraterritorial income". To accomplish this as a technical matter under the US tax system, the United States modified the domestic standard of "gross income", the concept that defines income that is subject to taxation for purposes of US tax law. In the words of the *FSC* Panel and the Appellate Body, the United States modified the "normative benchmark" for taxation under US law.

(a) Under US Tax Law, "Gross Income" Defines US Taxing Jurisdiction

69. Under US law, the taxing authority of the United States government is defined by the statutory definition of "gross income."[74] "Gross income" is defined in Parts I - III of Chapter 1B, Subtitle A of the IRC, in particular section 61, sections 71 through 90, and sections 101 through 139. These provisions define items that are

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[70] *FSC (AB)*, DSR 2000:III, 1619, para. 90 (emphasis in original).
[71] *FSC (Panel)*, DSR 2000:IV, 1675, para. 7.45.
[72] *Ibid.*
[73] *FSC (AB)*, DSR 2000:III, 1619, para. 90.
[74] *See* 501-2d Tax Mgmt. (BNA), page A-1(Exhibit US-6) ("Gross income is a fundamental ingredient in the determination of federal income tax liability").

specifically included in and specifically excluded from the definition of "gross income".

70. In addition to setting the outer limits of US taxing authority, "gross income" serves as the central reference point for determining the tax liability of US taxpayers. For example, it is the threshold reference point in determining whether a person or entity must file a tax return. It is the starting point for determining "taxable income," and thus one's tax obligations.[75] "Gross income" is the reference point for computing state and local taxes, for taking tax deductions, and for determining eligibility for certain tax benefits. In the context of prosecuting underpayment of taxes, whether the statute of limitations can be extended is based on whether the amount of omitted gross income exceeds 25 per cent of the amount of gross income reported.[76]

71. The definition of "gross income" is thus the "prevailing domestic standard" for US taxation. It defines the general rule, or the jurisdictional boundary, of US taxing authority. In the words of the Appellate Body, it is the "normative benchmark" under US law against which any particular measures must be evaluated. It is the benchmark against which exemptions or deductions or allowances are figured and, therefore, is the rule that would otherwise apply "but for" any exemption, deduction, or allowance. Income that does not come within the definition of "gross income" is beyond the statutory taxing authority of the US Government.

72. By modifying the definition of "gross income" through the Act, the United States made a fundamental change in its tax structure, establishing a new "prevailing domestic standard" for US taxation. Thus, new section 114(a) of the IRC, which provides that "[g]ross income does not include extraterritorial income," represents a significant shift in US taxing jurisdiction and the normative benchmark for US taxation of foreign income.

73. The legislative history of the Act makes clear that Congress understood that it was making just such a fundamental, jurisdictional change. The *House Report*, at pages 16-17, specifically states as follows:

> [The Act] modifies the general rule of US taxation by fundamentally amending the definition of gross income. Under the Code, the definition of "gross income" defines the outer boundaries of US income taxation. The bill excludes income derived from certain activities performed outside the United States, referred to as "extraterritorial income," from the definition of gross income and, thus, modifies the extent to which the United States seeks to tax such income. This new general rule thus becomes the normative benchmark for taxing income derived in connection with certain activities performed outside the United States.

(b) A WTO Member Is Free to Change the Standard that Governs Its Own Taxing Jurisdiction

74. WTO Members are, of course, free to modify their own tax systems. As the Appellate Body took pains to point out, WTO obligations do not dictate what type of tax system a Member must have. Indeed, as discussed further below, there is great variety in the tax principles that Members apply and in how they apply them. So long

[75] *See* IRC § 63 (US-4).
[76] IRC § 6501(e) (US-4).

as they do not contravene specific WTO obligations, Members have "the sovereign authority to tax any particular categories of revenue" and are "also free *not* to tax any particular categories of revenues."[77]

75. The Appellate Body thus confirmed a principle that is fundamental to the application of WTO rules to national tax measures. It must necessarily be the case that Members are free to change their policies as to what categories of revenue they choose to tax or not to tax. It could not be the case that Members are free to *expand* their taxing authority to new categories of income, but not free to *contract* their taxing authority by deciding not to tax certain previously taxed categories of income. To argue that a country's decision *not* to tax a category of income constitutes a subsidy (because "but for" the change the income would be taxed) would mean that a country could change its general taxing authority only by expanding it. Applying the "but for" test in such an over broad manner would produce a perverse situation in which any decision to reduce taxes or reduce taxing authority would constitute a "subsidy" under Article 1 of the SCM Agreement. Such a position would be untenable and illogical.[78]

76. Moreover, a Member must be free to modify its general rule of taxation in order to comply with a decision by a WTO panel or the Appellate Body. Where a Member has a measure that is inconsistent with the Article 1 subsidy standard, the Member is free to cure that failing by modifying the offending measure or by changing its general rule of taxation, or by doing both.

(c) Under the Modified US Normative Benchmark, the Income Excluded by the Act Is Not "Otherwise Due"

77. Applying the standard of Article 1, as articulated by the *FSC* Panel and the Appellate Body, the Act does not constitute a subsidy because tax on the excluded income is not "otherwise due". Because the United States lacks statutory authority to tax anything that falls outside the definition of "gross income", there is no general rule of taxation that would apply "but for" the definition of "gross income".

78. This new limitation on US taxing authority is analogous to territorial limits that other governments impose on themselves in limiting their own taxing jurisdiction. Although any limitation or restraint that causes a country to exercise less than its theoretical maximum taxing authority is, in one sense, a decision to forego potential revenue, it is clear, as the Appellate Body stated, that neither the WTO Agreement in general, nor the SCM Agreement in particular, requires Members to tax all categories of potentially taxable income.

79. The Act excludes extraterritorial income from gross income. This exclusion constitutes a defined, normative benchmark for taxing income earned on foreign transactions. Because this exclusion constitutes a jurisdictional limitation on taxing income from foreign transactions, taxes on extraterritorial income are not "foregone" and are not "otherwise due".

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[77] *FSC (AB)*, DSR 2000:III, 1619, para. 90.

[78] For example, assume that the United States chose to overhaul its tax system and adopt the tax regime of France (which the EC presumably maintains does not confer a subsidy, even though export transactions are treated more favourably than comparable domestic transactions). Under the EC's reasoning, the United States has foregone revenue that is otherwise due, because "but for" the legislation establishing the new tax regime, the United States would have taxed some categories of revenue that are excluded from tax under the new regime.

80. Under a "but for" analysis of the type the Panel undertook in *FSC*, the Act does not satisfy the Article 1 definition of a "subsidy". Applying that analysis, it is clear that, unlike the FSC, the Act's exclusion of extraterritorial income is not a narrow tax-reducing exception to a general tax-raising rule. Rather, the limitation that it places on US taxing authority is a part of the general rule of taxation itself. The exclusion does not provide an exception against a broader definition of "gross income" that would otherwise apply.

81. Indeed, under the "but for" test, the absence of the tax-raising exception would leave only the general exclusion. Section 114(a) of the IRC provides that gross income does not include extraterritorial income. Section 114(b) states that extraterritorial income does not include income that is not qualified foreign trade income. Thus, the exception found in section 114(b) raises revenue. But for section 114(b), all extraterritorial income would be excluded from gross income under section 114(a), and the exclusion would be broader.

82. Similarly, the Act meets other elements of the standard articulated by the Appellate Body. To constitute an Article 1 "subsidy", the government must have "given up an entitlement to raise revenue" and that entitlement must be based on "some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised 'otherwise.'"[79] Turning, as the Appellate Body directs, to the United States' "prevailing domestic standard", one finds that there is now no general principle that would impose tax on income now excluded by the Act. To the contrary, the general authority to tax extraterritorial income has now been eliminated from the prevailing US standard.

83. Accordingly, applying the ordinary meaning of subparagraph (ii) and the test articulated by the *FSC* Panel and the Appellate Body, the Act does not constitute a subsidy within the meaning of Article 1. No longer does the IRC contain a specific exception from a general rule that would broadly tax extraterritorial income; instead, it now contains a jurisdictional limit that places such income beyond the taxing authority of the United States. By making this change, the United States has imposed a type of territorial limit on its taxing authority that is in many respects similar to that imposed by numerous European countries. European taxing limits, many of which are defined or qualified narrowly by very specific provisions, cause certain foreign-source income to be taxed and some not to be taxed. In seeking to comply with the rulings in *FSC* by deciding not to tax a certain category of income – excluded extraterritorial income – the United States has exercised the same sovereign authority that has been exercised by numerous Members in Europe and elsewhere.

3. *The EC's Article 1 Arguments Are Inconsistent With the Text of Subparagraph (ii), as Interpreted by the* FSC *Panel and the Appellate Body*

84. The EC argues that the Act's exclusion of extraterritorial income comes within the definition of the term "subsidy" in Article 1 for reasons that are unrelated to the standard of subparagraph (ii), and for reasons that ignore the realities of tax systems around the world and in Europe, in particular. The reasons why the EC's arguments are not legally tenable are set forth below.

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[79] *FSC (AB)*, DSR 2000:III, 1619, para. 90.

(a) The EC's Argument that the Act's Exclusion of Extraterritorial Income Should Be Viewed as an Exemption

85. The EC argues that it is "misleading" for the Act to be denominated as an "exclusion" rather than an "exemption". The EC then argues that the tax-raising exception in section 114(b) is the general rule and the exclusion of extraterritorial income is the exception.

86. This line of argument is defective for several reasons. First, it fails to address the law that the United States did adopt. Instead, it seeks to redesign that law and then critique the redesigned version as legally insufficient. Obviously, the law before this Panel is the law that the US Congress enacted, not a different version that, had it been adopted and structured as the EC suggested, would, in the EC's eyes, be legally defective.

87. Second, whether, as a matter of US tax law, the new modifications to the term "gross income" are more appropriately designated as an "exclusion" than as an "exemption" is really a judgment that the United States Congress is in a better position to make than EC officials. Although the EC may believe that an "exemption" could be more readily challenged under Article 1 than an "exclusion," the EC cannot bootstrap itself into such an argument by claiming that the Act really should have been called an "exemption".

88. Third, and most important, the semantic distinction between an exclusion and an exemption would not, in any event, be determinative. Rather, the test under subparagraph (ii) is whether tax on the income now excluded would be otherwise legally owed to the government. Under that standard, as further explicated by the *FSC* Panel and the Appellate Body, tax on the now-excluded income is not "otherwise due" under the current prevailing standard of US taxation.

(b) The EC Argument that the Excluded Income Is a Subsidy Because the Exclusion Should be Larger

89. The EC makes a variety of arguments to the effect that the Act confers a subsidy because the exclusion ought to be larger. For example, the EC objects to the Act on the grounds that non-qualified foreign trade income *is* taxed. It characterizes the definitional limits of "extraterritorial income" as "conditions" that narrow the scope of the exclusion, and it faults the new Act because excluded "extraterritorial income" does not include all "foreign source income". Thus, the EC contends, because the exclusion is not larger or unqualified, it must be deemed to be a "subsidy" within the meaning of Article 1.

90. Subparagraph (ii), however, does not specify that revenue that governments elect to forego can be foregone only in particularly designed categories. Members are not obliged, for example, to take an "all-or-nothing" approach with respect to the taxation of "foreign source income". If that were the standard, then most likely all Members, including EC member states, would fail that standard.[80]

[80] For example, Belgium grants a 95 per cent participation exemption on distribution of earnings from a foreign subsidiary of a Belgian corporation. *FSC (Panel)*, DSR 2000:IV, 1675, para. 4.811, note 408. Under the EC's argument, Belgium is foregoing revenue that is otherwise due because it taxes the other 5 per cent.

91. Nor are Member governments required to ignore the revenue implications of their tax policy decisions. It is both appropriate and permissible for governments to adjust their taxing policies to meet certain revenue objectives or constraints. Thus, the fact that a category of income is given a partial rather than an absolute exclusion from tax is an appropriate fiscal determination for a Member to make. It was entirely appropriate for the US Congress to determine that the revenue implications of the Act should not be drastically different from the revenue implications of the discarded FSC. That an exclusion is qualified or moderated, however, does not convert it into a subsidy under Article 1.

(c) The EC Argument that "Extraterritorial Income" is not a "General Category"

92. A variation on the EC's argument that the Act's exclusion should be larger is its argument that "extraterritorial income" is "not a general category of income that a WTO Member may choose not to tax".[81] This is a conclusory, circular argument that can be advanced only by studiously avoiding the scope of the Act and the tax practices in use throughout Europe and the rest of the world.

93. To support the conclusory argument that "extraterritorial income" is not a suitable category of income to exclude from tax, the EC is simply asserting that this category is not, in its view, sufficiently unqualified, or that it cannot be structured so as to calibrate the fiscal consequences of the exclusion. Again, this is an argument that finds no textual support in subparagraph (ii) or in panel or Appellate Body decisions. Even if the EC's argument did have some basis in law, the fact remains that the Act applies generally to foreign transactions. It does so irrespective of whether goods are manufactured in the United States or abroad, and it applies to all US taxpayers who earn extraterritorial income.

94. Notwithstanding the general applicability of the Act's exclusion, the EC's argument that only the non-taxation of a "general" category falls outside of subparagraph (ii) would mean that most of the tax systems in Europe are subsidy schemes. In construing subparagraph (ii), it is reasonable for the Panel to consider whether the intent of the Uruguay Round negotiators was to adopt a principle under which the tax systems of most industrialized countries would be subsidies.

95. Specifically, European tax systems exclude from taxation a wide variety of categories of foreign source or extraterritorial income. However, the scope of those exclusions is by no means uniform. To the contrary, most European countries have detailed rules or conventions that allow certain income, either earned abroad or associated with foreign transactions, to escape domestic tax or to be taxed. Like the Act, these systems reflect some legislative discretion as to the size and extent of the categories that are not subject to domestic tax, and the line-drawing that occurs varies from country to country. However, it cannot be seriously contended that those systems constitute subsidies merely because they are not identical to one another. Likewise, it cannot be seriously contended that the Act constitutes a subsidy simply because the US Congress chose to draw a jurisdictional line in a place different from that chosen by European legislators.

96. To give just a few brief examples:

[81] *EC First 21.5 Submission*, para. 60.

- In *Belgium*, resident companies are subject to Belgian corporate income taxes on profits from their activities, wherever conducted, unless specifically excluded by domestic law or as a result of a tax treaty. One such exclusion is that 75 per cent of foreign branch income generated in a country with which Belgium has not concluded an income tax treaty – whether export-related or otherwise – is exempt from Belgian tax. Another source of profit that is excluded from taxation is foreign-source dividend income. Niney-five per cent of dividend income from a foreign subsidiary to a shareholder owning at least 5 per cent of the shares of the subsidiary (or holding an interest in the subsidiary with an acquisition value of at least BFr 50 million) is not taxed, but the remaining five per cent is taxed. Therefore, the tax exclusion is not unqualified.
- In *France*, foreign income directly attributable to operations conducted abroad – either by a company directly or though a branch – is exempt from tax. As a result, 95 per cent of the gross amount of dividends receivable from a foreign company by either a 10 per cent shareholder or a shareholder holding an interest in the foreign company of at least FF 150 million is exempt from French tax. However, this qualified exemption is further limited. A French corporate taxpayer is required to include in its taxable income its *pro rata* share of the income of a foreign company in which it either has a direct or indirect interest of 10 per cent or more or at least FF 150 million, if the foreign company is subject to a "privileged tax regime". A foreign tax regime is considered "privileged" if the foreign tax rate is two-thirds or less than the tax rate that would have been payable in France on the same income. This "low tax exception" does not apply if the foreign company at issue has an effective commercial or industrial activity predominantly performed in the local market. The "low tax exception" also may not apply under certain tax holidays or if a tax treaty provides for different tax treatment.
- In *Germany*, companies are subject to German corporate tax on their income regardless of its source if they have their statutory seat of business or effective place of management in Germany. However, German tax authorities exclude from income dividends received from foreign branches and foreign subsidiaries of corporate shareholders in about 70 treaty countries. Nevertheless, despite this exclusion, foreign-source income is treated differently depending upon the country in which the foreign branch or subsidiary resides because the specific requirements for receiving the tax benefit vary from treaty to treaty.
- In *Italy*, resident companies are subject to corporate income tax on all sources of income. However, dividends paid to Italian shareholders are 95 per cent exempt from Italian tax, as long as (1) the company paying dividends is resident in a country included in a "parent-subsidiary directive list" (currently EC countries) and (2) the Italian shareholder (parent company) has held more than 25 per cent of the subsidiary's capital for over one year. This exemption will also apply

only if the subsidiaries are located in countries that do not have a privileged tax system.

97. These are but a few examples illustrating the point that tax systems around the world refrain from taxing foreign income in a qualified or conditional manner. Treating the Act's exclusion as a subsidy could result in parallel measures among many, if not most, WTO Members to be deemed subsidies. This would indeed be a disturbing result, one that would come as a surprise to these Members and one that could not have been intended by the drafters of the SCM Agreement.

98. In conclusion, the EC's arguments that the Act's exclusion constitutes a subsidy are not based on the text of subparagraph (ii) or the standards articulated by the *FSC* Panel and the Appellate Body. Instead, the EC's objections essentially are nothing more than that the Act did not make the US tax system sufficiently "European".

99. The EC asserts that by adopting the Act, the US Congress was "playing with words."[82] What, in fact, the US Congress was doing was being exceedingly attentive to the words of subparagraph (ii) and the words of the *FSC* Panel and the Appellate Body, as US WTO obligations required it to do. Ironically, the EC's arguments in this proceeding are not textual, but rather are based on standards that are not reflected in the SCM Agreement. However, when one applies the actual terms of subparagraph (ii) and the standards articulated by the *FSC* Panel and Appellate Body, it becomes clear that the Act's exclusion of extraterritorial income is not a "subsidy" within the meaning of Article 1 of the SCM Agreement.

4. The EC Has Failed to Demonstrate that, as a Factual Matter, the Act's Exclusion of Extraterritorial Income Results in the Foregoing of Revenue that Is Otherwise Due

100. As discussed above, the EC essentially argues that the determination of whether revenue is foregone depends upon a comparison of the US tax system before adoption of the Act with the US tax system after adoption of the Act. This comparison is not, and cannot be, the appropriate comparison for determining whether a measure foregoes revenue that is otherwise due, because, by that standard, any amendment to a Member's tax laws with a net revenue cost automatically would qualify as a subsidy.

101. Even assuming *arguendo* that the legal standard articulated by the EC is correct, the EC has not established, as a factual matter, that extraterritorial income would be taxed or taxed to a greater extent absent the Act. In fact, absent the Act, income currently defined as extraterritorial income may not be subject to tax at all or taxed to a lesser extent. Indeed, without additional facts, it is unclear how excluded income would be treated under US tax rules if the Act's exclusion did not exist. The EC simply has not presented any evidence demonstrating that the Act will cause the United States to forego revenue that would be otherwise due.

102. There are a number of factors suggesting that revenue is not foregone as a result of the Act's exclusion of extraterritorial income. For example, foreign corporations are among the taxpayers that may earn excluded extraterritorial income. The existence of the Act as part of the US tax system might motivate foreign corporations to structure a portion of their operations in the United States to achieve a tax-efficient global operating structure. Without the Act, these foreign corporations might struc-

[82] *EC First 21.5 Submission*, para. 39.

ture their operations in such a manner so as to avoid being subject to US taxation altogether. In that case, such foreign corporations might not pay any US taxes on income currently defined as extraterritorial income, and, thus, it cannot be said the Act has caused the United States to forego revenue.

103. Similarly, in the absence of the Act, US companies that otherwise would earn extraterritorial income could choose to structure their foreign sales operations through a jurisdiction that provides an exclusion for income from foreign sales similar to the exclusion currently provided by the Act (for example, by establishing the operation in a country that has adopted a territorial system). In that case, income that otherwise would have been excluded income under the Act would not be subject to US tax. Accordingly, it cannot be said that the United States has foregone any revenue.

104. Finally, because the Act does not allow for deferral, deductions, or foreign tax credits in relation to excluded income, it is possible, depending on the facts, that taxpayers would rely on such tax-reducing mechanisms in the absence of the Act.

105. All of these circumstances and variables undermine the EC's unsupported assertion that extraterritorial income excluded by the Act necessarily would be taxed absent the Act.

106. Similarly unavailing is the EC's attempt to "prove" that the United States is foregoing government revenue "otherwise due" by referring to a Congressional study on the "cost" of the Act.[83] The EC's reliance on this study is misplaced, because the EC misinterprets its meaning. The "cost" cited by the EC is actually a comparison of the revenue consequences under the Act versus the FSC and the former US worldwide tax system. By shifting to a territorial-like regime, the US is no longer collecting the same kinds and amounts of tax revenue that were collected under its worldwide system. This "cost" in relation to the prior US tax system is simply not relevant to an analysis under Article 1 and how the United States would capture tax "but for" the new law.

C. The Act's Exclusion of Extraterritorial Income does not Constitute a Prohibited Export Subsidy Under Article 3.1(a) of the SCM Agreement

107. Even assuming *arguendo* that the Act's exclusion of extraterritorial income constitutes a subsidy, the EC's claim that this "subsidy" is a prohibited export subsidy is based on an erroneous interpretation of Article 3.1(a) and a misunderstanding of the Act. As demonstrated below, the Act's exclusion of extraterritorial income is not contingent on export performance within the meaning of Article 3.1(a), and the EC has failed to demonstrate that it is.

1. The Meaning of Article 3.1(a)

108. Article 3.1(a) of the SCM Agreement provides in relevant part that "the following subsidies, within the meaning of Article 1, shall be prohibited: (a) subsidies contingent in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I." Thus, assuming *arguendo* that a subsidy exists, for the EC to succeed in establishing a *prima facie*

[83] *EC First 21.5 Submission*, para. 21.

case of a prohibited export subsidy, it must establish that the subsidy conferred is contingent, as a matter of law or fact, on export performance.

109. According to the Appellate Body, the "key word" in Article 3.1(a) is "contingent".[84] The Appellate Body has explained that the term "contingent" has an ordinary meaning of "conditional" or "dependent for its existence on something else."[85] Thus, an export subsidy within the meaning of Article 3.1(a) is a subsidy that requires recipients to export in order to obtain it. Or, in the words of the Appellate Body, "the subsidy is available only upon fulfillment of the condition of export performance."[86]

110. It is not enough for a subsidy to be granted upon the mere expectation that the subsidy will lead to new or additional exports; the grant of the subsidy in and of itself must be conditioned on export performance. As the Appellate Body has said, "It does not suffice to demonstrate solely that a government granting a subsidy *anticipated* that exports would result. The prohibition in Article 3.1(a) applies to subsidies that are *contingent* upon export performance ... . A subsidy may well be granted in the knowledge, or with the anticipation that exports will result. Yet, that alone is not sufficient, because that alone is not proof that the granting of the subsidy is *tied to* the anticipation of exportation."[87]

2. *The Act's Exclusion of Extraterritorial Income is not Contingent on Export Performance*

111. The Appellate Body has stated that *de jure* export contingency can be "demonstrated on the basis of the words of the relevant legislation"[88] or "derived by necessary implication from the words actually used in the measure."[89] As demonstrated below, the Act's exclusion of extraterritorial income is not export-contingent expressly or by implication.

(a) The Act does not Expressly Condition the Exclusion of Extraterritorial Income on Export Performance

112. The starting point in determining whether a measure grants prohibited *de jure* export subsidies is the text of the legislation, regulation, or other legal instrument in dispute.[90] In sharp contrast to the FSC, which the Panel found explicitly required

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[84] *Canada – Measures Affecting the Export of Civilian Aircraft* ("*Canada Aircraft (AB)*"), WT/DS70/AB/R, Report of the Appellate Body adopted 20 August 1999, DSR 1999:III, 1377, para. 167. In this case, the Appellate Body held that "the legal standard expressed by the word 'contingent' is the same for both *de jure* and *de facto* contingency." *Ibid.* The principal difference between the two is "what evidence may be employed to prove that a subsidy is export contingent." *Ibid.* While it appears that the EC has confined its challenge to the Act to a *de jure* claim, the analysis of Article 3.1(a) in *de facto* cases such as *Canada Aircraft* are relevant here.

[85] *Ibid.*

[86] *Canada – Certain Measures Affecting the Automotive Industry* ("*Canada Autos (AB)*"), WT/DS139/AB/R, WT/DS142/AB/R, Report of the Appellate Body adopted 19 June 2000, DSR 2000:VI, 2985, para. 100.

[87] *Canada Aircraft (AB)*, DSR 1999:III, 1377, paras. 171-172 (emphasis in original).

[88] *Ibid.*, para. 167.

[89] *Canada Autos* (AB), DSR 2000:VII, 3043, para. 100.

[90] *Ibid.* By contrast, proving *de facto* export contingency requires that "the relationship of contingency, between the subsidy and export performance, must be *inferred* from the total configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case." *Ibid.* (emphasis in original).

exportation in order for its tax exemption to apply,[91] the Act does not require or even refer to exportation in relation to the availability of its exclusion. Indeed, the EC concedes this point.[92]

113. In order to comply with Article 3.1(a), the Act was purposefully drafted to broaden the universe of transactions eligible for the exclusion beyond those eligible for the FSC tax exemption. The legislative history makes this point expressly:

> In addition to ensuring that the FSC replacement regime is not a "subsidy," the Committee believes that, in order to ensure WTO compatibility, it is important that the new regime not confer export-contingent benefits. To achieve this goal, the Committee has relied on the WTO Appellate Body's interpretation of the meaning of "contingent" for purposes of the Agreement on Subsidies and Countervailing Measures in crafting this legislation. It is the Committee's intent and belief that the exclusion of extraterritorial income from US gross income is not dependent on such income arising from export activities. Accordingly, the Committee has determined that it is appropriate to treat all foreign sales alike, whether the goods were manufactured in the United States or abroad. A taxpayer would receive the same US tax treatment with respect to its foreign sales regardless of whether it exports. As a result, the exclusion for certain extraterritorial income is not "conditional" or "dependent" on whether an entity exports; therefore, it clearly is not export contingent.[93]

114. Thus, unlike the FSC, the Act provides an exclusion from taxation for income derived from all qualifying foreign transactions, not simply exports.[94] The Act does not require that goods that are the subject of transactions eligible for the exclusion need be manufactured or produced in the United States.[95] Instead, they may be produced outside the United States.[96] Thus, the Act does not expressly require exportation in order for its exclusion to apply.

(b) In Operation, the Act does not Condition the Availability of the Exclusion of Extraterritorial Income on Export Performance

115. Just as the Act does not require exportation on its face, it does not do so through its operation or application. As demonstrated below, the Act's exclusion of extraterritorial income is available to a range of foreign transactions that do not necessarily involve exportation. In this way, the exclusion is not contingent, conditioned, or dependent for its existence on export performance.

(i) The Act Implements an Export-Neutral Principle

116. As previously noted, the rationale for the Act's exclusion of extraterritorial income was to treat all foreign transactions alike, regardless of where goods are

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91 *FSC (Panel)*, DSR 2000:IV, 1675, para. 7.108.
92 *EC First 21.5 Submission*, para. 99.
93 *House Report*, page 17.
94 The Act § 3, amending IRC § 942(a)(1).
95 The Act § 3, amending IRC § 943(a)(1)(A).
96 *Ibid.*

manufactured.[97] To the extent that exporting is involved in relation to the Act at all, it is merely incidental:

> The Committee emphasizes that the extraterritorial income excluded by this legislation from the scope of US income taxation is parallel to the foreign-source income excluded from tax under most territorial tax systems. Under neither the US tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems. While exporters may be among those who are eligible for the exclusion, this fact does not make that exclusion "export contingent". If it did, every general exclusion from tax applicable to, among others, exporters would become a prohibited export subsidy.[98]

117. Just as a production or sales subsidy could include exports, the Act's exclusion is based on an export-neutral principle – foreign-transaction income – which can, but does not necessarily, include income derived from export transactions. That a private party might *choose* to export in order to rely on the exclusion does not mean that the exclusion is conditioned or dependent on exporting.

(ii) Because Extraterritorial Income Arises from a Broad Range of Foreign Transactions, Taxpayers May Qualify Under the New Regime Without Exporting

118. The Act's exclusion of extraterritorial income can be triggered by a broad range of transactions. Irrespective of whether the goods or services involved originate in the United States, such transactions may include:

- the sale, exchange, or other disposition of qualifying foreign trade property;
- the lease or rental of qualifying foreign trade property for use by the lessee outside the United States;
- the provision of services which are related and subsidiary to any sale, exchange, or other disposition of qualifying foreign trade property;
- the provision of services which are related and subsidiary to any lease or rental of qualifying foreign trade property;
- the provision of engineering or architectural services for construction projects located (or proposed for location) outside the United States; or
- the performance of managerial services for a person other than a related person in furtherance of the production of foreign trading gross receipts.[99]

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97 *House Report*, page 18.
98 *Ibid.*
99 The Act § 3, amending IRC § 942(a)(1).

119. This expansive definition permits a broad range of taxpayers to earn extraterritorial income, including US and foreign corporations, as well as individuals. In addition, US corporations may earn extraterritorial income through either domestic or offshore manufacturing operations.[100] For example, a US multinational manufacturer can produce qualifying merchandise in foreign plants, and US companies selling products abroad can source their goods through suppliers located outside the United States. Despite EC claims to the contrary, the goods that may be the subject of qualifying transactions can be manufactured, produced, grown, or extracted within or outside the United States,[101] and nothing in the Act precludes a US or foreign manufacturer from producing or selling such property exclusively from foreign-produced inputs.[102]

120. Thus, not only does the Act make no reference to exporting, but its exclusion of extraterritorial income is available in a broad array of circumstances. While export transactions, as one type of foreign sale, can generate extraterritorial income, no provision in the Act requires exporting, and the Act's exclusion clearly applies to income that is wholly unrelated to exporting.[103]

(iii) Under the Act, Taxpayers Can Maximize Their Excludable Extraterritorial Income Without Exporting

121. Another factor indicating that the Act is not export-contingent is that taxpayers do not have to export in order to maximize their benefits. Taxpayers may engage in an unlimited number of non-export transactions and continue to exclude a portion of income from qualifying transactions.

122. In this sense, the Act is quite distinct from the situation addressed by the Appellate Body in *Canada Autos*, which involved the question of whether certain import-duty exemptions provided to automobile manufacturers were export contingent. One class of exemptions under consideration did not require automobile manufacturers to export in order to participate in the duty-exemption programme, but the benefits available under this class of duty exemption were limited. The Appellate Body

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[100] The ability of US companies to generate excludable income from transactions taking place entirely outside of the United States refutes the EC's contention that US corporate taxpayers "have no choice but to export in order to obtain the subsidy in respect of those goods." *See EC First 21.5 Submission*, para. 97.

[101] The Act § 3, amending IRC § 943(a)(1)(C).

[102] The EC argues that the 50 per cent rule embodied in the definition of "qualifying foreign trade property under the Act "involves" an export contingency. *EC First 21.5 Submission*, paras. 104-120. As demonstrated below in Section V.E, the 50 per cent rule does not require the use of any goods exported from the United States.

[103] The Act thus stands in sharp contrast to the measure at issue in *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather*, WT/DS126/R, Report of the Panel adopted 16 June 1999, DSR 1999:III, 951 ("*Australia Leather*"), in which the Panel examined a series of grants provided by the Australian Government to Howe Leather, an Australian automotive leather company. At the time the grant contract was concluded, the overwhelming majority of Howe's sales were for export. The Panel concluded that, "in order to expand its sales in a manner that would enable it to reach the sales performance targets ... set out in the grant contract, Howe would, *of necessity*, have to continue and probably increase exports." *Ibid.*, para. 9.67 (emphasis added). Because these facts effectively transformed the sales performance targets into export performance targets, the Panel concluded that "Howe's anticipated export performance was one of the *conditions* for the grant of the subsidies." *Ibid.* (emphasis added).

observed that participating manufacturers could import duty-free only up to a fixed amount, and were required to export if they wanted additional duty-free import opportunities.[104] Because automobile manufacturers relying on this second class of duty exemption could not maximize their benefits without exporting, the Appellate Body found "a clear relationship of dependency or conditionality exists between the granting of the import duty exemption and the exportation of motor vehicles by manufacturer beneficiaries."[105]

123. The Act does not create a "clear relationship of dependency or conditionality" between the exclusion of extraterritorial income and export performance. US and foreign businesses subject to US taxation can rely on the Act's exclusion without limitation and without engaging in a single export transaction.

(iv) The Foreign Use Requirement Defines, in Part, a "Foreign Transaction"

124. The EC contends that the Act's foreign-use requirement – mandating that goods that are the subject of qualifying transactions must be "held for use, consumption, or disposition outside the United States"[106] – renders the Act and its exclusion of extraterritorial income export-contingent.[107] The EC believes that not extending the exclusion of extraterritorial income to transactions involving property consumed in the United States "makes the availability of the subsidy contingent upon export performance."[108] The EC's argument is illogical, and appears to be based on a misunderstanding of the nature of the Act.[109]

125. The Act provides for the exclusion of income arising in foreign sales transactions. The "use, consumption, or disposition" of property outside the United States is but one characteristic of a "foreign" transaction. Another is that the Act explicitly provides that the products in question need not be manufactured or produced in the United States. Thus, the foreign transactions that come within the scope of the Act's exclusion could involve shipments from the United States, but they also could involve transactions entirely within one other nation or within multiple nations other than the United States.

126. Transactions involving property used or consumed in the United States are not covered by the Act because they are not foreign transactions. For example, products manufactured and sold in the United States cannot be said to be foreign. If the United States is obligated to include such transactions in the Act, as the EC contends, that would mean that WTO Members are not permitted to provide a tax exemption or exclusion for foreign transaction income. Yet, that is not what Article 3.1(a) is about. It is about export-*contingent* subsidies.

127. Contrary to what the EC asks this Panel to believe, the Act's foreign-use requirement is not a "code word" for exports. As reflected in the discussion above, a broad range of foreign transactions are covered by the Act, many of which do not involve manufacturing in, or shipment from, the United States, and, thus, do not in-

[104] *Canada Autos* (AB), DSR 2000:VI, 2985, para. 105.
[105] *Ibid.*, para. 108.
[106] The Act § 3, amending IRC § 943(a)(1).
[107] *EC First 21.5 Submission*, paras. 99-103.
[108] *Ibid.*, para. 101.
[109] Simply as a matter of logic, if there are three possible options (A, B and C), precluding A does not compel B, because C remains an option.

volve exportation from the United States. Accordingly, the foreign-use requirement does not render the exclusion of extraterritorial income contingent on export performance.

3. *The EC's Claim Under Article 3.1(a) Rests Upon an Erroneous Legal Standard*

128. The EC's claim under Article 3.1(a) is based on a legal standard that is unfounded in the language of the SCM Agreement.

(a) The EC Creates a New Test for Applying Article 3.1(a)

129. The EC asserts that to assess export contingency, "there must be a comparison with some relevant benchmark."[110] The EC goes on to say that the "correct benchmark ... is the treatment accorded to domestic sales."[111]

130. This analytical framework is not found in Article 3.1(a) or anywhere else in the SCM Agreement, and has never been discussed or adopted by the Appellate Body in connection with Article 3.1(a). Indeed, such a comparison test is incompatible with the reasoning of the Appellate Body in prior cases involving export subsidies. As discussed above, the Appellate Body has said that a measure falls under Article 3.1(a) if, by its terms or operation, it conditions the granting of a subsidy on export performance. A comparison between treatment under one set of conditions and another – in particular between domestic and foreign sales – is irrelevant.

131. The EC's non-textual-based theory of Article 3.1(a) turns in large part on its mischaracterization of elements of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement. The EC cites paragraphs (d), (f), (g), (h), and (l) of Annex I as instances in which treatment of exported products is to be compared to that afforded to domestic products.[112] However, the comparison between exported and domestic products suggested by the cited paragraphs is not to be made for purposes of determining whether or not a measure is tied to exportation or is otherwise export contingent (since the practices in these paragraphs are directly tied to exportation). Instead, this comparison is to be done for purposes of determining whether a measure that applies to exports involves a financial contribution by a government or confers a benefit.

132. Even if a comparison between treatment provided to exported and domestic products were indicated by the paragraphs of Annex I cited by the EC – which are, after all, just examples of particular kinds of export subsidies – there is no indication that this type of comparison should be made in the present dispute. The language at issue here does not reference such a comparison, and neither the *FSC* Panel nor the Appellate Body proposed such a comparison.

(b) The Act Does Not Make Export Performance "One of Several Other Conditions"

133. Unable to meet the burden imposed by the "contingent" standard, the EC attempts to rewrite it by giving an expanded meaning to the language "one of several

[110] *EC First 21.5 Submission*, para. 79.
[111] *Ibid.*, para. 81.
[112] *Ibid.*, para. 88.

other conditions."[113] The EC contends that this language in Article 3.1(a) prohibits measures even where exporting is one way of satisfying export-neutral eligibility criteria.[114] The EC's interpretation of Article 3.1(a) goes well beyond export-contingency. It extends the provision's application to essentially any measure that has any relationship to exportation or that might result in exportation. However, the phrase "one of several other conditions" does not have such a meaning.

134. The key word in the phrase "one of several other conditions" is "other." The EC wrongly suggests that the meaning of "other" is "alternative."[115] The ordinary meaning of the word "other" is "one – of two" or "[t]hat [which] follows the first, second; further, additional".[116] In this light, the term "other" is synonymous with the concept of being *additional.*

135. Given the ordinary meaning of the term "other," the phrase "one of several other conditions" suggests that export performance may be an *additional* condition to others that apply, but export performance remains a condition that must be satisfied. The phrase "several other conditions" thus means a series of conditions precedent – all of which must be satisfied for something to occur. Therefore, in the context of Article 3.1(a), only where a government provides a subsidy contingent on the fulfillment of a series of conditions, one of which is export performance, is such a subsidy "contingent, ... as one of several other conditions, upon export performance".

136. One consequence of the EC's reasoning would be that territorial tax exemptions used by many WTO Members, including EC member states, would be export-contingent within the meaning of Article 3.1(a). In the same way that the EC argues that the Act's exclusion applies to exports and wholly foreign transactions – an over-simplification the United States rejects, as discussed above – tax exclusions applied by other countries with respect to offshore income can be said to apply to three types of transactions: imports, wholly foreign transactions, and exports. In the same way that the EC erroneously contends that US manufacturers must export in order to earn excluded income under the Act, it could equally be said that domestic manufacturers in these countries may obtain the benefits of a territorial exemption only by exporting. Income from the sale of those same manufacturers' products through a domestic distributor or directly on the domestic market is not eligible for a comparable exemption. It is difficult to imagine that this was the intent of the drafters of Article 3.1(a). Only by interpreting "several other conditions" as a series of conditions precedent can the proper effect be given to the term "contingent" in this context.[117]

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[113] *EC First 21.5 Submission,* paras. 121-130.

[114] *See Ibid.* para. 123; *see also Ibid.*, para. 96. At the outset, the EC's reliance on *Canada Aircraft (AB)* as support for its interpretation is misplaced. *See Ibid.*, para. 126. Nowhere in that case did the panel or the Appellate Body construe the phrase "one of several other conditions." Instead, the Panel and Appellate Body concluded that the export contingency relating to subsidies given to industries other than aircraft was not relevant to its *de facto* analysis of payments given to the aircraft industry. *See Canada – Aircraft (AB)*, DSR 1999:III, 1377, para. 179; and *Canada - Measures Affecting the Export of Civilian Aircraft*, WT/DS70/R, Report of the Panel, as modified by the Appellate Body, adopted 20 August 1999, DSR 1999:IV, 1443, paras. 9.305-9.348.

[115] *EC First 21.5 Submission*, para. 128.

[116] *The New Shorter Oxford English Dictionary* (1993).

[117] The EC discusses the US Department of Commerce's countervailing duty regulations as support for its interpretation of "one of several other conditions." *EC First 21.5 Submission*, para. 128. US countervailing duty regulations, however, cannot modify the ordinary meaning of provisions of the SCM Agreement.

4. *The EC's Contention that the Exclusion Will Not Apply to Foreign Manufacturing Is Erroneous and Without Any Factual Support*

137. The EC contends that the application of the Act's exclusion to foreign manufacturing is "merely cosmetic (and an attempt to hide a prohibited export subsidy)."[118] The EC contends that the application of the exclusion to foreign manufacturing "is only available where the foreign producer makes an election to be taxed as a domestic US corporation."[119] According to the EC, a foreign corporation would never make this "domestication election" because it allegedly would impose an additional tax liability without reducing the tax liability of the corporation in its original jurisdiction.[120] The EC's assertions are erroneous and are without any factual support.

(a) Application of the Exclusion to Transactions Involving Foreign Manufactured Goods Is Not Limited to Circumstances Where a Foreign Manufacturer Makes a Domestication Election

138. The EC asserts that the Act's application to foreign-manufactured goods is merely cosmetic because allegedly no foreign manufacturer will make an election under section 943(e)(1) of the IRC to be treated as a domestic corporation.[121] However, the EC's assumes that the Act applies to foreign-manufactured goods only where there has been such an election. This assumption is incorrect.

139. In general, the Act applies to foreign branches of US businesses manufacturing outside the United States without the need for an election. This is because, under US law, a foreign branch of a US business is not treated as a separate entity for tax purposes. Thus, goods manufactured by a foreign branch of a US business are treated as goods manufactured by the related US business, which is responsible for paying US taxes on manufacturing income arising from those goods.[122]

140. To demonstrate the point, an example may prove helpful. Assume a US corporation owns a factory in Mexico and regularly sells goods manufactured in that factory to purchasers outside the United States. Under prior US law, the US corporation generally would have been required to pay US taxes on the manufacturing income attributable to the Mexican factory. However, under the Act, income derived from these foreign transactions involving goods manufactured in Mexico by the branch would be treated as extraterritorial income of the US corporation.

141. In such a case, which is not uncommon, the Act's exclusion would apply to transactions involving foreign-manufactured goods without the need for a foreign manufacturer to elect to pay US tax. Accordingly, the EC's assertion that the Act's exclusion would never apply to foreign-manufactured goods is incorrect.

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[118] *EC First 21.5 Submission*, para. 131.
[119] *Ibid.*, para. 132.
[120] *Ibid.*
[121] The Act § 3, amending IRC § 943(e)(1).
[122] As noted above, qualifying foreign trade property includes property manufactured outside the United States. *See* The Act § 3, amending IRC § 943(a)(1)(A).

(b) Foreign Manufacturing Corporations May Make Domestication Elections Without Incurring Additional Tax Liability

142. In addition to this basic misunderstanding of the language of the Act, the EC also misunderstands the operation of the domestication election itself. With respect to the category of transactions for which a domestication election is required, the EC alleges that no foreign taxpayer would make such an election because it would increase its overall tax liability. This is a factual assertion for which the EC has not provided any support.

143. Moreover, the assumption underlying the EC's assertion – that a domestication election would necessarily increase a foreign corporation's tax liability – is false. In fact, there are a number of circumstances in which an election to be treated as a domestic corporation would not result in an increase in a corporation's overall tax liability.

144. For example, assume that a foreign manufacturing corporation is incorporated in country X and is the supplier to a distribution company located in the United States. Assume further that the country X tax rate is greater than or equal to the US tax rate. It is true that the corporation, upon making the election, would be subject to tax on its manufacturing income both in the United States and in country X.

145. However, under the Act, the election will cause the foreign corporation to be treated as a US corporation for all purposes of the IRC. As such, the corporation will be eligible to claim a foreign tax credit against its US tax liability with respect to any taxes paid to country X. US law would allow the foreign corporation to completely offset its US tax liability through the use of foreign tax credits. In this case, the foreign corporation will be in the same tax position as before the election, and, thus, should be indifferent to making the election. By virtue of the election, the Act's exclusion would apply to sales of goods manufactured by the foreign manufacturing company and sold abroad.[123]

146. Thus, the EC's assertion that the domestication election typically would entail a higher tax burden for an electing corporation is false.

(c) The Domestication Election Was Intended to Equalize the Tax Treatment of US Taxpayers Operating Abroad

147. As demonstrated by the Act's legislative history, the domestication election was intended to equalize the treatment of US taxpayers abroad, regardless of whether they operate in branch or corporate form. The purpose of the domestication election was not to discourage the application of the Act to foreign-manufactured goods. As described above, the application of the Act's exclusion to foreign-manufactured goods is real and establishes that the exclusion is not export-contingent.

148. Before the Act, US taxpayers manufacturing abroad in branch form generally were subject to current tax on all of their branch manufacturing income. US taxpay-

[123] If the foreign-manufactured goods are sold abroad by the US distribution company, the exclusion would apply to the income of the distribution company, not to the income of the manufacturing company. If the manufacturing company sells the goods abroad directly, then the exclusion would apply to the manufacturing company's foreign sales income. In that case, the manufacturing company would receive US foreign tax credits only with respect to its income that is not excluded under the Act. It would not receive credits with respect to excluded income.

ers, however, generally could defer taxation of manufacturing income of their foreign corporate subsidiaries. In drafting the Act, the US Congress sought to prevent taxpayers from inappropriately invoking the Act's exclusion with respect to tax-deferred income. Accordingly, the Act provides that property manufactured outside the United States is not qualifying foreign trade property unless it is manufactured by a person that pays US tax on its manufacturing income.

149. To ensure that this limitation did not cause the Act's exclusion to apply only to foreign sales by branches of US businesses, the Act permits foreign corporations – *i.e.*, subsidiaries – to elect to be treated as domestic corporations.

150. In sum, sections 942(a)(2) and 943(e)(1) of the IRC, as amended by the Act, were intended to equalize branch and corporate treatment of US taxpayers with production facilities abroad. These sections were not, as alleged by the EC, designed to discourage the application of the Act to foreign manufacturing companies or property manufactured outside the United States.

5. The EC Has Failed to Provide Evidence that the Act's Exclusion is Export-Contingent

151. The EC's new legal standards are born of necessity considering its lack of evidence demonstrating export-contingency. Even though the EC appears to be making a legal challenge, in reality, it is making factual assertions about the Act's effects on exportation that have not been substantiated. All that the EC has presented to the Panel regarding export-contingency is that, under the Act, some taxpayers may earn excluded extraterritorial income by exporting. However, as shown above, the fact that exporting is one way of satisfying a neutral standard does not render the Act export-contingent within the meaning of Article 3.1(a). The EC has not shown that there is any requirement to export in order to earn excluded income.

152. The EC has tried to point to the fact that some taxpayers who used the FSC may be eligible to earn excluded income under the Act, claiming that the export-contingency of the former proves the export-contingency of the latter. However, footnote 4 of the SCM Agreement, which is attached to Article 3.1(a), confirms that the granting of a subsidy to exporters, in and of itself, does not render a subsidy export-contingent. Footnote 4 states:

> The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of [Article 3.1(a)].

Thus, the fact that exporters may earn excluded income under the Act is not sufficient proof that the granting of subsidies is *tied to* or *contingent upon* exportation.[124]

[124] *Canada Autos (AB)*, DSR 2000:VI, 2985, para. 172. In the Article 21.5 proceeding in *Canada Aircraft*, the Appellate Body said that a subsidy granted to enterprises that export does not "compel the conclusion that there is a relationship of conditionality or dependence such that the granting of a subsidy is 'tied to' export performance." *Canada – Measures Affecting the Export of Civilian Aircraft - Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/AB/RW, Report of the Appellate Body adopted 4 August 2000, DSR 2000:IX, 4299, para. 48. Considering evidence that subsidies were specifically targeted to the aircraft industry because of its high export orientation, the Appellate Body said that "the targeting factors may very well be relevant to an inquiry under Article 3.1(a) of the SCM Agreement, but they do not necessarily provide conclusive evidence that the granting of a subsidy is 'contingent,' 'conditional,' or 'dependent' upon export performance. In these proceedings, we

153. In summary, assuming *arguendo* that the Act's exclusion of extraterritorial income constitutes a subsidy, the EC has failed to establish that this "subsidy" is contingent on export performance. Absent such a demonstration, the exclusion of extraterritorial income does not constitute an export subsidy within the meaning of Article 3.1(a) of the SCM Agreement.

D. Because the Act's Exclusion of Extraterritorial Income Is a Measure to Avoid the Double Taxation of Foreign-Source Income, the Exclusion Is Not a Prohibited Export Subsidy by Virtue of the Fifth Sentence of Footnote 59 of the SCM Agreement

154. Even if the Act's exclusion of extraterritorial income could be said to be a subsidy within the meaning of Article 1, and even if that "subsidy" could be regarded as export-contingent within the meaning of the otherwise unqualified language of Article 3.1(a), it nonetheless would not constitute a prohibited export subsidy under the SCM Agreement. This is because footnote 59 of the SCM Agreement qualifies the application of the SCM Agreement's prohibition against export subsidies. More specifically, the fifth sentence of footnote 59, when read in conjunction with footnote 5 of the SCM Agreement, provides that "measures to avoid the double taxation of foreign-source income" are not prohibited by the SCM Agreement. Because the Act's exclusion of extraterritorial income is precisely such a measure to avoid double taxation of foreign-source income, it is not prohibited by the SCM Agreement.

1. The Relationship Between Article 3.1(a) and Footnote 59

155. Before discussing the meaning of the fifth sentence of footnote 59, the United States first explains how the footnote fits into the SCM Agreement in general and how it relates to Article 3.1(a) in particular.

(a) Practices Identified in Annex I as Not Being an Export Subsidy Are Not Prohibited Under the SCM Agreement

156. To clarify the meaning of Article 3.1(a), the drafters of the SCM Agreement attached at Annex I an "Illustrative List of Export Subsidies." The drafters specified in Article 3.1(a) that this Illustrative List identifies practices that come within the provision's prohibition.[125] At the same time, the drafters also made clear that practices identified by the Illustrative List as *not* constituting an export subsidy are *not* prohibited by Article 3.1(a) or any other provision of the Agreement. They did so by means of footnote 5 of the Agreement, which is attached to Article 3.1(a). Footnote 5 states that "[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement". Under this structure, if a type of measure is deemed to be an export subsidy by the Illustra-

do not see the two 'targeting' factors, by themselves, as adequate proof of prohibited export contingency." *Ibid.,* para. 49.

[125] Article 3.1(a) states in relevant part that "the following subsidies, within the meaning of Article 1, shall be prohibited: (a) subsidies contingent in law or in fact, whether solely or as one of several other conditions, upon export performance, *including those illustrated in Annex I*" (emphasis added).

tive List, it is prohibited by Article 3.1(a); if a measure is deemed *not* to be an export subsidy by the List, it is *not* prohibited by *any provision* of the SCM Agreement.

(b) Paragraph (e)'s Relationship to Article 3.1(a)

157. Paragraph (e) of Annex I sets forth a general prohibition against foregoing or reducing taxes to be collected on export income. It states that "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes" is an export subsidy. The EC correctly defined the terms of paragraph (e) as "having a special, precise or clearly defined relationship or connection to exports."[126] This means that paragraph (e) applies to income tax exemptions, remissions, or deferrals that are directly connected to, narrowly or singularly tailored to, or overtly tied to income derived from export transactions.

158. Despite this definition, and in particular paragraph (e)'s use of the word "specifically," the EC argues that paragraph (e) *expands* the scope of Article 3.1(a). The EC asserts that:

> Contingency is a particular form of special relationship. Therefore any subsidy that is contingent upon export performance must, necessarily, also be 'specifically related to exports' within the meaning of item (e). However, the term 'specific relation' is broader than the term 'contingency.' The former covers any specific link and thus would include a simple incentive.[127]

159. The EC's theory of paragraph (e) is untenable, because the EC ignores the relationship between Article 3.1(a) and Annex I. Article 3.1(a) expressly states that the subsidies listed in Annex I are "illustrative" in that they provide a non-exhaustive list of export subsidies that are "contingent ... on export performance." For this reason, the drafters of the Agreement explained the relationship between Annex I and the prohibition against export subsidies by saying: "*including* those *illustrated* in Annex I". (emphasis added).

160. The ordinary meaning of the term "including" confirms that the Illustrative List does not expand Article 3.1(a). "Including" means "inclusive of", and "inclusive" means "that includes".[128] The term "include" is defined as "contain as a part of a whole" or "place in a class or category".[129] Thus, the export subsidies identified in Annex I are but *examples* of a class or category of "export subsidies" that come within the scope of Article 3.1(a). While they to some extent clarify the meaning of Article 3.1(a), these examples do not expand Article 3.1(a)'s application as the EC suggests. In contrast to the EC's position, paragraph (e) does not and cannot prohibit direct tax exemptions, remissions, or deferrals that are not "contingent ... upon export performance." Indeed, to the extent that the contingency requirement of Article 3.1(a) does not encompass subsidies granted based on *the mere expectation of export performance* – as discussed in section C above – paragraph (e) cannot provide a backdoor way of reaching what the EC refers to as "incentives" that are not export contingent.[130]

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[126] *EC First 21.5 Submission*, paras. 149-153.
[127] *Ibid.*, paras. 156-157.
[128] *The New Shorter Oxford English Dictionary* (1993).
[129] *Ibid.*
[130] The EC's attempt to expand the meaning of Article 3.1(a) through paragraph (e) differs from its approach in challenging the FSC. As the Panel may recall, in the initial proceeding, the EC invoked

161. The essence of paragraph (e) is a ban against export-specific income tax benefits or relief. It applies to measures that forego taxes *directly* or *only* on income derived from export transactions. In order for paragraph (e) to apply, the tax benefits at issue must be export-contingent within the meaning of Article 3.1(a).

(c) Footnote 59's Relationship to Paragraph (e)

162. Footnote 59 explains and qualifies the application of paragraph (e). Footnote 59, which is attached to paragraph (e),[131] identifies certain practices that, though they involve the failure to collect direct taxes on income earned in export transactions, nonetheless fall outside the scope of paragraph (e). As noted above, by virtue of footnote 5, if footnote 59 identifies measures that are not export subsidies, such measures are not prohibited by the SCM Agreement.

(i) The First Sentence of Footnote 59: Deferral

163. The first sentence of footnote 59 states that "[t]he Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected." This sentence makes clear that, despite paragraph (e)'s otherwise unequivocal pronouncement that "[t]he full or partial ... deferral specifically related to exports, of direct taxes" is a prohibited export subsidy, paragraph (e) does not apply to a deferral scheme if "appropriate interest" is charged.[132]

164. Neither paragraph (e) nor footnote 59 defines what is meant by the term "deferral", but it appears to refer to instances where taxation is delayed, perhaps indefinitely, pending the occurrence of some event.[133] Deferral could be applied to export income in a number of ways, but it is particularly relevant in connection with exports in situations where taxes on export income earned by an offshore related entity (*e.g.,* a foreign subsidiary) are not assessed unless and until they are repatriated to a domestic parent.[134] This means that, under the first sentence of footnote 59, a measure deferring taxes on foreign-source export income earned by an offshore subsidiary may escape the reach of paragraph (e) provided that "appropriate interest" is charged.[135]

165. Thus, the first sentence of footnote 59 qualifies paragraph (e). It makes clear that at least in one circumstance, despite the otherwise unqualified language of para-

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paragraph (e) because the FSC applied explicitly and only to exports, alleging in its first submission to the FSC panel, para. 159, the FSC benefits were "'specifically related to exports' since they are *conditional* upon exportation of US goods and *limited in scope* to the extent of such exportation". *FSC (Panel)*, DSR 2000:IV, 1675, para. 4.304 (emphasis added). The EC recognized then that paragraph (e) applies to a relatively narrow subset of subsidies that are contingent or "conditional" on – as well as focused on or "limited" to – exportation.

[131] Unlike footnote 58, which applies to more than one paragraph of Annex I, footnote 59 is connected only to paragraph (e).

[132] The reason this is so appears to be that charging "appropriate interest" sufficiently negates benefits that may be conferred on exports.

[133] According to *The New Shorter Oxford English Dictionary* (1993), "defer" means "to put off (an action or procedure, an event, matter, or question) to some later time; to delay, postpone."

[134] Deferral could also apply to the non-taxation of export income earned by offshore companies pending repatriation not only to domestic parents but also to shareholders in general.

[135] Deferral with interest is only one form of deferral of taxes on export income that is not an export subsidy. This is because the first sentence of footnote 59 identifies charging "appropriate interest" as but an "example" of an instance in which "deferral specifically related to exports" does not constitute a prohibited export subsidy.

graph (e), the non-taxation of export income is not prohibited by the SCM Agreement. While the Appellate Body in its FSC decision declined to comment on the meaning of the first sentence of footnote 59 because the FSC did not involve deferral, the Appellate Body did acknowledge that the first sentence is "specifically related to" and "qualifies" paragraph (e).[136]

(ii) The Fifth Sentence of Footnote 59: Avoiding Double Taxation

166. A second area in which footnote 59 carves out an exception to paragraph (e) is with respect to measures to avoid the double taxation of foreign-source income.[137] The last sentence of the footnote states that "[p]aragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member." Footnote 59 does not define what "double taxation" means, or what types of measures appropriately serve to "avoid" it, but the ordinary meaning of this language indicates that it encompasses measures to prevent the same income from being subjected to tax twice. This understanding of the last sentence of footnote 59 derives from the fact that "avoid" means "keep off; prevent; obviate",[138] "double" means "twice as much or as many" or "occurring twice",[139] and "taxation" means "the imposition or levying of taxes".[140]

167. Significantly, the fifth sentence of footnote 59 does not apply to any type of income, but only to "foreign-source income". The footnote does not define this term, but its ordinary meaning is as follows: (1) "income" means "the (amount) of money or other assets received or due to be received from employment, business, investments, etc.";[141] (2) "foreign" means "carried on or taking place abroad" or "situated outside the country; not in one's own land";[142] and (3) "source" means "a place or thing from which something material is obtained or originates."[143] Thus, for purposes of footnote 59, foreign-source income would appear to include money (or other assets) originating outside the borders or territory of the WTO Member instituting a measure to avoid double taxation.

168. Foreign-source income raises the possibility of double taxation because it can be subjected to taxation by the country that is the source of income (sometimes referred to as the country of source) as well as by the country in which the taxpayer resides (sometimes referred to as the country of residence). It also can arise because two countries claim that the same taxpayer is a resident subject to their jurisdiction or the same income originates within their borders. Whatever the legal basis, the issue of double taxation of foreign-source income is significant in the context of exports because, by definition, goods or services sold in an export transaction are sold from

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[136] *FSC (AB)*, DSR 2000:III, 1619, para. 97. The United States does not contend that the Act involves deferral, but discusses the first sentence of footnote 59 to illustrate the overall meaning and significance of the footnote.

[137] In the *FSC* case, the Appellate Body declined to examine the meaning of the fifth sentence of footnote 59, finding that the United States had not raised the issue before the panel. *FSC (AB)*, DSR 2000:III, 1619, paras. 101-03.

[138] *The New Shorter Oxford English Dictionary* (1993).

[139] *Ibid.*

[140] *Ibid.*

[141] *Ibid.*

[142] *Ibid.*

[143] *Ibid.*

one country to another. As a result, some or all of the income generated by an export transaction can be said to be "foreign" because the destination of the exported goods, the location of the purchaser, the transfer of title, the making of payment, or the economic activities giving rise to the sale may occur outside the seller's country of residence. A foreign country that can lay claim to being the "source" of some or all of income earned outside of the seller's country of residence – *e.g.,* for one of the foregoing enumerated reasons – might seek to tax such income. At the same time, the country of residence of a taxpayer might make the same claim with respect to that same income.

169. To alleviate this and related concerns, the fifth sentence of footnote 59 permits WTO Members to refrain from taxing foreign-source income earned in export transactions. There can be no doubt that this is so, because the fifth sentence of footnote 59 narrows the scope of paragraph (e), which prohibits direct tax exemptions, remissions, or deferrals that are made available "specifically in relation to exports." As the fifth sentence of footnote 59 states, "*Paragraph (e) is not intended to limit a Member* from taking measures to avoid double taxation of foreign-source income ... ." (emphasis added).

(d) Footnote 59 Identifies Certain Measures As Not Being Export Subsidies Within the Meaning of Footnote 5

170. As demonstrated above, the first and fifth sentences of footnote 59 qualify paragraph (e). These two sentences of footnote 59 identify certain tax practices that are permissible despite the fact that they may be directly tied to exports.

171. The first sentence of footnote 59 makes clear that deferral of taxation "specifically in relation to exports" is permissible where "appropriate interest in charged". A deferral that is not made "specifically in relation to exports" would be outside the scope of paragraph (e) and would need no qualification under footnote 59 in order to be exempt from the SCM Agreement's export subsidy prohibition. The first sentence of footnote 59 was included by the drafters to make clear that a deferral-with-interest regime, even one that applies specifically to exports, is not a prohibited export subsidy.

172. Likewise, the fifth sentence of footnote 59 permits measures to avoid double taxation even though they might otherwise constitute export-specific tax exemptions, remissions, or deferrals of direct taxes pursuant to paragraph (e). This can be seen from the fifth sentence's opening terms: "Paragraph e is not intended to limit a Member from taking measures to avoid ... double taxation ... ." Indeed, if a measure to avoid double taxation were permitted only if it were *not* specifically related to exports, then the fifth sentence would have no meaning. It would merely state what is obvious, that non-export-specific measures are not subject to paragraph (e) or Article 3.1(a) at all.

173. Measures to avoid double taxation, therefore, come within the meaning of footnote 5. That footnote provides that "[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited ... ." The ordinary meaning of "referred" is "to assign to a thing, or class of things, as being properly included or comprehended in this; to regard as naturally belonging, pertaining, or having relation to;

to attach or attribute to."[144] It also can mean something as simple as "a reference in a book".[145] Footnote 5 thus indicates that a measure need only be included or mentioned in Annex I in such a way as to be properly assigned or classified as not being an export subsidy. Footnote 5 does not require that the words "is not an export subsidy" appear in the Illustrative List's description of the measure in question.

174. In so arguing, the United States is not relying on the principle of *a contrario sensu*, the doctrine of assuming that the opposite conclusion may be drawn from an affirmative rule or statement. Rather, the fact that the fifth sentence of footnote 59 explicitly provides a narrowing of paragraph (e) signals that the drafters of the SCM Agreement intended that measures to avoid double taxation should not be treated as prohibited export subsidies.

175. This is a distinction made by the panel in the *Brazil Aircraft* case.[146] The panel first found that "in its ordinary meaning, footnote 5 relates to situations where a measure is referred to as *not* constituting an export subsidy."[147] In addition, the panel observed that the ordinary meaning of footnote 5 "could extend more broadly to cover cases where the Illustrative List contained some other form of affirmative statement that a measure is not subject to the Article 3.1(a) prohibition."[148] The panel then indicated that this reasoning applied to the first and fifth sentences of footnote 59.[149] Thus, following this reasoning, measures to avoid double taxation are "referred" to in Annex I as not being export subsidies and, therefore, are not prohibited under Article 3.1(a) or any other provision of the SCM Agreement.

2. *Measures to Avoid Double Taxation Under Footnote 59*

176. In the preceding section, the United States demonstrated that under the fifth sentence of footnote 59, measures taken to avoid double taxation of foreign-source income are not prohibited by the SCM Agreement. In this section, the United States demonstrates that the non-taxation of foreign-source income is a measure to avoid double taxation for purposes of footnote 59.

(a) Non-Taxation of Foreign-Source Income Is a Widely Accepted Method of Avoiding Double Taxation

177. There does not appear to be any dispute between the EC and the United States as to whether a system of non-taxation of foreign-source income is an acceptable means of avoiding double taxation. This mutual position derives from the fact that well-established international tax disciplines have long recognized that two countries may claim the right and ability to tax the same income, leaving taxpayers with an

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[144] *The New Shorter Oxford English Dictionary* (1993).

[145] *Ibid.*

[146] *Brazil - Export Financing Programme for Aircraft - Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW, Report of the Panel, as modified by the Appellate Body, adopted 4 August 2000, DSR 2000:IX, 4093.

[147] *Ibid.*, para. 6.36.

[148] *Ibid.*

[149] *Ibid.* In contrast, the Panel found that there is no basis to assume that measures that merely fall outside the scope of illustrative export subsidies in Annex I are *not* export subsidies for purposes of footnote 5. *Ibid.*

undue burden and requiring that the respective countries take action to rectify a potential injustice. As the EC stated to the *FSC* Panel,

> When a resident of a country earns income from outside the country (foreign-source income), the claim of that country to tax the income based on its worldwide residence jurisdiction may overlap the claim of a foreign country to tax revenue based on source jurisdiction. Consequently, foreign-source income earned by a resident of a country may be taxed by both the country of source and the country of residence, absent relief provisions to prevent double taxation. The necessity for relief is clear on grounds of equity and economic policy.[150]

178. While the WTO has not defined the types of measures that may be used to avoid double taxation of foreign-source income, two general categories of measures are well accepted and used around the world for this purpose. They are the exemption (or non-taxation) method and the credit method. Both have been endorsed by the two leading model tax treaties, prepared under the auspices of the Organization for Economic Cooperation and Development ("OECD") and the United Nations ("UN").[151] Indeed, the EC cited both to the Panel as establishing proper ways of avoiding double taxation.[152]

(b) An Explanation of the Exemption (Non-Taxation) Method for Avoiding Double Taxation: the OECD Model Rules

179. Both the OECD and the UN model treaties expressly allow countries to use either exemption (non-taxation) or credits to avoid double taxation of foreign-source income. Though their relevant provisions differ on the details, the two model treaties achieve the same ends for present purposes. To explain what the exemption method is and how it operates to avoid double taxation, the United States will refer to the OECD Model Convention's provision on exemption.[153] The OECD Convention is the model treaty that most EC member states rely on, and it makes clear how exemption (non-taxation) may be employed to avoid double taxation.

180. The OECD Model Convention provides in pertinent part:

METHODS FOR ELIMINATION OF DOUBLE TAXATION

Article 23A

EXEMPTION METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the

[150] Annex EC-2, page 1 (US-5).

[151] *Model Tax Convention on Income and Capital* (OECD 1992) ("OECD Model Tax Convention") (Exhibit US-7); *see also United Nations Model Double Taxation Convention Between Developed and Developing Countries*, Pub. No. ST/ESA/102 (1980).

[152] Annex EC-2, page 2 (US-5).

[153] In doing so, the United States does not rely on the OECD Model Convention as an authoritative source for interpreting WTO rules. The United States cites the Convention solely as an example.

other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.[154]

* * * * *

Article 23B

CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:

(a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;

(b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.[155]

181. The Commentary to the OECD Model Convention explains that both the exemption method and the credit method serve to avoid double taxation in the context of foreign-source income.[156] The Commentary makes clear that exemption applies not only to foreign-source income earned directly by a resident of the taxing country, but also to dividend and interest income that is repatriated to the taxing country.[157]

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[154] The rest of Article 23A states:

2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 and 11 [involving cross-border dividend and interest income, respectively], may be taxed in the other Contracting State, the first mentioned state shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from the other state.

3. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

[155] Article 23B has a second paragraph, which provides that "[w]here in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of excess tax on the remaining income or capital of such resident, take into account the exempted income or capital."

[156] *OECD Model Tax Convention,* p. C(23)-3 (US-7) ("Articles 23A and 23B apply to the situation in which a resident of State R [residence] derives income from, or owns capital in, the other Contracting State S [source] ... and that such income or capital, in accordance with the Convention, may be taxed in such other State S.").

[157] Commentary to the *OECD Model Tax Convention*, p. C(23)-14 (US-7) ("In Articles 10 and 11 the right to tax dividends and interest is divided between the States of residence and the State of source. In these cases, the State of residence is left free not to tax if it wants to do so ... and to apply the exemption method also to the above-mentioned items of income."). The second paragraph of Article 23A, however, imposes limitations on the exemption method with regard to these types of income that do not apply to other types of income.

The Commentary further makes clear that countries are free to adopt one or both methods and the means by which they are implemented may vary from country to country.[158]

182. In addition, the Commentary provides that, "[u]nder the principle of exemption, the state of residence R does not tax the income which ... may be taxed in [another country]." Thus, the term "exemption" for purposes of double tax avoidance does not mean only the establishment of a legal exception to an otherwise applicable revenue-raising general rule. "Exemption" in this context means the non-taxation of income subject to double tax.[159] As long as income "may be taxed" in another country, the Commentary states that a country of residence must not tax that same income.[160]

(c) The Exemption Method May Allow for An Overall Tax Reduction for Some Taxpayers

183. An important distinction between the exemption (non-taxation) method and the credit method is that the former operates on an *ex ante* basis while the latter operates on an *ex* post basis. The exemption method does not tax income that potentially may be subjected to the tax systems of two sovereign nations. It does so in general and "before the fact" – that is, without regard to the particular income or foreign tax that is involved. This stands in contrast to the tax credit method, which only offsets foreign taxes actually paid on specific income "after the fact". International principles of taxation recognize these differences, but embrace both.

184. While tax credits are capped by the amount of foreign taxes paid – and can provide only partial relief where exceptions apply – the overall tax liability of a given taxpayer under the exemption method is determined by the tax rate applied by the source country. To the extent that the tax rate applied by the source country is *higher* than that of the country of residence, a taxpayer *will pay more* in taxes on the income in question than if that income were earned in the country of residence. Conversely, if the source country applies a *lower* rate, then a taxpayer *will pay less* than if the income were earned exclusively within the country of residence.

185. That the exemption method may result in an overall tax reduction in no way undermines the validity of the method under accepted international tax norms. Neither the OECD nor the UN model treaty requires treaty parties to impose any minimum level of tax under an exemption system. The model treaties leave to individual countries the determination of whether a minimum level of taxation by a treaty party is necessary for exemption to apply under their national laws. In fact, the OECD Commentary specifically provides that the state of residence must "give exemption whether or not the right to tax is in effect exercised by the other States."[161] The Commentary explains that this method is the most practical, "since it relieves the State of residence from undertaking investigation of the actual taxation position of the other States."[162]

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[158] *Ibid.*, page C(23)-14 ("In view of the wide variety of fiscal policies and techniques in the different States regarding the determination of tax, especially deductions, allowances and similar benefits, it is preferable not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique.").

[159] Commentary to the *OECD Model Tax Convention*, page C(23)-4.

[160] *Ibid.*, page C(23)-11.

[161] *Ibid.*

[162] *Ibid.*

186. The EC has acknowledged this feature of the exemption system. Because the exemption method of avoiding double taxation is not calibrated to the tax paid to a foreign country, the EC has explained, "[t]o the extent that foreign taxes are lower than domestic taxes, resident taxpayers with exempt foreign-source income are treated more favourably than other residents."[163]

3. The Act's Exclusion of Extraterritorial Income Is a Measure to Avoid Double Taxation Within the Meaning of Footnote 59

187. By operation and design, the Act is a measure to avoid double taxation of foreign-source income for purposes of footnote 59.

(a) The Act Relies on Non-Taxation Rather than Tax Credits as a Double Tax Avoidance Mechanism

188. The Act expressly relies on the non-taxation method to avoid double taxation of foreign-source income. The legislative history accompanying the Act makes the point explicitly: "Because the exclusion of such extraterritorial income is a means of avoiding double taxation, no foreign tax credit is allowed for income taxes paid with respect to such excluded income."[164] The legislative history further explains that, in shifting from a worldwide tax system to a more territorial approach, the United States was, through the Act, embracing an exemption (or non-taxation) method of avoiding double taxation typically employed under territorial systems. The Act's exclusion would take the place of foreign tax credits, which ordinarily serve under the IRC as the mechanism for avoiding double taxation. The legislative history states:

> It is important to note that each type of system [worldwide versus territorial] generally uses a different method to avoid double taxation of foreign-source in-come. Although this is an oversimplification, in a worldwide system, the "credit method" typically is used; that is, a tax credit is provided for taxes paid to foreign governments on income earned abroad. In a territorial system, the "exemption method" is used; that is, income earned abroad is simply not subject to tax. While tax policy arguments can be used to justify the superiority of one method over the other, both methods are accepted internationally, and it also is accepted internationally that a country is free to use either method or both.[165]

189. The Act achieves double taxation avoidance through the exclusion of extraterritorial income. In addition, section 114(d) of the IRC, as added by the Act, provides that "no credit shall be allowed under this chapter for any income, war profits and excess profits taxes paid or accrued to any foreign country or possession of the United States with respect to extraterritorial income which is excluded from gross income under subsection (a)." The Act also provides that deductions are not allowed with respect to excluded income.[166]

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[163] Annex EC-2, page 6 (US-5).
[164] *House Report*, page 10; *see also Senate Report, page 2*.
[165] *House Report*, page 13.
[166] The Act § 3, amending IRC § 114(c).

(b) The Act Provides a Partial Exclusion for Foreign-Source Income

190. By creating a general exclusion from US taxation for extraterritorial income in section 114(a), and then establishing limited exceptions that allow for tax on a portion of such income in section 114(b), the Act provides a partial exclusion for foreign-source income within the meaning of the fifth sentence of footnote 59. As noted above, the ordinary meaning of the term "foreign-source income" is profits or proceeds originating outside the borders or territory of the WTO Member instituting a measure to avoid double taxation. The essential characteristics that would indicate whether profits or proceeds originate outside the borders or territory of a country might include one or more of the following: the goods or services in question are sold outside the territory of the taxing authority, the purchaser is located outside the territory of the taxing authority, title to the merchandise is transferred outside the territory of the taxing authority, payment is made or issued outside the territory of the taxing authority, or economic activities giving rise to the sale occur (at least in part) outside the territory of the taxing authority.

191. "Extraterritorial income" under the Act involves these foreign attributes. The central premise of the Act is to provide a tax exclusion for income from foreign sales.[167] With regard to the types of transactions that may generate excludable income, the Act provides that the goods involved must be used, consumed, or disposed of outside the United States.[168] As such, the purchasers of these goods typically will be located outside the United States, they generally will authorize or make payment for the goods in another country, and in many instances title will pass in that country as well. The goods may be produced outside the United States,[169] and certain required levels of foreign economic activities must be performed with respect to the sales and distribution functions associated with qualifying transactions.[170]

192. It is because of these considerations that income excluded under the Act may properly be characterized as extraterritorial and, thus, "foreign-source." Although the EC complains that the Act "does not concern 'extraterritorial' income in any real [sense] of that word",[171] the EC acknowledges that the Act applies to income "derived from foreign sales."[172] As discussed above, "extraterritorial income" under the Act is income derived from non-domestic sources. As such, it comes within the ordinary meaning of "foreign-source."

(c) The Act's Exclusion Is Akin to Territorial Exemptions Under EC Member State Systems

193. The exclusion established by the Act was designed to parallel aspects of the territorial exclusions or exemptions used by EC member states. The Act's legislative history makes this plain:

> The Committee emphasizes that the extraterritorial income excluded by this legislation from the scope of US income taxation is parallel to

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[167] The Act § 3, amending IRC § 114(e), defines "extraterritorial income" as the proceeds generated from qualifying foreign sales.

[168] The Act § 3, amending IRC § 943(a)(1)(B).

[169] The Act § 3, amending IRC § 943(a)(1)(A).

[170] The Act § 3, amending IRC § 942(b).

[171] *EC First 21.5 Submission*, para. 17.

[172] *Ibid.*

> the foreign-source income excluded from tax under most territorial tax systems. Under neither the US tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems. While exporters may be among those who are eligible for the exclusion, this fact does not make that exclusion "export contingent." If it did, every general exclusion from tax applicable to, among others, exporters would become a prohibited export subsidy.[173]

194. The exclusion provided under the Act is similar to the practice of a number of EC member-state tax systems in exempting foreign-source income from taxation.[174] Like the Act, these EC systems do not tax at least a portion of the income generated by foreign sales. Among EC tax systems that apply the territorial principle of taxation, the form and extent of each country's application of that principle vary. Some countries, such as France, have historically exempted all income earned outside their borders. However, no EC country now provides a blanket exemption for foreign-source income. In fact, as the EC explained to the *FSC* Panel, EC member states providing an exemption for foreign-source income do so only partially, and most generally treat foreign-source income as an exception to the general rule that the worldwide income of a domestic corporation is subject to taxation in its country of residence.[175] Just as the Act moves the United States toward a more territorial approach to its system of taxation, EC systems are a mix of worldwide and territorial principles.

4. Conclusion

195. For the foregoing reasons, the exclusion of extraterritorial income under the Act is a measure to avoid double taxation within the meaning of footnote 59. Therefore, pursuant to footnote 5 of the SCM Agreement, the exclusion does not constitute a prohibited export subsidy for purposes of Article 3.1(a).

E. The 50 Per cent Rule on Certain Foreign Value Does Not Render the Act's Exclusion of Extraterritorial Income Inconsistent with Article 3.1(b) of the SCM Agreement

196. The EC argues that the 50 per cent rule on certain foreign value in the Act violates Article 3.1(b) of the SCM Agreement.[176] The Panel need not reach this issue for two reasons. First, as demonstrated above, the Act's exclusion does not constitute a subsidy within the meaning of Article 1.1(a)(1)(ii). Second, footnote 5 provides that measures not constituting export subsidies under Annex I are not prohibited under any provision of the SCM Agreement, including Article 3.1(b). Should the Panel find that Article 3.1(b) is applicable to this dispute, however, the EC's claim nonetheless

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[173] *House Report*, page 18.
[174] These are discussed in more detail in the "Factual Background" section above.
[175] EC Annex-2, page 2 (US-5).
[176] *EC First 21.5 Submission*, paras. 159-184.

fails because it rests on a misunderstanding of the 50-per cent rule and a failure to demonstrate that the Act's exclusion is "contingent" on the use of domestic over imported goods.

1. The EC's Claim Under Article 3.1(b) Is Rendered Moot By Footnote 5 of the SCM Agreement

197. As demonstrated above in connection with Article 3.1(a), footnote 5 to the SCM Agreement states that "[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this *or any other* provision of this Agreement." Footnote 5 thus provides an immunity from all prohibitions in the SCM Agreement - including the one established under Article 3.1(b) - provided that the terms of the footnote are met. As also demonstrated above, the Act's exclusion of extraterritorial income is a measure to avoid double taxation within the meaning of footnote 59 of Annex I. Therefore, because the exclusion is a "[m]easure referred to in Annex I as not constituting [an] export subsid[y]", it is not prohibited under any provision of the SCM Agreement, including Article 3.1(b). Accordingly, the Panel need not address the EC's claim under Article 3.1(b).

2. The Meaning of Article 3.1(b)

198. If the Panel determines that the exclusion of extraterritorial income falls outside the scope of footnote 5, then analysis of the EC's claim under Article 3.1(b) must begin with the text of that provision. In this regard, Article 3.1(b) prohibits "[s]ubsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods." The Appellate Body has stated that the legal standard embodied by the term "contingent" applies equally under Articles 3.1(a) and 3.1(b) of the SCM Agreement.[177] Thus, for purposes of Article 3.1(b), the Appellate Body has confirmed that "contingent" means "conditional" or "dependent for its existence on" something else.[178] For a subsidy to be "contingent ... on the use of domestic over imported goods," it must be conditioned on or dependent for its existence on the use of domestic goods instead of imported goods.

3. The EC Misunderstands the 50 Per cent Rule

199. The EC's claim reflects a basic misunderstanding of the 50 per cent rule. The EC suggests throughout its First Submission that the Act contains a domestic *content* requirement that precludes manufacturers from using more than a fixed amount of imported inputs in their production operations.[179]

200. However, the Act neither precludes manufacturers from using more than a fixed amount of imported articles nor requires the use of any US manufactured articles for a transaction to earn excludable extraterritorial income. Instead, the Act provides that up to 50 per cent of the fair market value of goods involved in a transaction may be attributable to articles produced outside the United States and direct labour

[177] *Canada Autos (AB)*, DSR 2000:VI, 2985, para. 123.
[178] *Canada Aircraft (AB)*, DSR 1999:III, 1377, para. 167.
[179] *E.g., EC First 21.5 Submission*, paras. 55, 69, 106, 159 and 179.

costs incurred outside the United States.[180] Under this rule, a good can meet this requirement even if 100 per cent of its content is foreign.

201. The 50 per cent rule takes into account only the value of foreign articles and foreign direct labour costs used in producing a finished product. It does not limit other foreign value. Thus, the remaining 50 per cent of fair market value of the finished product can be attributed to non-tangible elements, including intellectual property rights, goodwill, capital, marketing, distribution, and other services, which may be of either US or foreign origin. The articles used in manufacturing, whatever their origin, account for only part of the total value.

202. The operation of the 50 per cent rule can be illustrated through an example. Assume a product consists of 100 per cent foreign articles and is manufactured using only foreign direct labour. Assume further that the sum of value of the foreign articles and foreign direct labour costs is $200. Assume also that, because of significant foreign brand name value and foreign capital costs, the fair market value of the product (i.e., the price at which it can be sold to consumers) is $450. The sale of such a product qualifies for the exclusion under the Act, notwithstanding the fact that no US goods are involved, because $200 is less than 50 per cent of $450.

203. The practical effect of the 50 per cent rule is further diminished by the principle of origin applicable to components incorporated into manufactured products. An input sourced from a US supplier may be deemed US-origin for purposes of the 50 per cent rule, despite the fact that the goods from which that component was manufactured may have been primarily, or even entirely, imported goods. In such circumstances, there is no preference for domestic over imported goods because the finished component typically is deemed to be a US-origin good.[181]

4. Canada Autos Confirms that the Exclusion of Extraterritorial Income Is Not Contingent Upon the Use of Domestic Over Imported Goods

204. The foregoing discussion of why the Act's 50 per cent rule does not violate Article 3.1(b) is confirmed by the Appellate Body report in *Canada Autos*. In that case, the Appellate Body found that even a 60-per cent value-added requirement does not necessarily raise a presumption of inconsistency with Article 3.1(b) of the SCM Agreement. The Appellate Body concluded that only where there is evidence that a manufacturer actually will be *required* to use domestic over imported goods will the prohibition in Article 3.1(b) be implicated.

(a) The Appellate Body's Decision

205. In *Canada-Autos*, the panel and the Appellate Body considered whether a Canadian value- added requirement rendered the subsidy at issue contingent on the

[180] The Act § 3, amending IRC § 943(a)(1)(C).

[181] The EC provides a comparison between the 50 per cent rule and the limitation on articles imported into the United States contained in the repealed FSC statute. *EC First 21.5 Submission*, paras. 159-162. This comparison, and any reference to the FSC rules, is irrelevant to the issues before this Panel. It should be noted, however, that in the initial proceeding, the United States provided a detailed explanation as to why the FSC provision was consistent with Article 3.1(b) of the SCM Agreement, but neither the *FSC* Panel nor the Appellate Body reached this issue.

use of domestic over imported goods.[182] Under the applicable measure, a Canadian motor vehicle manufacturer was entitled to benefit from an import duty exemption if, *inter alia*, that manufacturer's total Canadian value- added with respect to a class of vehicles reached a certain proportion of the final product's total value. Canadian value added (CVA) could be established through various elements. These elements, while including the costs of parts produced in Canada, also consisted of transportation costs; wages paid for non-production labour in Canada; cost of materials used in the production operation but not incorporated in the final product; overhead costs; worker's compensation and insurance; real estate taxes; and a capital cost allowance. One manufacturer was eligible for the import duty exemption if 60 per cent of the total value added by the manufacturer was Canadian. The record did not show the particular CVA requirements for other manufacturers.

206. In analyzing the Canadian CVA requirements, the Appellate Body stated that "[t]he precise issue under Article 3.1(b) is whether the *use* of domestic over imported goods is a 'condition' for satisfying CVA requirements, and, therefore, for receiving the import duty exemption."[183] The Appellate Body considered that the required CVA level, or percentage, was relevant to whether a particular manufacturer might be able to satisfy its specific CVA requirements without using any Canadian parts and materials in its production.[184] The Appellate Body found that, even where the CVA requirement was 60 per cent, a manufacturer could satisfy the requirement without having to use domestic goods.[185] According to the Appellate Body, where there is a "*multiplicity of possibilities* for compliance" with a value-added requirement, it is not enough to show that "use of domestic goods [is] only one *possible* means (means which might not, in fact, be utilized) of satisfying [such] requirements."[186]

207. The Appellate Body emphasized the importance of establishing "how they [the required CVA levels] operate for individual manufacturers."[187] Without this "vital information," a panel cannot know "enough about the measure to determine whether the CVA requirements were contingent 'in law' upon the use of domestic over imported goods."[188] For this reason, the Appellate Body concluded that the 60 per cent CVA requirement did not raise a presumption of inconsistency with Article 3.1(b). Thus, in order to prevail, a complaining party must demonstrate "how [value-added] requirements would *actually* operate" to substitute domestic goods for imported goods.[189]

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[182] A description of the measure in question can be found in *Canada Autos (AB)*, DSR 2000:VI, 2985, paras. 124-129.

[183] *Canada Autos (AB)*, DSR 2000:VI, 2985, para. 126 (emphasis in original).

[184] *Ibid.*, para. 130.

[185] *Ibid.*

[186] *Ibid.* (emphasis in original). By contrast, where the CVA requirements are set "very high," the Appellate Body stated that "the use of domestic goods may well be a necessity and thus be, in practice, required as a *condition* for eligibility for the import duty exemption." *Ibid.* (emphasis in original).

[187] *Ibid.*, para. 131.

[188] *Ibid.*

[189] *Ibid.* (emphasis added).

(b) The Application of *Canada-Autos* to the Act

208. Based on the Appellate Body's analysis in *Canada Autos*, the EC has not met its burden of showing that the exclusion of extraterritorial income under the Act is contingent on the use of domestic over imported goods. As with the CVA requirements at issue in *Canada Autos*, the 50 per cent rule can be satisfied without the use of any domestic goods. In fact, the 50 per cent rule does not require *any* US value in general, or US goods in particular. Because more than 50 per cent of the fair market value of any property sold in a transaction generating extraterritorial income may be attributable to elements other than goods – including intellectual property content, overhead, and other costs unrelated to goods – a manufacturer can earn extraterritorial income by selling products that consist entirely of imported goods.

209. In the words of the Appellate Body, the "multiplicity of possibilities for compliance" with the Act's 50 per cent rule suggests that the "use of domestic goods [is] only one *possible* means (means which might not, in fact, be utilized) of satisfying the ... requirements." As the Appellate Body made clear in *Canada Autos*, such a showing, without more, is simply insufficient to warrant a finding that a measure is "contingent" upon the use of domestic over imported goods.

210. In this case, the EC has offered no evidence that the Act's 50 per cent rule conditions the exclusion of extraterritorial income on the use of domestic over imported goods. The only "evidence" proffered by the EC in this case is an annex that purportedly describes products of which more than 50 per cent of their value derives from inputs or tangible articles.[190] The basis for these descriptions are "some data relating to the production in certain sectors ... cross-checked ... with information from certain European industries and in the course of various trade investigations."[191] This "evidence", though, does not describe how the Act's 50 per cent rule actually operates with respect to US taxpayers that are eligible to exclude extraterritorial income. Based on the teaching of the Appellate Body in *Canada Autos*, only through evidence showing that the 50 per cent rule actually requires the use of domestic goods can the EC make a viable claim under Article 3.1(b).

F. The Act's 50 Per cent Rule Is Not Inconsistent with Article III:4 of GATT 1994

211. The EC claims that the 50 per cent rule of the Act provides less favourable treatment to imported products than to like domestic products in violation of Article III:4 of GATT 1994.[192] Similar to the claim it makes in relation to Article 3.1(b) of the SCM Agreement, the EC's argument under Article III:4 rests on an inaccurate description of the 50 per cent rule and suffers from insufficient proof to establish a *prima facie* violation.

1. The Meaning of Article III:4

212. Article III:4 provides in relevant part that:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in

[190] *EC First 21.5 Submission*, Annex.
[191] *Ibid.*
[192] *EC First 21.5 Submission*, paras. 187-219.

> respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use ... .

To establish a violation of Article III:4, the EC must demonstrate the existence of: (a) a law, regulation or requirement affecting the internal sale, offering for sale, or distribution of an imported product; and (b) treatment accorded in respect of the law, regulation or requirement that is less favourable to the imported product than to like products of national origin.[193] The requirement of Article III:4 that imported products be accorded treatment "no less favourable" than that accorded to like products of national origin has been interpreted to ensure "effective equality of opportunities between imported products and domestic products."[194]

2. *The EC Inaccurately Describes the 50 Per cent Rule*

213. The EC's argument regarding Article III:4 is littered with erroneous descriptions of the 50 per cent rule contained in the Act. To start with, the EC states that "the limit on ... foreign inputs is one of the conditions to obtain the tax benefit."[195] The EC also claims that the Act contains a "legal requirement that the foreign inputs and labour not be used above a certain ceiling, if a taxpayer wants to obtain the tax benefit."[196] The EC maintains that the Act "requires in some cases the use of a minimum amount of domestic parts and materials ... [and] precludes producers wishing to benefit ... from using an equivalent amount of imported parts and materials."[197] Finally, the EC asserts that the Act *requires* "the ... use by an enterprise of products of domestic origin . . ., whether specified in terms of ... value of products, or in terms of a proportion of ... value of its local production."[198]

214. These statements simply do not accurately describe the Act. As discussed throughout this submission, including the immediately preceding section, the Act does not require the use of any US-origin goods for a transaction to earn excluded extraterritorial income. Instead, the Act provides that up to 50 per cent of the fair market value of goods involved in a transaction may be attributable to articles produced outside the United States and direct labour costs incurred outside the United States.[199] Goods can meet this requirement even if 100 per cent of the fair market value of their inputs is foreign. Thus, contrary to the EC's arguments,

- the Act does not place a "limit on foreign inputs";
- there is no "legal requirement that the foreign inputs and labour not be used above a certain ceiling";
- the Act does not "require[] in some cases the use of a minimum amount of domestic parts and materials"; and

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[193] *Japan - Measures Affecting Consumer Photographic Film and Paper* ("*Japan Film*"), WT/DS44/R, Report of the Panel adopted 22 April 1998, DSR 1998:IV, 1179, para. 10.369.

[194] *Canada - Certain Measures Affecting the Automotive Industry* ("*Canada Autos (Panel)*"), WT/DS139/R, WT/DS142/R, Report of the Panel, as modified by the Appellate Body, adopted 19 June 2000, DSR 2000:VII, 3043, para 10.78.

[195] *EC First 21.5 Submission*, para. 195.

[196] *Ibid.*, para. 203.

[197] *Ibid.*, para. 206.

[198] *Ibid.*, para. 217, quoting the Agreement on Trade-Related Investment Measures, Illustrative List, Item 1.a.

[199] The Act § 3, amending IRC § 943(a)(1)(C).

- the Act does not require "the ... use by an enterprise of products of domestic origin".

215. Certainly, a claim of inconsistency under Article III:4 cannot rest upon such an erroneous description of the contested measure. For this reason alone, the EC has not made a *prima facie* case of inconsistency with Article III:4.

3. The EC Proffers no Evidence to Support its Claim Under Article III:4

216. In addition to inaccurately describing the measure it seeks to invalidate, the EC has presented no evidence supporting its claim under Article III:4. The EC states that, "*in many cases*," the Act requires the use of US-produced inputs.[200] The EC also states "there will be *cases* in which a firm will be induced to increase the value of US goods it uses ... ."[201] Moreover, the EC claims that the Act will "*in many cases* determine which goods a producer will use",[202] and "it will *in many cases* be easier" to meet the 50 per cent rule if US products are used.[203] Finally, the EC claims that "prospective beneficiaries will *always* give preference, all other conditions being equal, to US 'articles.'"[204]

217. Despite the rhetoric, nowhere does the EC cite to a single case where a class of imported goods will be accorded less favourable treatment than a class of domestic "like products." In fact, the EC has not described one product that would be "affected" by the 50 per cent rule contained in the Act, thereby undermining the EC's own interpretation of Article III:4 as requiring an examination of "individual products" rather than "all possible products." Simply asserting that "many cases" of less favourable treatment exist does not make the assertion true and does not suffice to support a claim under Article III:4. In fact, the EC itself has acknowledged that, "an analysis [under Article III:4] has to be carried out at the level of an individual product, not at the level of the application of the law to all possible products."[205]

218. Many of the GATT and WTO panel cases cited by the EC involve laws, regulations, and requirements explicitly applicable to a particular class or category of imports.[206] In such cases, it is not difficult to consider how such imports would be "affected" by those measures. However, in cases involving a generally applicable measure, there must be a heightened evidentiary burden for the complaining party. Measures of general application, like the Act, do not necessarily affect imported *goods*. Evidence must be introduced to establish a "meaningful nexus" between such a measure and adverse effects on competitive conditions for a like class of imported goods before determining that the measure accords less favourable treatment to imports.[207]

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[200] *EC First 21.5 Submission*, para. 194 (emphasis added).
[201] *Ibid.*, para. 200 (emphasis added).
[202] *Ibid.*, para. 199 (emphasis added).
[203] *Ibid.*, para. 205 (emphasis added).
[204] *Ibid.*, para. 208 (emphasis added).
[205] *Ibid.*, para. 211.
[206] *See, e.g.*, *Canada Autos (Panel)* DSR 2000:VII, 3043; and *United States - Standards for Reformulated and Conventional Gasoline*, WT/DS2/R, Report of the Panel, as modified by the Appellate Body, adopted 20 May 1996, DSR 1996:I, 29.
[207] *See, e.g.*, *Japan Film*, DSR 19989:IV, 1179, para. 10.381.

219. The foregoing discussion demonstrates that the EC has failed to make a *prima facie* case of inconsistency with Article III:4. By inaccurately portraying the measure it seeks to invalidate and by failing to provide adequate evidence to substantiate its conclusions, the EC has not proven its claim that the Act is inconsistent with Article III:4.

G. The Act's Exclusion of Extraterritorial Income Does Not Violate US Obligations Under the Agreement on Agriculture

220. The EC contends that the Act's exclusion of extraterritorial income violates Article 10.1 of the Agreement on Agriculture, as read together with Article 8 of that Agreement, or, in the alternative, Articles 3.3 and 8, in conjunction with Article 9.1, of the Agreement.[208] For the following reasons, the EC's claim lacks merit.

221. Article 10.1 of the Agriculture Agreement provides that "[e]xport subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments ... ." In the *FSC* case, the Appellate Body relied upon the definitions of subsidy in Article 1 of the SCM Agreement and export contingency in Article 3.1(a) of the SCM Agreement as context in considering what is an "export subsidy" under the Agriculture Agreement.[209] For the same reasons already discussed by the United States that the Act's exclusion does not constitute an export subsidy within the meaning of Articles 1 and 3.1(a) of the SCM Agreement, the exclusion does not constitute an export subsidy within the meaning of Article 1(e) of the Agriculture Agreement. Thus, the exclusion of extraterritorial income under the Act does not violate US obligations under the Agriculture Agreement.[210]

H. The United States Complied with the DSB's Recommendations and Rulings

222. The EC contends that the United States has not complied with the DSB's recommendations and rulings because: (1) the Act contains transition rules that extend the FSC regime beyond 30 October 2000; and (2) because the Act was not signed into law until after 1 November 2000.[211] As discussed below, the United States believes that it satisfactorily complied with the DSB's recommendations and rulings.

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[208] *EC First 21.5 Submission*, paras. 222-233; *see also Ibid.*, paras. 67-68. The EC provides an extraneous and seemingly irrelevant description of the 50 per cent rule in its discussion of the Agriculture Agreement. *Ibid.*, paras. 220-21. Because the EC has failed to make any legal claim under the Agriculture Agreement with respect to this aspect of the Act, the United States does not address the factual inaccuracies contained in the EC's description in this section. The United States respectfully refers the Panel to the discussion in Section V.E, above, that explains the operation of the 50 per cent rule.

[209] *FSC (AB)*, DSR 2000:III, 1619, paras. 136-142, *citing Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products*, WT/DS103/AB/R, WT/DS113/AB/R, Report of the Appellate Body adopted 27 October 1999, DSR 1999:V, 2057.

[210] The EC posits an alternative argument under the Agriculture Agreement that is conditioned on the United States making an argument that the Act confers export subsidies that are covered by Article 9.1 of the Agriculture Agreement. Because the United States does not make this argument, the EC's alternative argument need not be addressed.

[211] *EC First 21.5 Submission*, paras. 234-241.

1. *Based on All of the Circumstances Surrounding this Dispute, the Panel Should Find that the Act's Transition Rules Constitute a Reasonable Method of Complying with the DSB's Recommendations and Rulings*

223. The Act repealed sections 921-927 of the IRC, the FSC tax provisions.[212] The Act also provides that no FSCs may be created after 30 September 2000.[213] As a result, the measures contested by the EC in the *FSC* case and found by the DSB to give rise to prohibited export subsidies under the SCM Agreement no longer exist.

224. The Act, though, does provide limited transition relief to lessen the administrative burden and impact on taxpayers' business operations that might result due to the repeal of the FSC. The Act provides one tax year (*i.e.*, through December 2001) for FSCs in existence as of 30 September 2000 to continue in operation.[214] In addition, with respect to FSCs that entered into long-term, binding contracts with unrelated parties before 30 September 2000, the Act does not alter the tax treatment of those contracts.[215] As such, these rules are relatively narrow and apply only in highly particularized circumstances.

225. It is customary practice in the United States and other countries to promulgate transition rules when repealing significant tax legislation. This is done to avoid impairing pre-existing binding contracts and to otherwise minimize uncertainties that may ensue. Complex and harmful tax consequences could result where, for example, a profit or a loss is accounted for in one tax year while the transaction creating that profit or loss was entered into in a previous year.[216] If tax laws affecting that transaction are amended, questions would arise as to which law governs and whether the transactions need to be unwound or substantially revamped.

226. Transition rules, therefore, provide domestic and foreign businesses with an opportunity to adjust, and they "protect people who might have altered their conduct in reliance upon" the tax treatment provided under the earlier law.[217] As one scholar has explained, "those who reasonably relied upon an existing law should not be subjected to the costs associated with unexpected changes in that law."[218]

227. The Appellate Body has recognized that WTO rules must be construed flexibly. Thus, the Appellate Body has stated that "WTO rules are not so rigid or so inflexible as not to leave room for reasoned judgments in confronting the endless and ever-changing ebb and flow of real facts in real cases in the real world. They will serve the multilateral trading system best if they are interpreted with that in mind."[219] In several recent cases, WTO panels have excused procedural violations in the absence of prejudice to the complaining party, essentially taking into account equitable considerations in issuing their decisions.[220]

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[212] The Act § 2.
[213] The Act § 5(b)(1).
[214] The Act § 5(c)(1)(A).
[215] The Act § 5(c)(1)(B).
[216] Kirk J. Stark, *The Elusive Transition to a Tax Transition Policy*, 13 Amer. J. Tax Pol'y 145, 149 (1996) (Exhibit US-8).
[217] *Ibid.*, page 150.
[218] *Ibid.*, pages 149-150.
[219] *Japan - Taxes on Alcoholic Beverages*, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, Report of the Appellate Body adopted 1 November 1996, page 34, DSR 1996:I, 97, at 123.
[220] *See, e.g.*, *United States - Safeguard Measures on Imports of Fresh, Chilled or Frozen Lamb Meat from New Zealand and Australia*, WT/DS177/R, WT/DS178/R, Report of the Panel circulated

228. A limited transition period allowing taxpayers to adjust to a new tax regime appears all the more reasonable in light of the circumstances surrounding this case. Specifically, notwithstanding the EC's assertions that it never agreed that the FSC was GATT- or WTO-consistent, it waited until thirteen years after the FSC was enacted before challenging it. During that time, US taxpayers came to rely on the FSC provisions in structuring their foreign transactions. Furthermore, the United States promulgated and maintained the FSC tax provisions in reliance on the 1981 Understanding adopted by the GATT Council. Notwithstanding the status ultimately accorded to the 1981 Understanding in this case, such reliance was not unjustified.

229. Despite the many obstacles posed by the fact that 2000 was a presidential election year in the United States, and acting under the strict time restraints set by the DSB, the United States did repeal the FSC provisions. The United States attempted to work in good faith with the EC to find a legislative solution that would be mutually acceptable. When that did not occur, the United States repealed the FSC provisions with effect from 1 October 2000, with the exception of the transition rules described above. Considering these factors, under the particular circumstances of this dispute, the United States believes that the Panel should find that the limited transition rules provided for in the Act constitute a reasonable implementation of the DSB's recommendations.

2. *The United States Complied with the Time Period Specified by the DSB*

230. The EC also argues that the United States failed to comply with the DSB's recommendations in the *FSC* case because the Act was not signed until 15 November 2000.[221] The EC's argument fails for several reasons.

231. First, the Act's provisions apply retroactively and repeal the FSC provisions before 1 November 2000. The DSB recommended that the United States withdraw the FSC subsidies with effect from 1 October 2000, which the DSB then extended to 1 November 2000. The DSB did not indicate when the legislation had to be enacted, although the United States obviously sought to eliminate any controversy on this point by attempting to enact the legislation by 1 October (and, thereafter, by 1 November). The Act provides that the "amendments made by this Act shall apply to transactions after 30 September 2000."[222] Thus, the United States repealed the FSC with effect from 1 October 2000, thereby complying with the DSB's recommendation.

232. Second, the WTO generally does not examine claims regarding measures that are no longer in effect and that were not in effect at the time a panel's terms of reference were established. This comports with the fact that the WTO does not provide relief retroactively for alleged past wrongs.[223]

233. The same principle applies here. The "measure" in question constitutes an omission in the form of an alleged failure to act by 1 November 2000. However, the

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21 December 2000 (on appeal), DSR 2001:IX, 4107, paras. 5.48-5.53, or on the basis of estoppel (*see, e.g.*, *FSC (Panel)*, DSR 2000:IV, 1675, para. 7.10.

[221] *EC First 21.5 Submission*, paras. 244-246.

[222] The Act § 5(a).

[223] This principle is reflected in Article 19.1 of the DSU, which provides that when a panel concludes that a measure is inconsistent with a covered agreement, the panel "shall recommend that the Member concerned bring the measure into conformity with that agreement." (footnote omitted).

measure (*i.e.*, the omission) ceased to exist as of 15 November 2000 when the Act was signed into law. In other words, by the time the EC made its panel request to commence this Article 21.5 proceeding, the measure it ostensibly was challenging no longer existed. Panels typically refrain from examining measures that cease to be in existence or in effect before a panel's terms of reference are set.[224]

I. The Panel Should Reject the EC's Preliminary Objection Regarding Third Party Rights

234. The EC has made a preliminary objection to paragraph 9 of the Panel's Working Procedures, which require the parties to serve their first written submissions on third parties. The EC essentially asks the Panel to require the parties to also serve their written rebuttals on third parties.[225] According to the EC, paragraph 9 is inconsistent with Article 10.3 of the DSU.

235. The EC has made similar arguments in other Article 21.5 proceedings in which a panel has held only a single meeting with the parties and third parties, and in each such proceeding, the panel has rejected the EC argument. The first in this line of cases is *Australia Leather*, in which the panel made the following ruling:

> In its 11 November 1999 response to the EC, the Panel indicated that it had decided not to change the existing working procedures which provide for third parties to receive the first written submissions of the parties, but not the rebuttals. The Panel stated that if it had decided to hold two meetings with the parties, as is the normal situation envisioned in Appendix 3 of the DSU, third parties would have received only the written submissions made prior to the first meeting, but not rebuttals or other submissions made subsequently. Thus, in the more usual case, third parties would be in the same position as they were in this case with respect to their ability to present views to the panel. In the view of the Panel, the procedure it had established conformed more closely with the usual practice than would be the case if third parties received the rebuttals, and was in keeping with Article 10.3 of the DSU in a case where the Panel holds only one meeting.[226]

236. More recently, the panel in *Korea DRAMS* also rejected the EC's position. Because the parties were able to reach a mutually acceptable solution in that case, the panel never issued a report. However, prior to the termination of the proceeding, the panel issued a decision in which it rejected the EC request. The pertinent portions of the decision read as follows:

> The Panel took note of the possible merit of the EC's argument when looking only at the words of Article 10.3. However, pursuant to the Vienna Convention rules on treaty interpretation one cannot isolate

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[224] *See, e.g., Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*, WT/DS56/R, Report of the Panel, as modified by the Appellate Body, adopted 22 April 1998, DSR 1998:III, 1033, paras. 6.13-15.

[225] *EC First 215. Submission*, paras. 247-258.

[226] *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather - Recourse to Article 21.5 of the DSU by the United States*, WT/DS126/RW, Report of the Panel adopted 11 February 2000, DSR 2000:III, 1189, para. 3.9. This decision was followed in *Australia - Measures Affecting Importation of Salmon - Recourse to Article 21.5 by Canada*, WT/DS18/RW, Report of the Panel adopted 20 March 2000, DSR 2000:IV, 2031, paras. 7.5-7.6.

> the words of a treaty from their context. The reference in Article 10.3 to "submissions ... to the first meeting of the panel" is made in the context of standard panel procedures. There, a panel holds two meetings and documentation is submitted before each of these meetings. Third parties normally do not have a right to hear the oral statements of the main parties at panel meetings (including the first meeting). A special third party oral session is reserved for them only once, subsequent to the first meeting with the main parties. In that context, the effect of Article 10.3 is to limit third party rights to receive only the parties' first written submissions (submitted to the first meeting); not the parties' written rebuttals (presented to the second meeting).
>
> A panel under Article 21.5 has to follow DSU panel procedures. But it is obliged to do so in a different context, namely in the context of a much stricter timeframe. As a result, this Panel decided to hold only one meeting; not two as is usually the case. The practice of obtaining from the parties two sets of documentation in the form of first written submissions and written rebuttals (both, however, before the single meeting of the Panel) was maintained. In this context, the Panel is of the view that, in order to give effect to Article 10.3, Article 10.3 has to be interpreted as limiting third party rights to the first written submissions only; not including the written rebuttals. The drafters of the DSU restricted third party rights. It is not the task of this Panel to extend them in Article 21.5 procedures.[227]

237. In the view of the United States, the reasoning of these prior panels is sound, and should be followed by this Panel. Thus, the Panel should find that third parties do not have a right to the rebuttal submissions of the parties in this proceeding.[228]

238. Having said that, the United States notes that, with the exception of business confidential information, it routinely makes its submissions to WTO panels available to the public by placing its submissions on the Internet Web page of the Office of the US Trade Representative. Thus, as a practical matter, third parties (along with the rest of the world) will have access to the US rebuttal submission. Nothing prevents the EC from providing its rebuttal submission to the third parties in this proceeding (or for that matter, to the citizens of EC member states).

VI. CONCLUSION

239. For the forgoing reasons, the United States requests that the Panel find as follows:

(a) The Act's exclusion of extraterritorial income from US taxation does not constitute a prohibited subsidy contingent upon export performance within the meaning of Article 3.1(a) of the SCM Agreement.

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[227] *United States - Anti-Dumping Duty on Dynamic Random Access Memory Semiconductors (DRAMs) of One Megabit or Above from Korea - Recourse by Korea to Article 21.5 of the DSU*, WT/DS99, Decision of the Panel Concerning the EC Request for Access to the Parties' Rebuttal Submissions, 27 June 2000 (footnotes omitted).

[228] The United States notes further that none of the third parties that have expressed an interest in this proceeding have requested expanded third party rights.

(b) The Act's exclusion of extraterritorial income from US taxation does not constitute a prohibited subsidy contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the SCM Agreement.

(c) The Act does not result in less favourable treatment being provided to imported goods in comparison to the treatment afforded to like domestic goods within the meaning of Article III:4 of GATT 1994.

(d) The Act's exclusion of extraterritorial income from US taxation is not inconsistent with US obligations under Articles 10.1 and 8, or Article 3.3 and 8, of the Agreement on Agriculture.

(e) The United States complied with the DSB's recommendations and rulings in the *FSC* dispute.

(f) The third parties in this proceeding do not have a right to the parties' rebuttal submissions.

EXHIBIT LIST

FSC Repeal and Extraterritorial Income Exclusion Act of 2000	US-1
U.S. Senate Report on the FSC Repeal and Extraterritorial Income Exclusion Act	US-2
U.S. House of Representatives Report on the FSC Repeal and Extraterritorial Income Exclusion Act	US-3
United States Internal Revenue Code	US-4
EC Second Written Submission to the FSC Panel	US-5
James E. Maule, *Gross Income: Overview and Conceptual Aspects*, 501-2d *Tax Management (BNA),* pages A-1 through A-4	US-6
OECD Model Tax Convention on Income and Capital	US-7
Kirk J. Stark, *The Elusive Transition to a Tax Transition Policy*, 13 Amer. J. Tax Policy 145 (1996), pages 145 - 149	US-8

ANNEX B
Third Party Submissions

ANNEX B-1

THIRD PARTY SUBMISSION BY AUSTRALIA

(14 February 2001)

Overview

1. Australia welcomes the opportunity to submit a third party submission for the Article 21.5 panel's examination on "United States – Tax Treatment for Foreign Sales Corporations (FSC)". As a medium size exporting country, Australia derives significant benefits from the rules-based framework of the WTO Agreements. The provision by the United States of prohibited export subsidies has a direct impact on the competitive trading opportunities of Australian exporters in all markets.

2. It is Australia's view that the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000", as enacted by the United States on 15 November 2000, remains WTO-inconsistent.

3. The FSC replacement measure provides a subsidy contingent upon export performance or the use of domestic over imported goods within the meaning of Article 3.1 of the Agreement on Subsidies and Countervailing Measures (the SCM Agreement). Moreover, the original FSC subsidies will continue to be provided until 1 January 2002. Australia will confine its comments to specific legal issues under the SCM Agreement.

The FSC Replacement Measure

4. As a general rule, the United States asserts the right to tax all income earned worldwide by its citizens and residents. The FSC measure provided certain tax exemptions to "foreign sales corporations" connected with the sale or lease of goods produced in the United States for export. This was found to be a prohibited export subsidy under Section 3.1(a) of the SCM Agreement, and under Articles 10.1 and 8 of the Agreement on Agriculture.

5. The "FSC Repeal and Extra-territorial Income Exclusion Act" (HR 4986) amended the Internal Revenue Code by repealing the FSC provisions and by exempting "extraterritorial income" from gross income on which tax liability is calculated. Extraterritorial income is defined as gross income attributable to "foreign trading gross receipts".[1]

[1] Section 114(a), (b) and (e) of the IRC, as amended by HR 4986.

6. "Foreign trading gross receipts" includes gross receipts from sale, exchange, lease or rental of "qualifying foreign trade property", and related and subsidiary services.[2] It does not include receipts from transactions where the qualifying foreign trade property or services are for ultimate use in the United States.[3]

7. "Qualifying foreign trade property" is defined as property:

(A) manufactured, produced, grown, or extracted within or outside the United States,

(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and

(C) not more than 50 per cent of the fair market value of which is attributable to:

(i) articles manufactured, produced, grown or extracted outside the United States, and

(ii) direct costs for labor performed outside the United States.[4]

8. Property shall be treated as qualifying foreign trade property only if it is manufactured, produced, grown or extracted outside the United States by: a domestic corporation; a citizen or resident of the United States; a foreign corporation which has elected to be subject to United States taxation; or a partnership in which all the partners or owners fall within one of the first three categories.[5]

The United States Has Not Withdrawn the Original FSC Subsidies "Without Delay"

9. Section 59(c)(1)(A) provides a transition period for FSCs in existence on 30 September 2000 from the FSC legislation amendments. The amendments do not apply to transactions of such FSCs before 1 January 2002 and FSCs can continue to benefit from FSC taxation refunds until that date.

10. Australia recalls that the panel report, as modified by the Appellate Body, required the United States to withdraw the FSC subsidies by 1 October 2000. This period was extended by agreement between the United States and the EC until 1 November 2000.

11. Given that existing FSCs can continue – until 1 January 2002 - to benefit from the original FSC subsidies, the United States has not withdrawn the subsidies "without delay" and has not implemented the recommendations and rulings of the DSB.

The Replacement FSC Measure Constitutes a Prohibited Subsidy Under the SCM Agreement

12. The replacement FSC measure constitutes a prohibited subsidy "contingent ... upon export performance" under Article 3.1(a) of the SCM Agreement and "contingent ... upon the use of domestic over imported goods" under Article 3.1(b) of the SCM Agreement.

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2 Section 942(a)(1)(A) and (B) of the IRC, as amended by HR 4986.
3 Section 942(a)(2) of the IRC, as amended by HR 4986.
4 Section 943(a)(1) of the IRC, as amended by HR 4986.
5 Section 943(a)(2) of the IRC, as amended by HR 4986.

13. Article 1.1(a)(1)(ii) of the SCM Agreement deems a subsidy to exist where government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits). The term "otherwise due" implies a comparison between the revenues due under the contested measure and revenues that would be due in some other situation. As stated by the panel and Appellate Body in the examination of the original FSC measure, the basis of comparison is the tax rules applied by the United States.[6]

14. Under the new regime, "foreign trading gross receipts" is excluded from gross income on which tax liability is calculated. The effect of the exclusion is to reduce the tax liability of the beneficiary corporation. This represents a departure from the rules of taxation that would "otherwise" apply to such gross income. Accordingly, government revenue otherwise due is foregone or not collected within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement. A benefit is also conferred under Article 1.1(b) in the form of a reduction in tax liability.

15. The subsidy is a prohibited subsidy within the meaning of Article 3.1 of the SCM Agreement. The tax exemption applies in relation to "qualifying foreign trade property". This is property manufactured, produced, grown or extracted within or outside the United States and which satisfies two requirements:

(1) it must be held primarily for sale, lease or rental for – in the ordinary course of business - direct use, consumption, or disposition *outside the United States*; and

(2) *at least 50 per cent* of its fair market value is attributable to articles manufactured, produced, grown or extracted in the United States, and the direct costs for labour performed in the United States.

16. Two conclusions can be drawn from this. Firstly, for property manufactured, produced, grown or extracted *within* the United States to qualify for the tax exemption, it must be transacted for direct use, consumption or disposition *outside the United States*. The subsidy is therefore "contingent, in law or in fact ... upon export performance" within the meaning of Article 3.1(a) of the SCM Agreement. This is further reinforced by Section 942(a)(2) of the IRC which excludes from "foreign trading gross receipts" qualifying foreign trade property or services for ultimate use in the United States.

17. Australia emphasizes it is not arguing the measure to be an export subsidy simply because it is provided to corporations that produce within the United States for sale, lease or rental outside the United States. Footnote 4 provides that the mere fact that a subsidy is granted to enterprises which export shall not, for that reason alone, be considered to be an export subsidy. However in the present case, the tax exemption to corporations that produce within the United States is *conditioned* on the sale, lease or rental of products for direct use, consumption or disposition *outside* the United States.

18. The measure is also "contingent, in law or in fact ... upon export performance" in relation to property manufactured, produced, grown or extracted *outside* the United States. For such property to qualify for the tax exemption, at least 50 per cent of its fair market value must be attributable to United States content and United States direct labour costs. This necessarily requires the *export* of United States prod-

[6] WT/DS108/AB/R, para. 90; WT/DS108/R, para. 7.42.

uct for the foreign producer to meet the 50 per cent United States content requirement.

19. Secondly, the subsidy is "contingent ... upon the use of domestic over imported goods" within the meaning of Article 3.1(b) of the SCM Agreement. For property to constitute "qualifying trade property" for which the tax exemption applies, at least 50 per cent of its fair market value must be attributable to articles manufactured, produced, grown or extracted *within the United States*, and direct costs for labour performed *within the United States*. Given the tax exemption only arises on the meeting of a 50 per cent local content requirement, it is contingent upon the use of domestic over imported goods.

It is Not a Measure To Avoid Double Taxation of Foreign-Source Income

20. Footnote 59 of the SCM Agreement provides that paragraph (e) of the Illustrative List of Export Subsidies is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

21. The FSC replacement measure cannot be justified as a measure "to avoid double taxation of foreign-source income". Firstly, the general United States tax rules already provide income tax credits to minimize double taxation. Sections 27(a) and 901 of the IRC provides tax credits to United States citizens and domestic corporations for taxes imposed by foreign countries and possessions of the United States. The United States has also entered into agreements with other countries to avoid double taxation of income. For example, Article 22(1)(a) of the 1983 Australia-United States double tax agreement obliges the United States to provide tax credits to United States residents or citizens for income tax paid to Australia.

22. Secondly, the tax exemptions provided by the proposed measure are not calculated on, or limited to, the amount of foreign tax paid on "extraterritorial income". It is calculated on receipts from the sale, exchange, lease or rental of "qualifying foreign trade property".

Conclusion

23. The FSC replacement measure provides prohibited subsidies within the meaning of Article 3.1 of the SCM Agreement. The measure constitutes a subsidy by providing tax exemptions which forego government revenue otherwise due. The subsidy is "contingent ... upon export performance" by being conditioned on the sale, lease or rental of products for direct use, consumption or disposition *outside* the United States. It is also "contingent ... upon the use of domestic over imported goods" by being conditioned on a 50 per cent United States content requirement. Accordingly, the United States has also breached Article 3.2 of the SCM Agreement.

24. In making this submission, Australia is not disputing the United States' right to maintain a worldwide taxation system as opposed to a territorial taxation system. However, Australia recalls the Appellate Body's statement in the original dispute that: "A Member of the WTO may choose any kind of tax system it wishes – so long as, in so choosing, that Member applies that system in a way that is consistent with its WTO obligations".

ANNEX B-2

THIRD PARTY SUBMISSION BY CANADA

(14 February 2001)

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I. EXECUTIVE SUMMARY

1. Canada's agrees with the European Communities that the United States has failed to bring its measures into compliance with the recommendations and rulings of the Dispute Settlement Body, and that the United States continues, through the *FSC Repeal and Extraterritorial Exclusion Act of 2000* (FSC Replacement scheme) to provide subsidies which are contingent upon export performance within the meaning of Article 3.1(a) of the *Agreement on Subsidies and Countervailing Duty Measures*. (*SCM Agreement*).

2. Canada only makes submissions with respect to Article 3.1(a) of the *SCM Agreement* and does not address the arguments raised by the European Communities under Article 3.1(b) of the *SCM Agreement*, Articles 8 and 10.1 of the *Agreement on Agriculture* and Article III:4 of the *General Agreement on Tariffs and Trade 1994*.

3. In Canada's view, the United States, through the FSC Replacement scheme, continues to provide both a financial contribution, in the form of government revenue foregone otherwise due, and a benefit to US-based enterprises by excluding from taxation income that they earn on exports from the United States. Accordingly, there still exists a "subsidy" under Article 1.1 of the *SCM Agreement*.

4. Canada argues that the "subsidy" is contingent upon export performance and, therefore, prohibited under Article 3.1(a) of the *SCM Agreement* as in order to benefit from the "subsidy", US-based enterprises must not sell their goods "for ultimate use in the United States." Canada agrees with the European Communities that these words are simply "another way of saying that they must be exported".

5. Finally, Canada argues that the fact that the FSC Replacement scheme is available to foreign manufacturers on the sale of foreign goods is irrelevant to the determination of whether the "subsidy" provided to US-based enterprises on the income earned from export transactions is contingent upon export performance.

II. INTRODUCTION

6. Canada is appreciative of the opportunity to participate in this proceeding under Article 21.5 of the Understanding on Rules and Procedures for the Settlement of Disputes.[1]

7. Canada participated in previous proceedings before the Panel and the Appellate Body.[2]

III. BACKGROUND

A. Findings of the Panel and Appellate Body

8. On 24 February 2000, the Appellate Body upheld the Panel's finding that various exemptions for certain types of income under the US Internal Revenue Code earned by foreign sales corporations (the FSC measure or FSC scheme), taken together, constituted a prohibited export subsidy under Article 3.1(a) of the *Agreement on Subsidies and Countervailing Measures (SCM Agreement)*.

9. More particularly, the Appellate Body agreed with the Panel that having decided to tax foreign-source income, the United States could not exclude certain types of this income from taxation without foregoing government revenue that would otherwise be due, and, therefore, without providing a financial contribution under Article 1.1(a)(ii) of the *SCM Agreement*. Having also agreed with the Panel that the FSC measure provided a "benefit" to the recipients of the exemption, the Appellate Body agreed that the FSC measure represented a "subsidy" within the meaning of Article

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[1] Although the European Communities raises several arguments in this 21.5 proceeding, Canada only makes submissions with respect to one of these arguments, i.e. the argument that the United States, through the *FSC Repeal and Extraterritorial Income Exclusion Act of 2000*, continues to provide prohibited export subsidies inconsistent with Article 3.1(a) of the *Agreement on Subsidies and Countervailing Duty Measures*.

[2] *United States – Tax Treatment for "Foreign Sales Corporations"*, Reports of the Panel (WT/DS 108/R, 8 October 1999DSR 2000:IV, 1675) (Complaint by the European Communities) and of the Appellate Body (AB-1999-9, WT/DS 108/AB/R, 24 February 2000, DSR 2000:III, 1619) (Appeal by the United States) adopted by the Dispute Settlement Body on 20 March 2000.

1.1 of the *SCM Agreement*. Finally, the Appellate Body upheld the Panel's finding that the "subsidy" was contingent upon export performance and, therefore, prohibited under Article 3.1(a) of the *SCM Agreement*.[3]

10. The Appellate Body recommended that the Dispute Settlement Body (DSB) request the United States to bring the FSC measure into conformity with its WTO obligations[4] .

11. The Appellate Body emphasized that its ruling was in no way a judgment on the consistency or the inconsistency of the relative merits of the tax system chosen by the United States. The Appellate Body held that:

> [a] Member of the WTO may chose any kind of tax system it wishes, so long as, in so choosing, that Member applies that system in a way that is consistent with its WTO obligations. Whatever kind of tax system a Member chooses, that Member will not be in compliance with its WTO obligations if it provides, through its tax system, subsidies contingent upon export performance that are not permitted under the covered agreements.[5]

12. The findings and conclusions of the Appellate Body were adopted by the DSB on 20 March 2000.[6]

B. Measures Taken by the United States

13. In order to comply with the recommendations and rulings of the DSB, the United States adopted the *FSC Repeal and Extraterritorial Income Exclusion Act of 2000*[7] on 15 November 2000.

14. According to the United States, the new taxing rules contained in the FSC Replacement scheme are consistent with US obligations under the WTO. The United States argues that the new legislation does not confer a "subsidy", rendering moot the issue of "export contingency". Nonetheless, the United States argues that in the event the Panel finds that there still exists a subsidy, it is not prohibited under Article 3.1(a) of the *SCM Agreement*, as it does not limit the income that is excluded from US taxing authority to export income. The United States also argues that the FSC Replacement scheme is meant to achieve some level of tax parity with European territorial tax systems in a WTO-consistent manner.

15. More specifically, the United States argues that by adopting the FSC Replacement scheme, it has withdrawn the export subsidy at issue, as the provisions relating to taxation of foreign sales corporations have been repealed.

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[3] Report of the Appellate Body, *Ibid*. paras. 90 to 121.The Appellate Body also upheld the Panel's finding that the United States acted inconsistently with its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture* by applying export subsidies, through the FSC measure, in a manner which resulted in, or which threatened to lead to, circumvention of its export subsidy commitments with respect to both scheduled and unscheduled agricultural products. Furthermore, having upheld the Panel's findings under Article 3.1(a) of the *SCM Agreement*, the Appellate Body did not rule on the European Communities conditional appeal under Article 3.1(b) of the *SCM Agreement.*

[4] Report of the Appellate Body, *Ibid*. DSR 2000:III, 1619, para. 178.

[5] Report of the Appellate Body, *Ibid*. DSR 2000:III, 1619, para. 179.

[6] Doc. WT/DS 108/10, 24 March 2000.

[7] US Public Law No. 106-519; Similar to the EC, Canada refers to the *FSC Repeal and Extraterritorial Income Exclusion Act* as the FSC Replacement scheme when we refer to the measure as a whole and as the FSC Replacement Act when we refer to particular sections.

16. Relying on the finding of the Appellate Body that a WTO Member has the sovereign right not to tax certain categories of income, the United States argues that the FSC Replacement scheme is WTO consistent as it creates a general rule exempting "extraterritorial income" from the definition of "gross income" in the Internal Revenue Code. According to the United States, the fact that this exclusion does not apply to all categories of "extraterritorial income" does not render the measure WTO inconsistent, as the exclusion is from a general rule of non-taxation rather than taxation. The United States argues that, as a sovereign nation, it is free not to tax certain categories of "extraterritorial income" and that the WTO does not compel Members to adopt pure territorial tax regimes.

17. The Unites States argues that the measure is not contingent upon export performance as the exclusion applies to qualifying income, whether it is earned in the United States or abroad, a substantially broader category of income than that which was exempted from tax under the FSC measure.

IV. ISSUE AND CANADA'S POSITION BEFORE THIS PANEL

18. The issue before this Panel is whether the FSC Replacement scheme is consistent with the recommendations of the DSB to withdraw the FSC measure found to be a prohibited export subsidy inconsistent with Article 3.1(a) of the *SCM Agreement*.[8] In order to be found to have complied, the United States must have ceased providing prohibited export subsidies.[9]

19. As noted by the Appellate Body, the Panel's task is not to examine the merits of the tax system chosen by the United States. Rather, the Panel's task is limited to determining whether the measure put in place by the United States is consistent with its obligations under the WTO.

20. Canada agrees with the EC that the FSC Replacement scheme fails to bring the United States into compliance with the DSB recommendations and rulings and that the United States, through the FSC Replacement scheme, continues to provide subsidies which are contingent upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*.

V. LEGAL ANALYSIS

A. The FSC Replacement Scheme Provides a "Subsidy" to US-based Enterprises Earning "Domestic Income from Export Transactions" Within the Meaning of Article 1.1 of the SCM Agreement

21. The definition of "subsidy" under Article 1.1 of the SCM Agreement consists of two discrete elements: (1) a financial contribution by a government or any public body; and (2) a benefit is thereby conferred.[10] Both of these elements must be present

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[8] Canada does not address arguments raised by the EC under Article 3.1(b) of the *SCM Agreement*, Articles 10.1 and 8 of the *Agreement on Agriculture*, and Article III:4 of the *General Agreement on Tariffs and Trade 1994*.

[9] *Canada – Measures Affecting the Export of Civilian Aircraft, Recourse by Brazil to Article 21.5 of the DSU*, Report of the Panel (WT/DS70/RW, 9 May 2000, DSR 2000:IX, 4315), para. 5.63.

[10] *Canada – Measures Affecting the Export of Civilian Aircraft*, Report of the Appellate Body (AB-1999-2, WT/DS70/AB/R, 2 August 1999, DSR 1999:III, 1377), para. 156.

in order for there to be a "subsidy" under Article 1.1 of the *SCM Agreement*, and, correspondingly, under Article 3.1 of that Agreement.

1. There is a "Financial Contribution" to US-based Enterprises Within the Meaning of Article 1.1(a)(ii) of the SCM Agreement

22. In Canada's view, the United States continues, through the FSC Replacement scheme, to provide a financial contribution to US-based enterprises by excluding from taxation domestic income that they earn from export transactions.

23. The Appellate Body stated the following regarding the meaning to be attributed to the words "foregoing" of government revenue "otherwise due":

> [i]n our view, the "*foregoing*" of revenue "*otherwise* due" implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, "otherwise". Moreover, the word "foregone" suggests that the government has given up an entitlement to raise revenue that it would "otherwise" have raised.[11]

24. The Appellate Body held that the decision as to whether the government has given up an entitlement to raise revenue that it would "otherwise" have raised implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. The Appellate Body agreed with the Panel that the basis for comparison must be the tax rules applied by the Member in question.[12]

25. As noted above, the Appellate Body ruled that a WTO Member has the sovereign authority to tax any particular categories of revenue it wishes, and that it is also free not to tax any particular categories of revenue. However, the Appellate Body ruled that, in both instances, the WTO Member must respect its WTO obligations. The Appellate Body held that what is "otherwise due" depends on the rules of taxation that each Member, by its own choice, establishes for itself.[13]

26. The Appellate Body held that the "but for" test established by the Panel, that is, "the situation that would prevail but for the measure in question", provided "a sound basis for comparison" in the case of the FSC scheme, because it was "not difficult to establish in what way the foreign-source income would be taxed "but for" the contested measure". The Appellate Body stated that it had "certain abiding reservations about applying any legal standard, such as this "but for" test, in the place of the actual treaty language", and "particular misgivings about using a "but for" test if its application were limited to situations where there actually existed an alternative measure, under which the revenues in question would be taxed, absent the contested measure." The Appellate Body believed that it would "not be difficult to circumvent such a test by designing a tax regime under which there would be no general rule that applied formally to the revenues in question, absent the contested measure." The Appellate Body, therefore, observed that, although the Panel's "but for" test worked in the case of the FSC scheme, that it might not work in other cases.[14]

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[11] Report of the Appellate Body, *supra*, note 1, para. 90.
[12] *Ibid*.
[13] *Ibid*.
[14] Report of the Appellate Body, *supra* note 1, para. 91.

27. It appears that the United States has relied on this "but for" test in implementing the recommendations and rulings of the DSB. Essentially, the United States' position is that it has brought its measures into conformity with its WTO obligations by reversing the situation under its tax rules from one of having decided to tax a particular category of income and then excluding part of that income from taxation to one of having decided to exclude from taxation a category of income which includes the previously excluded income. In the view of the United States, since there is no general rule that formally applies to tax the revenues in question, there can be no foregoing of government revenue, as absent the contested measure, there would be no tax due.

28. The United States appears to have designed the precise type of tax regime the Appellate Body believed a Member could design in order to circumvent the "but for" test. Canada, therefore, submits that the analysis conducted by the Panel does not work in this case to determine whether the government has given up an entitlement to raise revenue that it would "otherwise" have raised. The exclusion of "extraterritorial income" from the definition of "gross income" in section 114(a) of the *FSC Replacement Act*[15] is, therefore, not determinative of the issue of whether the government has foregone revenue otherwise due.

29. In Canada's view, the finding of the Appellate Body clearly stands for the proposition that, absent a rule formally taxing the revenues in question, a more complete analysis of domestic tax rules must be conducted in order to determine what situation would apply to the revenues in question absent the contested measure. Canada submits that such an analysis of US tax rules in this case reveals that income earned by US-based enterprises on export transactions, which is part of the income excluded from taxation under the definition of "extraterritorial income", would otherwise be subject to tax, absent the FSC Replacement scheme.

30. It is clear that although the FSC Replacement scheme excludes "extraterritorial income" from the definition of "gross income", that the "true exclusion" from taxation under this scheme is only for "qualifying foreign trade income".[16] Accordingly, only certain categories of "extraterritorial income" are excluded from tax.[17]

31. The definition of "qualifying foreign trade income" in the *FSC Replacement Act* encompasses two very different types of income that must be clearly distinguished for purposes of the analysis. On the one hand, it includes income earned from export transactions by US-based enterprises, that is, transactions entered into by an enterprise located in the United States entailing the shipments of goods from the territory of the United States to the territory of another country. The definition of "qualifying foreign trade income" also includes foreign-source income earned by

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[15] Section 114(a) of the *FSC Replacement Act* provides as follows:

EXCLUSION.— Gross income does not include extraterritorial income

[16] Section 114(b) of the *FSC Replacement Act*, which, in Canada's view, is the critical section in the Act provides as follows:

EXCEPTION.— Subsection (a) shall not apply to extraterritorial income which is not qualifying foreign trade income as determined under subpart E of part III of subchapter N.

[17] The highly selective application of the income exclusion under the scheme is achieved by imposing conditions and providing elections to taxpayers in order for them to maximize the amount of the exclusion to fit their specific circumstances. Canada therefore agrees with the EC that "the FSC Replacement Act does not *qualitatively* define a *class* or *category of income* that is excluded from the tax base – it lays down *conditions* for the partial non-taxation of income that would otherwise be taxed" (First Submission of the European Communities, para. 57.

enterprises (through a branch of a US corporation, a subsidiary of a US corporation or other entities otherwise eligible under the scheme) located outside the United States, that is, entailing the sales of goods from a territory other than that of the United States.

32. Canada agrees with the EC that income earned from export transactions under the FSC Replacement scheme "corresponds arithmetically to the exempt foreign source income of the FSC scheme". [18] Canada submits that the United States continues to provide subsidies to US-based enterprises earning this type of income.

33. The United States has argued that the exclusion of "extraterritorial income" from the definition of "gross income " is a measure to avoid double taxation of foreign source income, and, therefore, the income covered under this exclusion would normally not be subject to domestic tax. Canada agrees that the "foreign income" component of "extraterritorial income" is the type of income typically subject to a measure designed to avoid double taxation. However, in Canada's view, the United States has added this new category of income to the measure in question in an attempt to confuse the domestic tax situation that would otherwise apply to the "domestic export income" component of "extraterritorial income".[19]

34. In Canada's view, income earned from export transactions is income that would generally be taxable only in the United States, since it is sourced in the United States, that is, it arises from economic activities taking place in the United States. The fact that the proceeds of sales are from foreign sources does not transform the export income into "foreign income" for tax purposes. Exporting goods in a foreign country does not create a sufficient nexus to trigger taxation in the importing country, even when one takes into account the "foreign economic processes" required under the FSC Replacement scheme.[20] Canada submits that such processes do not create a taxable presence abroad, and, therefore, would not be considered foreign business income subject to double taxation. Therefore, no double taxation needs to be relieved with respect to this component of "extraterritorial" income.[21]

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[18] First Written Submission of the European Communities, para. 35.

[19] It must be noted that the FSC Replacement scheme does not purport to replace the foreign tax credit as the means by which double taxation of foreign income earned by US taxpayers is relieved. The foreign tax credit provisions of the US Internal Revenue Code have not been repealed by the *FSC Replacement Act* and still provide the basic approach used by the United States to relieve double taxation with respect to income subject to tax in other countries. If, as the United States allege, the exclusion of "extraterritorial" income is a measure to avoid double taxation, then it cannot, at the same time, be argued that the exclusion constitutes "a defined normative benchmark for taxing income earned on foreign transactions", since there cannot be two benchmarks. Canada submits that the US taxation of foreign income subject to a foreign tax credit remains the true benchmark despite the enactment of the *FSC Replacement Act*, and that the latter cannot be regarded as a "new" benchmark for the taxation of foreign income in the United States.

[20] These "foreign economic processes" may consist of one or more of the following five categories: (1) advertising and sales promotion; (2) processing of customer orders and arranging for delivery; (3) transportation outside the United States in connection with delivery to the customer; (4) billing activities; and (5) the assumption of credit risks.

[21] This is certainly the case under US tax treaties that adopt the approach of the *Model Tax Convention on Income and on Capital* (OECD Committee on Fiscal Affairs, Paris), under which the need for double tax relief with respect to income derived from sales made in a foreign country does not arise unless the sales activities occur through a fixed based that the taxpayer maintains in that foreign country, thereby ruling out the possibility that such relief may be granted to "domestic export income". Under Article 7 of the OECD Model Tax Convention "a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a per-

35. In Canada's view, since income earned from export transactions cannot by definition face double taxation, the exclusion from taxation provided for this income under the FSC Replacement scheme can only reduce US tax otherwise payable.

36. Canada therefore submits that the revenue or tax that would otherwise be due on "income earned from export transactions", which is part of the income excluded from taxation under the FSC Replacement scheme, would be the tax applicable to such income under US taxation rules. Thus, the US Government is providing a financial contribution to US-based enterprises earning this type of income by foregoing revenue that would otherwise be due in the sense of Article 1.1(a)(ii) of the *SCM Agreement*.

2. *The "Financial Contribution" Confers a "Benefit" to US-based Enterprises Earning "Domestic Income from Export Transactions"*

37. The Panel held as follows regarding the issue of "benefit":

> Having found that the various tax exemptions under the FSC scheme give rise to a financial contribution, our next task is to consider whether a benefit is thereby conferred. In our view, the financial contribution clearly confers a benefit, in as much as both the FSCs and their parents need not pay certain taxes that would otherwise be due. Further, that benefit can be quite substantial; according to the US Department of Commerce, "the tax exemption can be as great as 15 to 30 per cent on gross income from exporting.[22]

38. The Appellate Body upheld the Panel's finding on this issue. Canada submits that this reasoning is equally applicable to the FSC Replacement scheme, as it applies to US-based enterprises by exempting from taxation the domestic income they earn on export transactions.

39. Accordingly, Canada submits that there still exists a "subsidy" within the meaning of Article 1.1 of the *SCM Agreement*, as the two elements of a "subsidy" continue to be present, i.e. a "financial contribution" and a "benefit".

B. *The Subsidy Provided Under the FSC Replacement Scheme to US-based Enterprises is Prohibited Under Article 3.1(a) of the* SCM Agreement*, as it is "Contingent Upon Export Performance"*

40. Canada submits that the "subsidy" provided to US-based enterprises is clearly "contingent upon export performance", as in order to benefit from the "subsidy", goods must not be sold "for ultimate use in the United States."[23] Canada agrees with the EC that this is simply "another way of saying that they must be exported"[24], and that these words are sufficient to make the subsidy *de jure* export contingent. As

manent establishment situated therein." Article 5 defines a permanent establishment as being "a fixed place of business, through which the business of an enterprise is wholly or partly carried on." In this definition, "place of business" means facility such as premises or, in certain instances, machinery or equipment.

[22] Report of the Panel, *supra*, note 1, para. 7.10.

[23] *FSC Replacement Act*, section 942(a)(2)(A)(i).

[24] First Submission of the European Communities, *supra* note 1, para. 71.

stated by the Appellate Body in *Canada – Certain Measures Affecting the Automotive Industry*[25]:

> a subsidy is ... properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfilment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.[26]

41. In Canada's view, the fact that the FSC Replacement scheme is available to foreign manufacturers is irrelevant to the determination of whether the "subsidy" provided to US-based enterprises on the income earned from export transactions is contingent on export performance.

42. It is clear that, under the FSC Replacement scheme, a US-based enterprise must export in order to qualify for the exclusion from tax. Whether, in addition to US-based enterprises, a foreign entity may qualify or not for the scheme does not modify the requirement imposed on US-based enterprises and the fact that it explicitly discriminates amongst US-based enterprises on the basis of export performance.

43. As indicated earlier, the FSC Replacement scheme, when applied to income earned from exports of domestic goods of US-based enterprises, results in the permanent reduction of US taxes otherwise payable, in particular as compared to taxes payable on equivalent domestic sales of US-based enterprises. The export-contingent nature of the scheme leaves no doubt that the only way that income derived from the sale of a domestic good can qualify under the scheme is if the good is exported.

44. Canada submits that this export-contingent nature of the scheme cannot be eliminated or otherwise mitigated by the fact that the scheme applies to goods sold by a foreign branch or a foreign corporation subject to US taxation. Discrimination among sales of US domestic goods on the basis of export performance is not ameliorated by the imposition of a similar discrimination with respect to sales of goods by foreign entities. In Canada's view, the only way that the scheme could be non-export-contingent is if it conferred benefits to the sales of US domestic goods that are not exported. Such is not the case under the FSC Replacement scheme. Canada agrees with the EC that the proper basis of comparison must necessarily be with the tax treatment of domestic sales of domestic goods.[27]

45. In Canada's view, the Reports of the Panel and of the Appellate Body in *Canada – Measures Affecting the Export of Civilian Aircraft*[28] provide clear support for Canada and the EC's position in this case.

46. In *Canada – Aircraft*, Canada argued that a "subsidy" provided through Technology Partnerships Canada (TPC) was not contingent upon export performance as TPC provided support to a broad base of sectors and technologies that touched on

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[25] WT/DS139/AB/R, WT/DS142/AB/R, Report of the Appellate Body adopted 19 June 2000, DSR 2000:VI, 2985.

[26] *Ibid*. para. 100.

[27] First Submission of the European Communities, *supra* note 1, para. 71.

[28] Report of the Panel, WT/DS70/R, 14 April 1999, DSR 1999:IV, 1443; Report of the Appellate Body, *supra* note 9.

virtually all industrial sectors of Canada. According to Canada, the fact that some of the contributions provided under the programme were made to companies that were involved in exports did not make the program export contingent. The Panel rejected Canada's arguments and found that the "subsidy" was contingent upon export performance.

47. Canada appealed the finding of the Panel. One of the issues raised by Canada on appeal was the fact that the Panel had given "no indication that ... the operation of the TPC programme as a whole" had been considered. The Appellate Body rejected this argument and ruled as follows:

> the fact that some of the TPC's contributions, in some industry sectors, are *not* contingent upon export performance, does not necessarily mean that the same is true for all of TPC's contributions. It is enough to show that one or some of TPC's contributions do constitute subsidies "contingent ... in fact… upon export performance."[29]

48. Canada submits that this reasoning equally applies to the financial contribution or "subsidy" being provided to US-based enterprises on domestic income earned on export transactions. The fact that the exclusion provided to foreign source income may not be contingent on export performance does not mean that the same is true for income earned on export transactions. It is enough to show that part of the contribution under the FSC Replacement scheme is export contingent.

49. Canada therefore submits that the United States continues to provide prohibited export subsidies inconsistent with Article 3.1(a) of the *SCM Agreement*.

VI. CONCLUSION

50. Accordingly, Canada respectfully requests that the Panel find that the United States has not complied with the recommendations and rulings of the DSB and that the United States continues to provide prohibited export subsidies under the FSC Replacement scheme inconsistent with Articles 3.1(a) of the *SCM Agreement*.

[29] Report of the Appellate Body, *Ibid*. para. 179.

ANNEX C

Second Submissions by the Parties

ANNEX C-1

SECOND WRITTEN SUBMISSION OF THE EUROPEAN COMMUNITIES

(27 February 2001)

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1. INTRODUCTION

1. The EC respectfully submits to the Panel its second written submission in this case in rebuttal to the first written submission of the US.

2. The EC finds that the US submission does not respond to a number of the arguments contained in the first written submission of the EC. The EC will therefore commence this submission (Section 2 below) by recalling the arguments to which the US has not responded, as this may assist the Panel in identifying what is not contested.

3. Another feature of the first written submission of the US is that it provides little in the way of concrete information in response to that furnished by the EC but instead contains a number of misleading statements. The EC will comment on the US presentation of the facts in Section 3 below in order to clarify these issues for the Panel.

4. The legal arguments of the US are rebutted in Section 4 below. This section commences with a discussion of the questions of the burden and standard of proof to

be applied in Article 21.5 *DSU* proceedings and its consequences for the present proceedings. It will continue with a discussion of the legal issues in the following order:

- Arguments relating to the existence of a subsidy;
- Arguments relating to export contingency;
- Arguments relating to the requirement to use US over foreign articles;
- The double taxation defence;
- Arguments relating to Article III:4 *GATT 1994;*
- Arguments concerning the transitional period;
- Arguments concerning the failure of the US to implement the rulings and recommendations of the DSB by 1 November 2000.

5. Finally, the EC will summaries its conclusions (Section 5).

6. The EC notes that the third parties who have submitted comments agree with the EC position. The EC will comment on these submissions as required during the discussion of the arguments.

2. THE EC ARGUMENTS THAT REMAIN UNADDRESSED

7. The US has failed to address a number of claims and arguments made by the EC in its first written submission. The EC wishes to draw the attention of the Panel to the following unanswered claims and arguments.

2.1. The EC's basic argument concerning export contingency and illustrations

8. In paragraphs 77 to 79 of the EC's first written submission, the EC explained that one basic error of the US was to consider that extending a tax exemption (or exclusion) to other categories of income than that earned by selling US goods could prevent it being contingent upon export in those situation where export is a necessary condition for obtaining the tax exemption. More generally, a subsidy that is export contingent in *some situations* does not cease to be so if it can also be obtained in *other situations* which may not require export.

9. In other words, it should not be possible for the US to hide, what is essentially the same subsidy as that before the Panel in the original proceeding, within a slightly wider subsidy by adding to the basic FSC Replacement subsidy what the EC has called the extended FSC Replacement subsidy.[1]

10. The simple fact that tax-free income – or even income that is given the name "extraterritorial" or "excluded" – can be earned without exporting in some situations cannot suffice to prevent an export subsidy from being present if such income can be earned in other situations only by exporting. Otherwise, it would have been sufficient for the US to include in the FSC scheme any other category of income which is already exempted, or which it is thought desirable to exempt from tax to bring itself into 'compliance'.

[1] For an identification and explanation of the two subsidies see first written submission of the EC, paragraphs 62 to 66.

11. The EC does not consider that the US has replied to these arguments.[2]

12. The EC developed its position by arguing that in order to assess whether a subsidy is contingent upon export or specifically related to export it is necessary to compare like with like – or, as the EC put it, there must be a comparison with some relevant benchmark.

13. The EC illustrated its point as follows:[3] suppose a subsidy programme is available to all goods produced in a certain region of a WTO Member's territory, but only available to goods produced outside that region if exported from that WTO Member's territory. It is true that it is not in all circumstances necessary to export to obtain the subsidy, since goods from the eligible region can benefit if sold domestically. But goods from outside the eligible region can only qualify for the subsidy when exported. There are no "alternative" conditions in this case - the subsidy is export contingent. The same situation arises with the FSC Replacement scheme. Although there may be cases of production outside the US that may benefit in the absence of export, goods produced in the US can only obtain the benefit in one way – if exported. In these circumstances, the subsidy is export contingent.

14. It is true that where a subsidy is made available, for example, to all producers of shoes, some producers may in fact qualify by producing shoes which they export, but this does not make the subsidy export contingent. Each producer is free to sell on the domestic market or to export and this does not affect entitlement to the subsidy. However, in the case of the FSC Replacement scheme, the situation is different. Owners of US goods produced in the US do not have a choice in how to obtain the subsidy. They cannot, unlike the shoe manufacturers in the above example, satisfy the conditions by selling domestically. They have to export. Thus they obtain the subsidy by performing one function, export, in preference to another, selling on the domestic market.

15. The EC also pointed out that the situation of the FSC Replacement Act is in this respect similar to the export subsidy found by the panel and Appellate Body in *Canada – Aircraft*.[4] One of the subsidies involved in that case, the Technology Partnerships Canada programme, was available to non-export sectors such as environmental technologies and "enabling technologies."[5] The fact that the subsidy was available in some situations without any export contingency did not stop the payments under the programme to the regional aircraft industry being found export contingent.

16. Again, the EC finds no answer to these arguments in the first written submission of the US.

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[2] The EC replies to the arguments that the US has made in Section 4.3 below.

[3] First written submission of the EC, paragraphs 123 to 127.

[4] Panel Report, *Canada – Measures Affecting the Export of Civilian Aircraft ("Canada – Aircraft")*, WT/DS70/R, adopted 20 August 1999, as upheld by the Appellate Body Report, WT/DS70/AB/R, DSR 1999:IV, 1443.

[5] See, e.g., Panel Report, *Canada – Aircraft,* , DSR 1999:IV, 1443, paragraph 6.174.

2.2. The EC argument that the extended FSC Replacement Subsidy is also contingent upon export performance and specifically related to exports

17. The US also fails to comment at all on the EC's further argument that adding the extended FSC Replacement subsidy to the basic FSC Replacement subsidy cannot, in any event, prevent the basic FSC Replacement subsidy from being export contingent because the extended FSC Replacement subsidy is itself also export contingent or specifically related to exports due to the existence of the foreign content limitation, which is equivalent in many cases to a US content requirement.[6]

18. It may be that the US considers that it has responded to this argument with its arguments relating to Article 3.1(b) of the *SCM Agreement* (that it does not consider that there is any requirement to use goods exported from the US).[7] In no way however does it respond to the argument that the extended FSC Replacement subsidy is *specifically related to exports* within the meaning of Item (e) of the Illustrative List.

2.3. The EC claim that the FSC Replacement scheme also provides subsidies under the Agreement on Agriculture and that these are contrary to Articles 10.1 and 8 of the Agreement on Agriculture

19. The US defence of the FSC Replacement scheme under the *Agreement on Agriculture* is limited to a reference back to its arguments under the *SCM Agreement* that the scheme does not give rise to export contingent subsidies.[8]

20. The US does not contest that if the FSC Replacement subsidies are contingent upon export performance for the purposes of the *SCM Agreement* for any reason, the FSC Replacement scheme will be inconsistent with Articles 10.1 and 8 of the *Agreement on Agriculture*. In particular, the US expressly confirms[9] that it does not argue that the FSC Replacement subsidies fall under any of the categories listed in Article 9.1 of the *Agreement on Agriculture*. In the light of the Report of the Appellate Body, the question of whether the FSC Replacement subsidies do fall under any of the categories listed in Article 9.1 of the *Agreement on Agriculture* may therefore be considered academic.

3. COMMENTS ON THE FACTUAL BACKGROUND

21. As mentioned above, there are a large number of incorrect and misleading statements in the US first written submission. The EC will comment on and correct the statements that it considers most relevant and important for a proper understanding of the case.

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[6] First written submission of the EC, paragraphs 104 to 120, 220-221 (and paragraphs 147 to 158 in connection with the term "specifically related to exports").

[7] First written submission of the US, footnote 102.

[8] First written submission of the US, paragraph 221.

[9] First written submission of the US, footnote 210.

3.1. The relationship between the FSC and FSC Replacement schemes

22. The US challenges[10] the EC's comment that the FSC Replacement scheme provides "essentially the same subsidy" as the FSC scheme. The EC made this comment when considering the subsidy from the point of view of US exporters and maintains that it is accurate. The attempt of the US to present the schemes as different deserves a number of comments here.

23. First, as the EC explained, in particular in paragraphs 35 to 37 of its first written submission, the FSC Replacement scheme provides arithmetically identical tax benefits to what was (and still is) available under the FSC scheme, but the availability had been facilitated and somewhat widened.

24. The US does not contest these facts. The EC notes that Canada also agrees with its arithmetic.[11]

25. Second, it is also clear from the transitional rules that the FSC Replacement scheme replaces the FSC.[12] The FSC Replacement Act does not apply to FSCs until 31 December 2001 and in some case may not ever apply to them. In fact, one scheme is phased in while the other is phased out. Also exporters can opt into the FSC Replacement scheme for individual transactions instead of using the FSC scheme.[13]

26. Third, the US statement in footnote 181 to its first written submission is wrong (or at least contradicts the stated intent of the US Congress) when it states, with reference to the foreign content limitation, that:

> This comparison, and any reference to the FSC rules, is irrelevant to the issues before this Panel.

The US Congress Joint Committee on Taxation made a statement to the contrary (taken up in the House and Senate Reports) in the following terms:

> Gap period before administrative guidance is issued
>
> The Committee recognizes that there may be a gap in time between the enactment of the bill and the issuance of detailed administrative guidance. It is intended that during this gap period before administrative guidance is issued, taxpayers and the Internal Revenue Service may apply the principles of present-law regulations and other administrative guidance under sections 921 through 927 to analogous concepts under the bill. Some examples of the application of the principles of present-law regulations to the bill are described below. These limited examples are intended to be merely illustrative and are not intended to imply any limitation regarding the application of the principles of other analogous rules or concepts under present law.

3.2. The FSC Replacement Act as a "fundamental change" to the US tax system

27. Central to the US argument that the FSC Replacement scheme cannot give rise to any subsidies at all are the contentions that the FSC Replacement Act is the

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[10] First written submission of the US, paragraph 47 *et seq.*

[11] Written Observations of Canada, paragraph 32.

[12] The transitional rules are in section 5 of the FSC Replacement Act and are explained in paragraphs 234 to 241 of the first written submission of the EC.

[13] Section 5(c)(2) of the FSC Replacement Act.

result of congressional review of the US tax system[14] and represents a fundamental shift in the jurisdiction to tax.[15] The legislative history (even if considered relevant) does not, when examined, actually reflect any such intention and the EC challenges these statements as misleading and incorrect.

28. The US attempt to contrast the FSC Replacement Act with the "former US worldwide approach"[16] only serves to highlight the artificiality of its arguments. The US approach to the taxation of income is still fundamentally worldwide, even as regards so-called "extraterritorial income". As the EC has explained and the US has nowhere attempted to refute, the FSC Replacement Act excludes only a variable part of "extraterritorial income" from gross income and therefore tax, and does so subject to numerous conditions.[17]

29. The EC refers the Panel to an Article published in the US specialist publication Tax Notes International entitled "US Treasury Official Denies FSC Repeal Signals Move to Territoriality.[18] The Article is attached as Exhibit EC-10. The official concerned was the US Treasury's acting international tax counsel and was closely involved in the preparation and defence of the FSC Replacement Act, representing the US at the consultations held with the EC on 4 December 2000. She is reported as saying that the FSC Replacement Act "is a narrow exception from the traditional US tax model based on reaching the worldwide income of each tax payer, regardless of where such income is derived." The Article also makes clear that the US review of its subpart F legislation is yet to be completed.[19]

3.3. The US argument that 'extraterritorial income' is 'outside the taxing jurisdiction of the United States'

30. A related argument to that about 'fundamental change' to the US tax system is the often repeated US claim that 'extraterritorial income' is outside the taxing jurisdiction of the US. For example, in paragraph 20 of the first written submission of the US:

> Under the new regime, extraterritorial income is excluded from gross income for US tax purposes, and, as explained below, is thereby placed outside the taxing jurisdiction of the United States.

and in paragraph 25:

> the Act creates a new general rule under which excluded extraterritorial income earned by US taxpayers is outside US taxing jurisdiction.

31. These statements are misleading. First, as the EC has explained in its first written submission, the US does tax 'extraterritorial income'. It is only a variable part thereof – qualifying foreign trade income that is excluded and then subject to numerous conditions, some of which were listed by the EC in paragraph 55 of its first written submission.

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14 First written submission of the US, paragraph 25.
15 First written submission of the US, paragraphs 52 to 54 (see also paragraphs 67 to 73).
16 First written submission of the US, paragraph 52.
17 First written submission of the EC, paragraphs 48 to 51.
18 Tax Notes International, 18 December 2000, pp. 2749 to 2752.
19 *Ibid.* page 2752.

32. The extent of the exclusion of 'extraterritorial income' from US taxation is very much under US government control. There are many conditions in the FSC Replacement Act and further extensive executive powers to regulate the taxation of this 'extraterritorial income'. For example, new section 943(a)(4) allows the President to designate any property as in short supply and exclude income from its export from the FSC Replacement scheme. And new section 943(e)(4)(C) allows the Secretary to the Treasury to generally exclude 'one or more classes of corporations' from the making 'domestication elections' and thus from participating in the FSC Replacement scheme.

3.4. The US inaccurate and misleading description of the FSC Replacement scheme

33. The EC considers that the first written submission of the US is replete with other misleading and unjustified statements about the FSC Replacement scheme. For example, the US states that:

> Rather than providing unique or special treatment for export-related income, the Act treats all foreign sales and all taxpayers alike.[20]

34. As the EC has pointed out the 'special tax treatment' under the FSC Replacement scheme is only available for 'foreign sales' on condition that they are not 'for ultimate use in the US'[21] and is also only available if certain conditions are met including a limitation on foreign content which restricts availability of the 'special tax treatment' in some cases to foreign goods incorporating US exports.[22]

35. Similarly, the US statement at another point of its first written submission:

> Thus, taxpayers receive the same US tax treatment with respect to income derived from foreign transactions regardless of whether exports are involved.[23]

is also, to say the least, misleading. It is clear that the vast majority of 'foreign transactions' are treated very differently by the US tax system.

36. A general feature of the first written submission of the US is the pervasive confusion that exists between 'foreign transactions', 'foreign sales', 'foreign goods', 'exports' and 'foreign-source income.' Different concepts are often assimilated when in truth they are distinct or only partially overlap. To take a few examples:

- In paragraph 126 of the first written submission, the US attempts to deny the comparability of goods sold domestically and those sold abroad by saying:

  > Products manufactured and sold in the US cannot be said to be foreign.

Obviously, products made in the US and then exported do not suddenly become foreign, even if the transaction is made with a foreign company.

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[20] First written submission of the US, paragraph 23.

[21] Section 942(a)(2)(A)(i) of the IRC as explained, for example, in the first written submission of the EC, paragraphs 100-101.

[22] Section 943(a)(1)(C) of the IRC as explained, for example, in the first written submission of the EC, paragraph 107 *et seq.*

[23] First written submission of the US, paragraph 23.

- In quoting the House Report, the US says[24] that under the US and European systems

  exporting is one way to earn foreign source income…

Of course, under the European systems, only the foreign activities relating to exporting earn such income, while under the Act all the domestic activities relating to exports earn such income.

37. The US also attempts to blur the distinction between "extraterritorial" income and "excluded" income. It erroneously states in paragraph 28 of its first written submission that the FSC Replacement Act gives a detailed definition of extraterritorial income which is contained primarily in sections 114, 941, 942 and 943 of the IRC. It refrains from referring to the straightforward definition contained in section 114(e) IRC but goes on in paragraph 29 to bring into the definition elements of *qualifying* foreign trade income which, as the EC explained, merely limit the extent to which "extraterritorial income" is subject to less tax than other income.

38. Thereafter, the US varies its terminology referring to "excluded income"[25] "excluded extraterritorial income"[26] and even "excludable extraterritorial income"[27].

39. The EC considers that the US attempt to confuse the basic facts concerning its law to be unhelpful. The EC considers that its own description of the FSC Replacement Act is more reliable and notes that the US has not demonstrated any instance in which the EC may have misunderstood any aspect of the FSC Replacement Act.

3.5. US descriptions of European Tax systems

40. The US is also inaccurate in its description of "European" tax systems.[28] The EC has no intention to defend the tax systems of its Member States, which it is convinced comply fully with their international obligations. It will only make the following brief comments:

- First, it is misleading to talk of a "European Model"[29] tax systems. Most EU tax systems are not territorial, as is shown in the description the EC produced in the original proceedings and the US has attached to its first written submission as exhibit US-5.
- Secondly and most importantly, the FSC Replacement Act is not comparable to any EC system. The description of the "European tax exemptions" is misleading. The US is simply wrong when its states, at the end of paragraph 40 of its first written submission, that:

  Insofar as the sale of goods is concerned, European manufacturers operating in these types of tax regimes may obtain the benefits of a territorial exemption only by exporting.

Contrary to the situation under the US FSC Replacement scheme, exemptions in the EC Member States do not depend on whether the product on which the

[24] First written submission of the US, paragraph 193.
[25] E.g., First written submission of the US, paragraph 33.
[26] E.g., First written submission of the US, paragraph 31.
[27] First written submission of the US, paragraph 200.
[28] First written submission of the US, first in paragraph 25 and then in detail in paragraphs 39 to 46.
[29] First written submission of the US, paragraph 39 *et seq.*

income arises is exported or not. If a foreign distribution subsidiary of a Dutch producer, to take the example used by the US, of goods sells those goods in the Netherlands, the resulting profit will have exactly the same tax treatment as when the foreign subsidiary sells them outside the Netherlands.

Another important difference is that the exemption of foreign branch profits under the Dutch tax system (as well as under any other EC Member State's tax system which provide for the exemption of foreign branch profits) is limited to the profits attributable to the foreign branch in accordance with the arm's length principle. The applicability of this principle to the attribution profits between branch offices and head offices is well established in the international tax disciplines[30] and it is strictly adhered to by the Dutch tax law. Under the FSC Replacement scheme the amount of excluded income is simply calculated according to three alternative formulas. In practice none of these formulas is likely to give a result that would correspond to the amount of profits attributable to business activities carried out outside the territorial limits of the US.

3.6. The FSC Replacement Act as a measure for the avoidance of double taxation

41. The EC will be refuting the double taxation defence in detail in Section 4.6 below. However, in the present context, it takes issue with the US statement that the avoidance of double taxation was a *purpose* of the FSC Replacement Act.[31] The US refers to the House Report in footnote 28, but this, on examination, does not bear out its contention. The passage referred to (page 18 of the House Report) makes no reference to the avoidance of double taxation. The only references to double taxation in the legislative history relate, in fact, to the need to limit the use of foreign tax credits in respect of excluded income, a matter to which the EC will return in its discussion of the legal merits of this defence below.

42. In truth, the avoidance of double taxation was not a motivation for the FSC Replacement Act, since the US had no problem of double taxation to resolve but rather a need to replace a prohibited export subsidy with a measure of equivalent effect.

4. RESPONSE TO THE LEGAL ARGUMENTS OF THE US

43. The EC will now proceed to refute in detail all the arguments that the US has made in its first written submission.

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[30] Among such internationally embraced disciplines, perhaps most relevant to the attribution of business profits to a permanent establishment (e.g. a branch office) is that of Article 7 of the OECD Model Tax Convention. This principle and its applicability to the attribution of business profits is clearly set out in paragraph 2 of Article 7 of the Convention: "Subject to the provisions of paragraph 3, where an enterprise carries on business in the other Contracting State through a permanent establishment situated therein, *there shall be in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."* (emphasis added).

[31] First written submission of the US, paragraph 26.

4.1. Comments on the factual burden of proof in DSU Article 21.5 proceedings

44. The EC did not address the burden of proof in its first written submission but the US has. More specifically, the US submits that the EC has the "burden of proof both in terms of presenting a *prima facie* case and in the sense of the ultimate burden of persuasion. Thus, if the balance of evidence is inconclusive, the EC will have failed to have established its claims."[32]

45. This assertion suggesting that the EC generally bears the burden of proof in these Article 21.5 proceedings is too simplistic and calls for some clarification. At the outset, it might be noted that the US has already accepted, e.g., the burden to establish its defence under footnote 59.[33]

46. The EC considers that the burden of proof should not give rise to any difficulty in the present case because the FSC Replacement Act is *de jure* inconsistent with the covered agreements. The EC believes that it has demonstrated this in its first written submission and will bring further arguments below to refute those of the US. The EC has also provided some factual evidence – going beyond the text and history of the FSC Replacement Act – in the Annex to its first written submission – which it has developed and appends anew to this submission – but this is for the purposes of illustration[34] rather than in response for a need to provide such evidence.

47. The EC does however wish to make two brief clarifications regarding the burden and standard of proof in these Article 21.5 proceedings for reasons of principle.

4.1.1. The burden of proof in DSU Article 21.5 Proceedings

48. The case law governing the burden of proof in Article 21.5 proceedings is very limited. In the Article 21.5 proceedings on *Brazil – Aircraft* and *Canada – Aircraft*, the Appellate Body has not specifically addressed the issue. However, some guidance can be gleaned from scattered sentences in these rulings suggesting that a compliance panel should, in principle, apply the basic rule governing the burden of proof as established for original proceedings.[35]

49. Thus, following the decision of the Appellate Body in *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India ("United States – Shirts and Blouses")*,

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[32] First written submission of the US, paragraph 57 (footnote omitted).

[33] *Ibid.* , paragraph 166, where the US qualified its defence as being an "exception".

[34] First written submission of the EC, paragraph 116.

[35] Appellate Body Report, *Brazil – Export Financing Programme for Aircraft Recourse by Canada to Article 21.5 of the DSU*, ("*Brazil – Aircraft, 21.5*"), WT/DS46/AB/RW, adopted 4 August 2000, DSR 2000:VIII, 4067, paragraph 66, which reads: "[T]he fact that the measure at issue was 'taken to comply' with the 'recommendations and rulings' of the DSB does not alter the allocation of the burden of proving Brazil's 'defence' under item (k)." See also, Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft Recourse by Brazil to Article 21.5 of the DSU* ("*Canada – Aircraft, 21.5*"), where the Appellate Body added, in paragraph 38, that "the examination of 'measures taken to comply' is based on the relevant facts proved, by the complainant, to the Article 21.5 panel, during the panel proceedings."

> the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence.[36]

50. In other words:

> The initial burden lies on the complaining party, which must establish a *prima facie* case of inconsistency with a particular provision ... When that *prima facie* case is made, the burden of proof moves to the defending party, which must in turn counter or refute the claimed inconsistency.[37]

51. In short, the claimant in the Article 21.5 proceedings has the onus of establishing a *prima facie* case of inconsistency of the implementing measure with the covered agreements. The EC considers that it has met its burden, so that the onus is on the US to disprove the claims.

4.1.2. The standard of proof in DSU Article 21.5 proceedings

52. The EC takes issue with the statement of the US that in "cases involving a generally applicable measure, there must be a heightened evidentiary burden for the complaining party".[38] In fact, the attempt, on the part of the US, to raise the standard of proof is tantamount to conceding that the EC has successfully reached the initial level of proof which is to make a "presumption" or a "*prima facie* case" of inconsistency with a particular provision.[39] The term *prima facie* denotes the minimum quantum of evidence "which unexplained or uncontradicted is sufficient to maintain the proposition affirmed."[40] The Appellate Body elaborated on the standard of proof in *United States – Shirts and Blouses* when holding:

> In the context of the GATT 1994 and the *WTO Agreement*, precisely how much and precisely what kind of evidence will be required to establish such a presumption will necessarily vary from measure to measure, provision to provision, and case to case.[41]

Thus, the precise requirement of how much and which kind of evidence is necessary to substantiate a claim needs to be tailored on a case-to-case basis.

53. The case before the Panel involves a specific evidentiary situation. The measure at stake is "legislation as such" as opposed to individual measures. Moreover, the Panel is now faced with a measure purportedly implementing its recommendations in the original proceedings. The FSC Replacement scheme is still in the process of being defined by regulation and considered by taxpayers. Thus, no factual evidence exists, e.g., on the question whether the non-US producers will, in practice, ever benefit from the FSC Replacement subsidy. When considering the standard of proof

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[36] Appellate Body Report, *United States – Shirts and Blouses*, WT/DS33/AB/R, adopted 23 May 1997, p. 14, DSR 1997:I, 323, at 335.

[37] Appellate Body Report, *European Communities – Measures Concerning Meat and Meat Products (Hormones) ("EC – Hormones")*, WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, DSR 1998:I, 135, paragraph 98.

[38] First written submission of the US, paragraph 218.

[39] Appellate Body Report, *United States – Shirts and Blouses*, p. 14, DSR 1997:I, 323, at 335. See also, Appellate Body Report, *EC– Hormones*, DSR 1998:I, 135, paragraph 98.

[40] *Kazazi,* Motjaba, "Burden of Proof and Related Issues, A Study of Evidence Before International Tribunals" (Hague, Boston: Kluwer Law International, 1996), at 328 with further references.

[41] Appellate Body Report, *United States – Shirts and Blouses*, p. 14, DSR 1997:I, 323, at 335.

to be applied in this case, the EC submits that the Panel should take account of the following principles and considerations.

54. First, where the evidence regarding the effects of a piece of legislation is limited, panels may be forced to adjudicate the dispute on the basis of the general make-up and design of the measure. Thus, for example, in *Argentina – Textiles and Apparel*, the Appellate Body agreed with the Panel that "the structure and design" of the measure resulted in a violation of Article II of the GATT.[42] More importantly, the Appellate Body did not find it necessary that the application of the measure "result in a breach of Article II for *each and every* import transaction".[43]

55. A further illustration of how a *prima facie* case may be made on the basis of the law is the recent ruling in *Korea – Beef*. In that case, the Appellate Body declined Korea's argument that the Panel's finding on Article III:4 of the GATT 1994 was "seriously flawed, relying largely on speculation rather than on factual analysis" and affirmed that the dual retail system infringed Article III:4 of the GATT 1994 on the basis of an analysis of "the fundamental thrust and effect of the measure itself".[44]

56. Second, the Panel might also recall that, in the *Canada – Aircraft* case, Brazil did not possess much evidence about one of the subsidy schemes alleged in that case. To offset this lack of information on the part of the complainant, the Appellate Body clarified that each party has the duty to produce the evidence in its possession as requested by the panel under Article 13.1 of the DSU.[45] A failure to furnish the information sought permits the panel to draw adverse inferences from it.[46] While the Panel, in that case, refused to draw adverse inferences from Canada's failure to provide the information requested under Article 13.1 of the DSU arguing that Brazil had failed to make a *prima facie* case[47], the Appellate Body emphasized that adverse inferences may be drawn independently of whether a *prima facie* has been made. Thus:

> A *prima facie* case, it is well to remember, is a case which, in the absence of effective refutation by the defending party (that is, in the present appeal, the Member requested to provide the information), requires a panel, as a matter of law, to rule in favour of the complaining party presenting the *prima facie* case. […] [A] panel is vested with ample and extensive discretionary authority to determine *when* it needs information to resolve a dispute and *what* information it needs. A panel may need such information before or after a complaining or a responding Member has established its complaint or defence on a *prima facie* basis. A panel may, in fact, need the information sought in order to evaluate evidence already before it in the course of determin-

[42] Appellate Body Report, *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items ("Argentina – Textiles and Apparel")*, WT/DS56/AB/R, adopted 22 April 1998, DSR 1998:III, 1003, paragraph 62.

[43] *Ibid.*(emphasis added).

[44] Appellate Body Report, *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef* ("*Korea – Beef*"), WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001, DSR 2001:I, 5, paragraph 142.

[45] Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft ("Canada – Aircraft")*, WT/DS70/AB/R, adopted 20 August 1999, DSR 1999:III, 1377, paragraphs 186-196.

[46] *Ibid*., paragraphs 197-205.

[47] Panel Report, *Canada – Aircraft*, as upheld by the Appellate Body Report, DSR 1999:IV, 1443, paragraph 9.181.

> ing whether the claiming or the responding Member, as the case may be, has established a *prima facie* case or defence.[48]

57. Finally, the specific situation of these Article 21.5 proceedings also bears upon the application of the standard of proof. The main piece of evidence available to the Panel is the FSC Replacement Act. In contrast to the original proceedings, there is only one Panel meeting at which the parties can request and discuss factual evidence in addition to the implementation measure itself.

58. In applying the standard of proof, the Panel should consider the DSU objective of prompt settlement of trade disputes and, in particular, the accelerated implementation provisions enshrined in Article 4 of the *SCM Agreement*. Article 21.5 of the DSU and Article 4 of the *SCM Agreement* envisage that an implementing measure be examined as soon as it is adopted. There is no time for its application in practice to be assessed. Thus, the EC believes that the principles governing the assessment and weighing of evidence in Article 21.5 cases involving prohibited export subsidies must ensure that the obligation to "withdraw the subsidy" in Article 4.7 *DSU* does not simply mean, in practice, maintaining the subsidy and disguising the export contingency in a manner that cannot be established until long after the expiry of the period of time fixed for withdrawal.

4.2. The FSC Replacement scheme continues to provide subsidies

4.2.1. The meaning of "revenue foregone" and "otherwise due"

59. The US is correct in considering that the words "revenue foregone" and "otherwise due" in Article 1.1(a)(1)(ii) of the *SCM Agreement* are the key to determining whether the FSC Replacement scheme gives rise to a financial contribution and therefore a subsidy.

60. The EC is pleased to note that the US recognizes in particular that

> Where the tax laws of a country themselves create a special exception from general tax obligations, that, too, may come within the language of subparagraph (ii).[49]

61. However, the US proceeds to fundamentally misunderstand or misrepresent the interpretation that the Appellate Body gave to these terms in the original proceedings. It quotes frequently from paragraph 90 of the Appellate Body Report[50] but conspicuously fails to refer to the fact that the Appellate Body considered "otherwise due" to refer to revenue that would be due '*in a different situation*' or '*in some other situation*' under the tax system of the member concerned. The US omits these key words and instead contrives to conclude that the test is simply whether the taxes would have been collected 'but for' the measure in question.[51]

62. The US is wrong to say that the Appellate Body agreed that the 'but for' test was appropriate to the FSC case.[52] It stated that it *worked* in the FSC case but that

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[48] Appellate Body Report, *Canada – Aircraft*, DSR 1999:III, 1377, paragraph 192.
[49] First written submission of the US, paragraph 63.
[50] First written submission of the US, paragraphs 63 and 64. The EC quoted paragraph 90 of the Appellate Body Report correctly and in full in paragraph 30 of its first written submission.
[51] First written submission of the US, paragraph 65.
[52] First written submission of the US, paragraph 65.

> It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be *no* general rule that applied formally to the revenues in question, absent the contested measures. We observe, therefore, that, although the Panel's "but for" test works in this case, it may not work in other cases.[53]

63. The FSC Replacement scheme is a tax regime that endeavours to 'circumvent' in precisely the way the Appellate Body had feared the 'but for' test would permit. The EC notes that Canada shares its opinion.[54]

64. The 'normative benchmark' referred to by the Appellate Body is therefore the tax that would be due under the tax system of the Member in question *in some other situation,* not the legal rule that would apply if the rule under consideration did not exist.

4.2.2. The US 'prevailing legal standard'

65. The second step in the US false reasoning, after having attempted to dispense with the requirement to consider the revenue that would be due in some other situation (i.e. domestic sale), is to manipulate the phrase 'prevailing legal standard'.

66. The US asserts that

> Under US law, the taxing authority of the United States government is defined by the statutory definition of "gross income."[55]

and

> The definition of "gross income" is thus the "prevailing domestic standard" for US taxation.[56]

67. The EC contests this approach. First, of course, the correct approach is, as explained above, to compare the revenue due in one situation to that due in another under the tax system of the US. But secondly, the US is confusing the income actually subject to taxation under US law with the taxing authority of the US. It arrives at a ridiculous conclusion that would allow Members to provide any subsidy they like through the tax system using the simple device of excluding the income concerned from the definition of 'gross income'. In this way, the exclusion from tax of 'income derived from the sale of textile products' or 'income earned from export' from 'gross income' would also not be a subsidy!

68. In reality, the US 'prevailing domestic standard' applying to the type of income under consideration, that is corporate income from a commercial activity, is that income may be taxed if it is earned by a US corporation or is 'effectively connected' with a US trade or business. The so-called 'exclusion' of 'extraterritorial income' from US taxation is a derogation from this prevailing domestic standard. The fact that there are 'exceptions' to the exclusion does not change this.

69. In any event the US contention that

> the general authority to tax extraterritorial income has now been eliminated from the prevailing US standard[57]

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53 Appellate Body Report, DSR 2000:IV, 1675, paragraph 91.
54 Third Party statement of Canada, paragraph 28.
55 First written submission of the US, paragraph 69.
56 First written submission of the US, paragraph 71.
57 First written submission of the US, paragraph 82 *in fine*.

is simply wrong. The US does tax 'extraterritorial income.' It is only 'qualifying foreign trade income' that is excluded and then under certain conditions, as the EC has explained in Section 3.2 above.

4.2.3. Inter-temporal comparisons

70. In paragraphs 74 to 76 of its first written submission, the US replies to an argument that the EC has never made, reasoning that Members must have the right to change their tax systems and that by doing so they are not forgoing revenue that would otherwise be due.

71. The misunderstanding by the US of the EC position is even clearer in paragraph 100 of its first written submission, where it states that:

> As discussed above, the EC essentially argues that the determination of whether revenue is foregone depends upon a comparison of the US tax system before adoption of the Act with the US tax system after adoption of the Act.

72. The EC trusts that it is clear to the Panel that it is not making such an argument. The misunderstanding by the US of the EC position would not have arisen if the US had properly described the standard established by the Appellate Body – that is that the comparison must be between the revenue due under the special regime and the revenue that would be due "in some other situation" under the *prevailing* domestic standard of the Member in question. For the EC it is clear that the comparison must be conducted between situations prevailing at the same time, not between the present and the past (or the present and the future).

73. Indeed, this further demonstrates that it is not appropriate to apply a simple 'but for the measure' approach to establishing whether revenue that would otherwise be due is forgone.

4.2.4. The US response to the EC's arguments

74. The EC will now reply in detail to the US response to the arguments on these issues contained in the EC's first written submission.

75. First, on the issue of whether the FSC Replacement scheme is an exclusion or an exemption, the EC notes that the US is in substance agreeing with its position. To be clear, the EC agrees that

> … whether, as a matter of US tax law, the new modifications to the term "gross income" are more appropriately designated as an "exclusion" than as an "exemption" is really a judgment that the United States Congress is in a better position to make than EC officials.[58]

76. The important point is that made by the US in paragraph 88 of its first written submission where it states that

> … the semantic distinction between an exclusion and an exemption would not, in any event, be determinative. Rather, the test under subparagraph (ii) is whether tax on the income now excluded would be otherwise legally owed to the government.

77. The EC agrees and said as much in paragraph 53 of its first written submission, where it stated that:

[58] First written submission of the US, paragraph 87.

> The EC submits that the factor that determines whether the FSC Replacement scheme gives rise to a financial contribution and therefore a subsidy is not whether the legislative provisions on which it is based use the word "exclude" or the word "exempt" or neither, but whether there is revenue forgone that is otherwise due within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement.*

78. On this point at least the parties are in agreement.

79. The US next responds to what it calls "a variety of arguments to the effect that the Act confers a subsidy because the exclusion should be larger" although it does also recognize that the EC's arguments related not to the size of the subsidy but the conditions under which it is granted.[59] The US argument is that if it can do more, it must be entitled to do less. In this way the US concludes

> That an exclusion is qualified or moderated, however, does not convert it into a subsidy under Article 1.[60]

80. Again, the US seems to be proclaiming a subsidizer's charter. The very essence of a subsidy is that a government gives to some but not to others. The principle "he who can do more can do less" may apply to the *amount* of an exemption but it does not apply to the *scope* of exemptions (just as it cannot justify discrimination).

81. In defence of its view that it is entitled to exclude from tax whatever arbitrarily defined 'category' of income it wishes on whatever condition it wishes without there being a subsidy the US argues that

> the EC's argument that only the non-taxation of a "general" category falls outside of subparagraph (ii) would mean that most of the tax systems in Europe are subsidy schemes. In construing subparagraph (ii), it is reasonable for the Panel to consider whether the intent of the Uruguay Round negotiators was to adopt a principle under which the tax systems of most industrialized countries would be subsidies.[61]

82. Here the US is of course departing from the words of the *SCM Agreement* and looking to the intent of the Uruguay Round negotiators. The EC would make two comments.

83. First, the extent to which revenue is forgone that is otherwise due, depends principally on the meaning given to the word 'otherwise'. The Appellate Body has said that there must be a comparison with a 'normative benchmark', that is with the revenue that would be due in some other situation under the tax system of the Member concerned. The EC shares this view and considers in addition that this 'other situation' must be a comparable situation. Thus, the EC believes, for example, that lottery winnings cannot be compared with earned income. The fact that these classes of income may be taxed differently does not mean that revenue is being forgone.

84. That is why the EC has argued[62] that different categories of income may be taxed differently if the categories are defined generally, objectively and neutrally. It may be that the word 'category' is insufficiently precise for this purpose because it can be defined arbitrarily (the US is arguing that 'extraterritorial income' or rather 'qualifying foreign trade income' is a 'category'). It is perhaps more accurate to speak

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[59] First written submission of the US, paragraph 89.
[60] Paragraph 91.
[61] First written submission of the US, paragraph 94.
[62] First written submission of the EC, paragraphs 57 to 61.

of 'classes' or 'types' of income. The important point is, as the EC has stated above, that like be compared with like. Income from the sale of goods is a type or class of income. Exporting and selling domestically are simply *different situations* in which it may arise or be earned.

85. In the case with the FSC Replacement scheme, income from the sale of goods by commercial enterprises is taxed in one way if the goods are for final consumption outside the US and in another if they are for final consumption in the US. These are not in the EC's views properly considered different categories (in the sense of class or type) of income. In addition, as the EC pointed out in its first written submission, the FSC Replacement scheme excludes from tax part of the income from a single taxable event but only if this taxable event satisfies certain strict conditions.[63]

86. Second, the definition of subsidy in Article 1.1 of the *SCM Agreement* is clearly very broad. Apart from the provision on revenue forgone, which concerns us in this case, the definition is also drafted in very wide terms in other respects, covering, for example any actual and potential transfer of funds and even the purchase of goods by government where a benefit is conferred. The limitation on the scope of the disciplines is laid down in Article 1.2, which provides that these disciplines only apply to subsidies that are specific, within the meaning of Article 2. Of course Article 2.2 provides that subsidies falling under Article 3 are *deemed* to be specific. Thus, the intent of the Uruguay Round negotiators not to make all the exemptions and special conditions in tax laws (and indeed the provisions of many other measures) subject to the disciplines of the *SCM Agreement* is expressed in Article 1.2 rather than Article 1.1.

87. Accordingly, the EC maintains that for all the reasons that it set out in paragraphs 46 to 61 of its first written submission, that the FSC Replacement scheme results in revenue being forgone that would in other circumstance be collected.

4.2.5. The US' Factual Allegations

88. There is one final argument of the US. In paragraphs 100 to 106 the US seems to be arguing that the EC has not demonstrated any revenue loss and even suggests that

> The existence of the Act as part of the US tax system might motivate foreign corporations to structure a portion of their operations in the United States to achieve a tax-efficient global operating structure.[64]

89. The US dismisses the EC's reliance on the Congressional Budget Office study in exhibit EC-8 on the grounds that it compares the revenue consequences of the FSC Replacement scheme with those of the FSC scheme under the "former US worldwide taxation system".[65]

90. The EC will first note that the US is not contesting the figures that the EC drew from the Congressional Budget Office study. If it wanted to do so, or wanted to contest the conclusions that the study appears to warrant, it should have produced the evidence that only it has of the budgetary consequences of the FSC Replacement

[63] First written submission of the EC, paragraph 57.
[64] First written submission of the US, paragraph 102.
[65] First written submission of the US, paragraph 106.

scheme. If the US does not, the Panel must assume that these figures mean what they appear to mean.

91. The EC has already explained that the US still has a worldwide taxation system and that the US argument that revenue is not forgone because the "jurisdictional boundary" of the US tax system has changed is unfounded.[66] It therefore appears that the US argument that the EC has not demonstrated a revenue loss shares the same fate as its argument that there is no revenue forgone.

92. In case the US is arguing that that the Congressional Budget Office Study is insufficient because it compares the situation with that prevailing under the FSC scheme, the EC also attaches as exhibit EC-11 an extract from the US Treasury Budget estimates for Financial Year 2001 entitled Total Revenue Loss Estimates in the Income Tax and providing FSC revenue loss figures for financial years 1999 to 2005. Since the Congressional Budget Office Study revenue loss figures which the EC referred to in its first written submission are based on a comparison with the situation prevailing under the FSC scheme, the total amount of revenue forgone by the FSC Replacement scheme is obtained by adding to them the amounts shown in the table in exhibit EC 11.

93. In the absence of evidence from the US to the contrary, it must be presumed that the Congressional Budget Office Study revenue figures took account of any possible increase of revenue due to corporations paying US tax that they would not otherwise have paid. In any event, any such effect can only represent a small part of the revenue forgone.

94. One reason for this is that the controlled foreign corporation ("CFC") rules of the US IRC are aimed exactly at preventing this type of jurisdiction-shopping. A sales subsidiary that was incorporated in Country X, bought products from the US parent, and then had sales operations in Country Y would have "foreign base company sales income" as defined in section 954(d) of the IRC. In general, the CFC rules would require the US parent to include this amount in the US parent's taxable income whether actually distributed to the US parent or not.

95. In any event, if the study did not take this into account, it would be for the US to produce the contrary evidence, which only it has. To the extent that it has not done so, the Panel must presume that the figures mean what they appear to mean. Also, for the purposes of these Article 21.5 *DSU* proceedings, it is only relevant that there will be revenue forgone; the precise amount does not need to be established.

4.3. The FSC Replacement subsidy is contingent upon export performance

96. The EC has already remarked on the incomplete manner in which the US has responded to the arguments in the EC's first written submission.[67] The EC has also already commented[68] on a number of misleading and wrong statements of the US concerning the FSC Replacement scheme. Many more are made when the US attempts to defend the FSC Replacement scheme as not contingent upon export per-

[66] Section 3.2 above.
[67] Sections 2.1 and 2.2 above.
[68] Section 3 above.

formance or not specifically related to export, for example that the FSC Replacement scheme is "unrelated to exporting"[69] or that exporting is "merely incidental"[70] to it.

97. The EC does not comment further on such statements but in this section, will reply to the US analysis of its legislation under Article 3.1(a) of the *SCM Agreement* and the comments that the US does make on the EC's analysis.

4.3.1. The fundamental difference between the EC and the US

98. The US is correct when it says that there is a difference in "analytical framework"[71] between the EC and the US. However, it is the US analytical framework that does not correspond to the *SCM Agreement*, not that of the EC.

99. The US argument is that there are various alternative ways ("a broad range of foreign transactions") in which a company may earn excluded income and therefore this is not export contingent. According to the US, these include:[72]

- the sale, exchange, or other disposition of qualifying foreign trade property;
- the lease or rental of qualifying foreign trade property for use by the lessee outside the United States;
- the provision of services which are related and subsidiary to any sale, exchange, or other disposition of qualifying foreign trade property;
- the provision of services which are related and subsidiary to any lease or rental of qualifying foreign trade property;
- the provision of engineering or architectural services for construction projects located (or proposed for location) outside the United States; or
- the performance of managerial services for a person other than a related person in furtherance of the production of foreign trading gross receipts.

100. The US concludes that this allows a 'broad range of taxpayers' to earn 'extra-territorial income'.[73]

101. A first comment of the EC on this argument is that most of this impressive list relates to services. As the EC argued in its first written submission (and as stated above,[74] the US has ignored), an export-contingent subsidy for goods cannot cease to be so just because it is made available in other, different, circumstances - for the supply of services abroad. [75]

102. The EC argument is that one has to compare like with like. For owners of US produced goods, export is a condition for obtaining the benefits under the scheme for those goods.

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69 First written submission of the US, paragraph 120.
70 First written submission of the US, paragraph 116.
71 First written submission of the US, paragraph 130.
72 First written submission of the US, paragraph 118.
73 First written submission of the US, paragraph 119.
74 Section 2.1.
75 First written submission of the EC, paragraph 102.

103. In the real world (and this is the perspective from which the *SCM Agreement* is drafted and from which contingency must be assessed) companies do not start with a desire to earn excluded income and then consider the various options available for this purpose. They then compare the attractiveness of selling domestically and exporting goods they have produced or plan to produce. If the goods and the place they are produced is taken as given, then the companies have no other option than exporting if they want the benefit of the scheme.

104. Under the "analytical framework" of the US, on the other hand, companies are supposed to compare the option of earning excluded income by exporting the goods they have produced in the US with that of earning it by selling foreign-made goods abroad. Because the objective of companies is to make a profit from selling the goods they produce rather than simply earning "excluded income", this is not the choice that is really before them. This is also clear from the fact that the US analytical framework leaves open the question of what is to happen to the US produced goods if excluded income is earned by selling foreign goods abroad. Assuming that the US produced goods are not to be destroyed, the producer still has the choice of exporting them or selling them domestically. If it does the former it will earn (more) excluded income, if it does the latter, it cannot. The US analytical framework does not correspond to the true choice which is to be made.

105. To show that it is the EC approach that is required by the *SCM Agreement*, the EC set out in its first written submission a number of contextual reasons why the comparison should be with the sale of the same goods domestically (not different goods abroad).[76] The US has set out no reasons why its analytical framework should be used. It merely criticizes some (but by no means all) of the EC's contextual arguments. The argument that the US chooses to respond to is the EC's reference to items (d), (f), (g), (h) and (l) of the Illustrative List as examples of where the benchmark is the domestic sale of goods. The US claims[77] that the comparison made in these items of the Illustrative List is made for the purpose of determining the financial contribution.

106. The US is wrong. For instance, under item (f) there is clear comparison between the domestic and export tax base in order to determine whether there is export contingency. The financial contribution already derives from the requirement that there be "special deductions".

107. The US argument is in any event strange since financial contribution is defined in Article 1.1 of the *SCM Agreement* and the Illustrative List in Annex I merely illustrates export contingency. As the Appellate Body observed in *US - FSC*, the Illustrative List is relevant for determining what are prohibited export subsidies, not for determining what is a subsidy (and therefore what is a financial contribution). Rather, the fact that the comparisons relate in many cases also to the question of financial contribution, simply illustrates that the benchmark for establishing export contingency should be the same as that for establishing the financial contribution.

108. Just as in the case of the examples in the Illustrative List, the relevant benchmark for assessing the existence of a financial contribution in this case is the same as for establishing the export contingency – it is the "some other situation" referred to by the Appellate Body.

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[76] First written submission of the EC, paragraphs 85 to 98.

[77] First written submission of the US, paragraph 131.

109. In the case of the export of US goods the "other situation" for assessing whether there is a financial contribution includes a situation where the goods are not exported, that is they are sold domestically. The same comparison is to be made for assessing export contingency.

110. The error of the US is also reflected in the fact that it repeatedly considers exports to be a subcategory of "foreign transactions"[78] and income from exports as a subcategory of "foreign income".[79] They are not. In reality, exports are a subcategory of the total sales of a company and income from exports a subcategory of total sales income.

4.3.2. Whether there are 'alternative' conditions for obtaining the benefit of the FSC Replacement scheme

111. The US has misunderstood the EC's argument when it claims that the EC's position is that the word "other" in the phrase "contingent, ... *whether solely or as one of several other conditions*, upon export performance" means "alternative" rather than "additional" in Article 3.1(a).[80]

112. The EC takes no position on the meaning of the world "other" in the above phrase. It would only state that it is not necessary to the EC argument for the word "other" to mean "alternative". The EC argument is simply that a subsidy that is export contingent in some circumstances does not cease to be so if it can also be obtained in other situations which do not require export.[81] The EC proceeded to give two illustrations of this principle[82] which the US has studiously ignored, as already observed above.[83]

113. An owner of US goods does not have an alternative means of obtaining the FSC Replacement Act subsidy on the sale of his goods. Export is a *necessary* condition for obtaining the benefit of the FSC Replacement scheme in these circumstances and this is therefore export-contingent. This derives directly from the ordinary meaning of 'contingent' and does not depend on the words "one of several other conditions," which were really only relevant to the EC's observation that the US appeared to consider export contingency to exist where export was truly an alternative condition in the US Department of Commerce's countervailing duty regulations.[84]

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[78] E.g. first written submission of the US, paragraph 114, where it is stated that:

> Thus, unlike the FSC, the Act provides an exclusion from taxation for income derived from all qualifying foreign transactions, not simply exports

Another interesting example is in paragraph 126, where it is stated that

> Transactions involving property used or consumed in the United States are not covered by the Act because they are not foreign transactions.
>
> Exports are covered by the FSC Replacement Act, whether or not they are foreign transactions.

[79] E.g. first written submission of the US, paragraph 25, where it is stated that

> By excluding extraterritorial income from the definition of "gross income", the Act fundamentally changes the way the United States taxes foreign income.

[80] First written submission of the US, paragraphs 134 and 135.

[81] First written submission of the EC, paragraph 123.

[82] First written submission of the EC, paragraphs 124 to 126.

[83] Section 2.1 above.

[84] The EC is pleased to note from footnote 117 of the US submission that the US does not consider that its Department of Commerce's countervailing duty regulations cannot change the interpretation

4.3.3. The US comments on the EC's de facto export contingency arguments

114. In Section V.C.4 (paragraphs 137 to 150) of its first written submission, the US responds to the EC's subsidiary arguments (Section 3.3.5, paragraphs 131 to 145 of the EC's first written submission) that, even if the EC's other arguments are not successful, the FSC Replacement scheme must be considered *de facto* export contingent because it cannot be expected that the extended FSC Replacement scheme will be much used in practice.

115. The EC gave a whole series of reasons why this would be so. The US only replies partially to this argument, as the EC will now explain.

116.The US has made three comments on this *de facto* export contingency argument, to which the EC will now reply: that a 'domestication election' is not always necessary; that foreign corporations may make 'domestication elections' without increasing their tax liability; and that the 'domestication election' was intended to provide tax equity.

4.3.3.1. The US argument that a 'domestication election' is not always necessary

117. The EC agrees with the US[85] that a 'domestication election', that is for a foreign corporation to opt to be treated as a domestic US corporation for US tax purposes, is not necessary if the foreign manufacture is performed by a branch of a US corporation. In such cases the US corporation is already subject to US tax as a domestic corporation. It is already 'domesticated'. The EC never made any assumption to the contrary.

118. It is, however, crucial to note that situations whereby the foreign manufacture is performed by a branch of a US corporation are in relative terms bound to be far less common than those where the US corporation decides to establish a subsidiary in the foreign jurisdiction to undertake such activities. Undoubtedly, the choice of the legal form for the foreign manufacturing operations depends on the particular circumstances present in each individual case but in general there are a number of both tax and commercial reasons for the general preference for the legal form of a subsidiary.

119. First, and perhaps most importantly, from a US corporation's point of view, it is essential to take account of the fact that the mainstream profits of a foreign branch are subject to current taxation in the hands of the corporation in the US. A foreign subsidiary is only liable to tax on such profits in its country of residence and the taxation in the US is deferred until the repatriation of the profits (in the form of dividends) to the US shareholder. The FSC Replacement scheme has not introduced any fundamental change in this respect as the exclusion is merely partial and concerns only 'qualified foreign trading income'. The potential benefit of the deferral of taxation until the time when a foreign subsidiary distributes dividends is, however, still available to US corporations who decide to structure such foreign manufacturing operations in the legal form of a subsidiary.

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of the *SCM Agreement* but does still wonder if it considers them to be compatible with the *SCM Agreement*.

[85] First written submission of the US, paragraphs 138 to 141.

120. Second, it is often a critical factor affecting the decision between a branch office and a subsidiary that as a branch is not a separate legal entity and thus it has no separate limited liability protection, i.e. distinct from that of the corporation of which it is an inherent part. Also, a local subsidiary may have a marketing advantage as compared to a branch as it is more closely identified within the local market.

121. Third, the legal form of a separate legal entity incorporated in the foreign jurisdiction may often be an absolute precondition for being entitled to fully engage in all transactions necessary for the carrying out of the manufacturing operations. For example, it is not uncommon that the legal provisions of the host jurisdiction prevent a foreign entity from acquiring immovable property such as land on which a manufacturing plant is to be built.

122. Fourth, it is also not uncommon that the legal provisions or the standard practice in the host jurisdiction (where a branch is located) require disclosure of the annual financial statements for the whole enterprise. This, in its turn may entail additional administrative burden and lead to tedious disputes over the correct attribution of profits to the branch.

123. Fifth, when operating in the form of a branch there are many potential areas where disputes concerning the proper attribution of profits to the branch may arise. A typical example is the allocation and deductibility of the expenses incurred at the head office level but nevertheless partly for the purposes of the branch (e.g. marketing, advertising, executive and general administrative expenses). Moreover, there may be differences between the ways as to how the two tax jurisdictions in question treat different classes of income, for example, currency conversion differences for tax purposes. The resolution of such disputes between the tax jurisdictions may well be difficult to achieve under (or it is fair to say, despite) the mutual agreement provisions. A non-incorporated entity as a branch is under the double tax treaties not normally considered as a resident of the State in which it constitutes a permanent establishment and therefore generally not entitled to the treaty benefits unless there are specific rules to that effect.[86]

124. Sixth, there may be local tax incentives which are only applicable to local incorporated companies (i.e. only to subsidiaries and not to branches), that may equally affect the choice of the legal form for the foreign manufacturing operations.

125. The EC therefore considers that the possibility for foreign branches of US corporations to benefit from the extended FSC Replacement subsidy is of little practical significance.

4.3.3.2. The US argument that foreign corporations may make 'domestication elections' without increasing their tax liability

126. The EC can also agree that there may be circumstances in which foreign corporation can make a 'domestication election' without increasing its tax liability. The US is wrong to say that the EC has assumed the opposite.[87]

127. The EC's point is, simply, that since

[86] Such as the non-discrimination rule contained in paragraph 3 of Article 24 of the OECD Model Tax Convention.

[87] First written submission of the US, paragraph 137.

(a) The US does not normally tax foreign corporations more heavily than its domestic corporations;

(b) Foreign countries cannot be expected to tax their companies less simply because they make a 'domestication election' in the US;

Then making a 'domestication election' will only rarely reduce the tax burden and be advantageous.

128. The US is correct when it says that foreign corporations that make a 'domestication election' in the US will be entitled to foreign tax credits for foreign taxes in the same way as US corporations. This will mean that when the foreign tax rate is *higher or just as high* as in the US, such corporations may get full credit for foreign taxes paid in the US. (The reason the EC uses the word 'may' is that in reality, matters are likely to be complicated by differing methods of calculating tax – e.g. rules on deductions, tax deductible capital allowances, whether different classes of income are in fact subject to tax and many other rules.)

129. Even when it is possible for a company to conclude that making a 'domestication election' in the US is unlikely to give rise to an *increase* in overall taxation, this simply means that there will be no immediate *penalty* for such a company. It will clearly not in itself persuade a company to make such an election. A tax *advantage* from making a 'domestication election' is only likely to arise in special circumstances, notably because the availability of the FSC Replacement scheme, will in the first place involve a loss of the possibility of *deferring* US taxation of foreign income.

130. The EC's main point is ignored by the US, however. It is that the minor benefit that a company may sometimes have in making a 'domestication election' in the US cannot be expected to overcome the following disadvantages:

- The additional reporting requirements and administrative burden involved in being fully subject to an additional tax jurisdiction;
- The requirement to waive *all* benefits granted by the US under *any* treaty; [88]
- The fact that upon domestication election, the retained earnings of the foreign corporation (the non-distributed profits of a foreign subsidiary of a US corporation) will immediately become subject to US tax; [89]
- The fact that reversing the 'domestication election' will give rise to additional and unpredictable tax liability arising out of deemed transfers of assets under sections 367 and 354 of the IRC; [90]
- The conflicts that complying with US taxation requirements may create for foreign corporation in their own jurisdictions and the application of double taxation treaties;[91]
- The fact that foreign states may object to their companies being made subject to US jurisdiction in this way and prevent their companies from making 'domestication elections;[92]

[88] First written submission of the EC, paragraph 135.
[89] First written submission of the EC, paragraph 138.
[90] First written submission of the EC, paragraph 136 to 138.
[91] First written submission of the EC, paragraph 139 to 141.
[92] First written submission of the EC, paragraphs 142 to 143.

- The need to ensure that the 50 per cent foreign content limitation is complied with.[93]

131. For all these reasons the EC maintains that the obligation of 'domestication' is bound to make the use of the extended FSC Replacement subsidy rare and the FSC Replacement scheme is at least *de facto* contingent upon export performance.

4.3.3.3. The US argument that the 'domestication election' was intended to provide tax equity

132. In paragraphs 147 to 150 of its first written submission, the US claims that the purpose of the FSC Replacement Act was to "equalize the treatment of US taxpayers abroad, regardless of whether they operate in branch or corporate form." It also claims that the restrictions placed on the use of the scheme by foreign corporations arise because:

> In drafting the Act, the US Congress sought to prevent taxpayers from inappropriately invoking the Act's exclusion with respect to tax-deferred income.[94]

And that

> These sections were not, as alleged by the EC, designed to discourage the application of the Act to foreign manufacturing companies or property manufactured outside the United States.[95]

133. The EC does not wish to speculate as to the intent of the US Congress but would simply point out some objective facts:

- The legal and factual situations of foreign branches and subsidiaries are complex and diverse. The EC has pointed to a series of factors affecting the choice of using one or other vehicle. Equalizing the tax treatment of the two vehicles will only partially affect the overall balance. In any event, the FSC Replacement Act does not do this. To give just one example, only foreign corporations making a domestication election are required to waive all benefits granted by the US under any treaty;
- Whether deliberate or not, the obstacles in the way of foreign manufacturers benefiting from the extended FSC Replacement subsidy are, as explained above, considerable;
- The FSC scheme is of much greater significance for US exporters who see the WTO-inconsistent FSC scheme replaced by an arithmetically identical scheme.

134. The EC submits that objectively the overwhelming purpose of the FSC Replacement scheme can only be considered to be the preservation of the FSC scheme benefits for US exporters.

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[93] First written submission of the EC, paragraph 144.
[94] First written submission of the US, paragraph 148.
[95] Paragraph 150.

4.3.3.4. Evidence

135. The title to Section V.C.5 of the US first written submission,[96] alleges that the EC has not provided *evidence* that the FSC Replacement subsidies are export contingent. It is not entirely clear what argument the US is making but the EC would make two points.

136. First, the EC believes that it has established with the arguments in its first written submission, and developed above, that FSC Replacement subsidies are export contingent.

137. These arguments are based on the text and structure of the FSC Replacement Act and other laws. The US has a responsibility to produce rebuttal arguments and, if necessary evidence. The EC has set out its views on the standard and burden of proof in Section 4.1 above. The EC cannot be expected to produce evidence that is within the control of the US.

138. Second, if the US is suggesting that *factual* proof is called for of specific companies actually be required to export, the EC rejects this contention because it is attacking the FSC Replacement Act *as such.*

4.4. The FSC Replacement subsidies are specifically related to exports within the meaning of item (e) of the Illustrative List

139. In Section 3.4 (paragraphs 147 to 158) of its first written submission, the EC argued that its conclusion that the FSC Replacement subsidies were prohibited export subsidies was confirmed by Item (e) of the Illustrative List, which defines as an export subsidy:

> The full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises (footnotes omitted)

140. The US responds to this argument indirectly in an introduction to its double taxation defence. It expresses the view[97] that the Illustrative List does not expand the prohibition in Article 3.1(a) and concludes that

> In order for paragraph (e) to apply, the tax benefits at issue must be export-contingent within the meaning of Article 3.1(a).[98]

141. The US position is therefore that the Illustrative List can only *reduce* the scope of the prohibition in Article 3.1(a) through the operation of footnote 5 to the *SCM Agreement*,[99] not expand it.

142. The EC rejects this contention of the US. The word 'including' in Article 3.1(a) of the *SCM Agreement* does not have to be taken to mean that the Illustrative List cannot expand the ordinary meaning of the first part of Article 3.1(a). It can also mean that the export subsidies defined in Annex I are *deemed* to be included in the prohibition of export subsidies.

143. The US is quoting the dictionary partially when it says that

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[96] Preceding paragraph 151.
[97] First written submission of the US, paragraphs 158 to 161.
[98] First written submission of the US, paragraph 161 *in fine*.
[99] First written submission of the US, paragraph 156.

> The term "include" is defined as "contain as a part of a whole" or "place in a class or category".[100]

144. The word "include" can also mean, according to the same dictionary:

> contain by implication, involve[101]

and, even more pertinently, the preposition "including" is defined as meaning

> If one takes into account, inclusive.[102]

Therefore the word "including" can also mean that 'taking into account', 'containing by implication' and therefore 'incorporating'. Indeed the same dictionary also gives 'include' as one of the meanings of 'incorporate'

145. This latter meaning of the word 'including' (that is 'incorporating' or 'taking into account') is confirmed by, indeed, required by, the *context*. Footnote 5 expressly excludes from the scope of the prohibition the measures referred to in Annex I as not constituting export subsidies. If the Illustrative List could only *reduce* and not *expand* the prohibition, it would not have been necessary to include the words 'including those illustrated in Annex I' in Article 3.1(a) which would then become redundant, a result that the Appellate Body has many times made clear is not acceptable.[103]

146. The meaning of the word 'including' is also required by the *object and purpose* of the *SCM Agreement*.

147. One of objectives of the Uruguay Round negotiations, and one to which the US was particularly attached, was to introduce more effective disciplines on certain subsidies which are considered particularly pernicious – export subsidies and import substitution subsidies. This can be seen from the fact that these subsidies are, unlike all other subsidies, *prohibited* and that action can be taken against them without there being any need to prove adverse effects.[104] It is also evident from the tighter deadlines[105] and more expeditious procedures[106] and remedies[107] contained in Article 4 of the *SCM Agreement*.

148. The intent of the parties in incorporating Annex I was not to ensure that everything that was previously not prohibited would now be exempted (which would mean *no progress*). It was to ensure that what was previously prohibited would remain prohibited (which means *no backtracking*). They added footnote 5 to ensure that only what was *referred to* (that is *identified*) in the Illustrative List as not being an export subsidy, would be exempted. If the Illustrative List exempted measures that are simply not identified as export subsidies, the general words of Article 3.1(a) would fail in their basic task of introducing stricter disciplines.

149. Therefore, the EC maintains that either

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[100] First written submission of the US, paragraph 160.

[101] New Oxford Shorter English Dictionary (1997 - CD-ROM version)

[102] *Ibid.*

[103] See e.g. Appellate Body Report, *United States - Import Prohibition of Certain Shrimp and Shrimp Products* WT/DS58/AB/R, adopted 6 November 1998, DSR 1998:VII, 2755, paragraph 131 and the other sources quoted there.

[104] Cp. Article 5 of the *SCM Agreement*.

[105] Deadlines are generally half those applicable in other disputes.

[106] For example, a Panel may be established on the first request – Article 4.4 of the *SCM Agreement*.

[107] Article 4.7 *SCM Agreement* requires an offending Member "withdraw the subsidy without delay".

- Item (e) is relevant as a separate source of prohibition of export subsidies; or
- It requires the term 'subsidies ... contingent upon export performance' in Article 3.1(a) to be read as including, at least as regards direct taxation measures, subsides that are specifically related to exports.

150. In either case the arguments presented by the EC in this connection in its first written submission, remain valid and item (e) of the Illustrative List confirms that the FSC Replacement scheme gives rise to prohibited export subsidies.

4.5. The FSC Replacement scheme provides subsidies which are contingent upon the use of domestic over imported goods contrary to Article 3.1(b) of the SCM Agreement

4.5.1. Footnote 5 of the SCM Agreement

151. The US first refers to footnote 5 of the *SCM Agreement*.[108] According to this footnote,

> Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any provision of this Agreement.

This reference is not entirely clear. The US does not specify which item of Annex I to the *SCM Agreement* would provide that the FSC replacement subsidies are not "prohibited".

152. To the extent that it hints to item (e) of Annex I, and in particular to the "double taxation" reference in footnote 59, which is the EC's assumption, it is addressed in Section 4.6 below.

4.5.2. The meaning of "contingent" and of the "local content" requirement

153. Next, the US also points out that the word "contingent" has the same meaning both in Article 3.1(a) and in Article 3.1(b) of the *SCM Agreement*, and specifically that it means " conditional" or "dependent for its existence on something else".[109]

154. From this the US draws the consequence that the basic FSC Replacement subsidy is not "contingent" within the meaning of Article 3.1(b) because, in the US view, they do not affirmatively require the use of any US manufactured articles or preclude using more than a fixed amount of imported articles.

155. It will already be clear to the Panel that the EC agrees that "contingent" means the same both in Article 3.1(a) and 3.1(b), and notably means "dependent for its existence".[110] In the Annex to its first written submission, the EC has precisely shown cases in which the "foreign content limitation " in the FSC Replacement Act will render the use of US articles *necessary*. It has done so with respect to certain production sectors in its first written submission. It further exemplifies those data with company related information in this submission.

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[108] First written submission of the US, paragraph 196.
[109] First written submission of the US, paragraph 198.
[110] First written submission of the EC, paragraphs 166, 83.

156. The EC notes that in an attempt to rebut the EC's claim, the US makes a very generic allegation that under the foreign content limitation "a good can meet this requirement even if 100 per cent of its content is foreign".[111]

157. It is rather ironic that later in its submission the US contends that in order to establish its case under Article 3.1(b) the EC has the burden of proving how the foreign content limitation works at individual company level, while crafting for itself this very light standard of proof. At any rate, the EC claim does not relate to a hypothetical and unspecified "good". The EC has not argued that for each and every product that can possibly be produced by the beneficiaries of the FSC replacement scheme the foreign content limitation will require use of US over imported goods. Article 3.1(b) however prohibits local-content contingency with respect to each and every product that can be produced by a beneficiary of a subsidy scheme. Therefore, a WTO Member adopting a measure of general application cannot excuse the WTO-inconsistencies of such measure in respect of some products by referring to the possible WTO-conformity of the same measure in respect of other products.

158. The US further tries to disguise the real scope of the foreign content limitation by suggesting that its rules of origin anyway turn non-US inputs into US origin components, thus diluting the real impact of the foreign content limitation.

159. A number of WTO Members have rules of origin turning foreign inputs into a domestic product upon a certain "transformation" or "processing", but this has never affected the application of WTO rules and notably those prohibiting local content requirements. The US rules of origin may increase the scope for some companies to arrange their affairs so as to comply with the requirement but do not remove the requirement.

160. The distinction between components entirely made of US inputs and components made up of a mix of US and foreign inputs nowhere is drawn in the FSC Replacement Act. More importantly, it is completely irrelevant under applicable WTO rules, and rightly so. If Article 3.1(b), in prohibiting subsidies contingent upon "use of domestic over imported goods" made a distinction between "pure" and "mixed" components, a WTO Member could simply dilute the local content contingency to the necessary extent and then escape Article 3.1(b) prohibition.[112] Instead, Article 3.1(b) prohibits local-content contingency to *any* degree, even a slight bias in favour of domestic goods. There is no *de minimis* rule for prohibited subsidies in the *SCM Agreement*.

161. The foregoing considerations are confirmed by practice under Article III:4 of GATT 1994. If the origin of the inputs of the domestic goods favoured by "local content" requirements were to be relevant, probably hardly any case could have been successfully brought under Article III:4 of GATT. Any country has rules of origin turning foreign inputs into a domestic product upon a certain "transformation" or "processing" but assessing the underlying input composition of a domestic good is not a type of enquiry which is required under WTO rules at issue in this dispute.

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[111] First written submission of the US, paragraph 200.

[112] Suppose, for example that, in order to meet a foreign content limitation, a domestic good is used which is in turn made up of foreign inputs for 85 per cent. According to the country's rules of origin, these foreign inputs are turned into a good of domestic origin by adding 10 per cent domestic inputs and 5 per cent domestic value added. If this new good was not caught by Article 3.1(b), there would be a 10 per cent *de minimis* rules.

162. If moreover, it was true that the foreign content limitation is so limited in its impact, the US has failed to explain why it has been so attached to it over the last fifteen years and continues to be so, to the point of reproducing in identical terms the relevant wording of the FSC Act in the FSC Replacement Act.[113]

4.5.3. Proof of the "contingency" in Article 3.1(b)

163. The US contends that the EC has failed to bring any evidence supporting its claims against the foreign content limitation.[114]

164. The US response to the EC's claims under Article 3.1(b) of the *SCM Agreement* and Article III:4 of GATT 1994 mainly relates to the burden and the standard of proof, and is an adaptation of that provided in connection with Article 3.1(a). The same considerations already developed by the EC on these issues in Section 4.1 above are the first reason why the US arguments do not refute the EC's demonstration.

165. The only way to back up this proposition is to put forward, as the US does in paragraphs 204 and 207 of its first written submission, a standard of proof for the present case that nowhere has been set out or applied to *per se* claims against legislative measures under Article 3.1(b). In essence, the US argues that the EC would have to prove how the foreign content limitation would actually operate at the level of individual beneficiaries of the FSC replacement scheme. As demonstrated below, this contention rests on a misrepresentation of the *Canada - Automobiles* Appellate Body Report and should be rejected.

4.5.3.1. The Canada – Automobiles case

166. The US seeks support for its contention in the Appellate Body's interpretations of Article 3.1(b) of the *SCM Agreement* in the *Canada – Automobiles* case.[115]

167. The EC is aware of such interpretations, but does not consider that they affect its case and draws the attention of the Panel to the following.

168. The measures before the Appellate Body in the *Canada - Automobiles* case were fundamentally different in nature and content from that at issue in these proceedings. The measures challenged in that case were a series of specific measures, each one contingent upon a different local content requirement, each one addressed to one particular beneficiary. While the possibility of becoming eligible for the duty free benefit (subject to the local content requirement set for each beneficiary) had existed for any company for some time, as of 31 July 1989 this possibility disappeared and the list of beneficiaries was frozen into a small closed class.[116]

169. The claim under Article 3.1(b) of the *SCM Agreement* concerned a "value added requirement" ("Canadian value added", or "CVA" requirement), imposed on car manufacturers as a condition for obtaining a benefit (in the form of a right to im-

[113] See the comparison in the first written submission of the EC, Section 3.5.
[114] First written submission of the US, paragraphs 207, 210, 216-217.
[115] First written submission of the US, paragraphs 204 ff.
[116] Panel Report, *Canada – Certain Measures Affecting the Automotive Industry* ("*Canada – Automobiles*"), WT/DS139/R, WT/DS142/R, adopted 11 February 2000, DSR 2000:VII, 3043, paragraph 2.10.

port cars duty-free, which amounted to revenue forgone by the Canadian tax authorities).[117]

170. The benefit was conferred upon a closed list of beneficiaries based on different individual measures laying down a different levels of CVA. The measures were of two types:

(i) The "Auto Pact" of 1965, later replaced by the Motor Vehicles Tariff Order (MVTO) of 1998

The MVTO was an administrative measure (Order-in-Council) addressed to a closed class of beneficiaries (certain companies, four overall, which were manufacturing cars in Canada in a previous "base-year", that is 1963-64).[118] For each of the beneficiaries, a different CVA was set in the "letters of undertaking" that each of them had submitted to the Canadian authorities, as well as in the Order-in-Council.

(ii) Special Remission Orders (SROs)

The SROs were also individual measures of administrative nature (Orders-in-Council). Some car-making companies, which could not qualify under the Auto Pact of 1965 because not producing in the "base year", had later been granted the same benefit through these measures. These additional beneficiaries also constituted a closed class[119] as a result of the 1989 "freezing". The SROs which were reviewed in the *Canada – Automobiles* case were thus individual measures, each one setting its own CVA requirement.[120]

171. Thus, the measures that the Appellate Body had before it in *Canada – Automobiles* were individual measures, each one applying a specific local content requirement to individual companies. The requirement of bringing evidence as to how the individual and different local content requirements were operating was set out by the Appellate Body in this context.

172. By requiring information at the level of individual company, the Appellate Body was seeking to assess how each different CVA requirement, and thus each of the challenged company-specific measures, would operate.

173. On the contrary, the measure at issue in this dispute is a legislative measure applying to an undetermined and unlimited series of instances and beneficiaries and setting out a single local content requirement. It does not therefore correspond to the hypothesis reviewed by the Appellate Body in the *Canada – Automobiles* case.

174. Moreover, the EC is contesting the consistency of the FSC Replacement Act with Article 3.1(b) *as such* – it is not making any claim in respect of its application in a particular sector or to a particular product.

175. Accordingly, the EC merely has to establish, based on the wording of the FSC Replacement Act, that the Act *in the abstract,* or *in some cases*, will give rise to the use of US over imported goods.

176. It may be that in certain sectors the foreign content limitation will not require the use of US products. This circumstance does not however make the foreign content limitation consistent with Article 3.1(b) for all the cases where that requirement

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[117] Panel Report, *Canada – Certain Measures Affecting the Automotive Industry* ("*Canada – Automobiles*"), WT/DS139/R, WT/DS142/R, adopted 11 February 2000, DSR 2000:VII, 3043, paragraph 10.202.

[118] *Ibid.*, paragraphs 2.4, 2.21-22.

[119] *Ibid.*, paragraph 2. 31.

[120] *Ibid.*, paragraph 2.32.

necessitates use of domestic goods over imported goods in order to obtain the tax benefit. Therefore the US cannot maintain a general, horizontal measure with such a foreign content limitation. Article 3.1(b) must be respected in each and every case, and the fact that the FSC Replacement Act may not in all cases give rise to use of domestic over imported goods cannot compensate for the cases where it will give rise to such use.

177. At any rate, the EC provided information in the Annex to its first written submission in order to *illustrate* its legal points. The EC notes that the US, while arguing that the EC should provide information at company level, has not even tried to challenge the information supplied by the EC relative to certain sectors.

178. Furthermore, although the EC does not believe that it is required to provide company specific information, for the case the Panel considered it necessary that the EC respond to the US contention, it has developed the Annex to its first written submission by providing additional explanation for the figures indicated therein. This additional explanation is in the form of examples of companies operating in the sectors considered in the Annex, for which the foreign content limitation gives rise to an obligation to use US over foreign goods. For ease of understanding, this information is added to the text of the Annex itself, which is hereby resubmitted. Should the Panel wish to review these data, the EC will ensure that the confidential documents establishing the accuracy of the figures used in the Annex are available at the meeting with the Panel.

179. For the foregoing reasons, the US has not refuted the EC's claim that the foreign content limitation makes the grant of the FSC Replacement subsidy contingent upon the use of domestic over imported products, contrary to Article 3.1(b) of the *SCM Agreement*. Accordingly, the EC requests the Panel to uphold its claim and find that the FSC Replacement Act is contrary to Article 3.1(b) and that the US has not withdrawn its subsidy, thus contravening the DSB recommendations and rulings.

4.6. The Double Taxation Defence

4.6.1. Introduction – The status of footnote 59

180. The US develops in some detail the position that both the first and last sentences of footnote 59 refer to measures that are not export subsidies within the meaning of footnote 5 to the *SCM Agreement*. The EC notes that the US is invoking the last sentence of footnote 59 as a defence.

181. The EC sees no reason to contest that the last sentence of footnote 59 may be an exception to Article 3.1(a). However, for the reasons that it will explain below, the FSC Replacement scheme is not a measure to avoid the double taxation of foreign source income.

182. The first sentence of footnote 59 on the other hand is more in the nature of a reminder that there is only a subsidy if revenue is forgone, rather than a statement concerning export subsidies, and in any event uses the words 'need not'. However, since the first sentence of footnote 59 does not appear relevant to the issues before the Panel, the EC will not comment further.

183. The EC notes that the terms "double taxation" and "foreign-source income" are terms of art with special meanings. It therefore considers that an analysis of the particular meanings these *terms* have acquired in the field of taxation is a more useful

starting point than the dictionary definitions of the individual words of which they are composed.

184. The EC will proceed to respond the double taxation defence by making the following points:

- Commenting on the meaning of 'measures to avoid double taxation';
- Explaining that the income excluded by the FSC Replacement scheme is not 'foreign source';
- Explaining why the FSC Replacement Act is not necessary for the avoidance of double taxation and may create double taxation or the 'over-compensation' of double taxation;
- Arguing that even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) because it gives exporters a choice that is not available to other operators.

185. Finally, the EC will comment on the view expressed by Canada that the income exempted under the extended FSC Replacement subsidy may be foreign-source income.

4.6.2. The meaning of 'measures to avoid double taxation'

186. The relief of double taxation forms one of the cornerstones of international tax policy. Eliminating the burden which unrelieved double taxation places on international trade and investment is one of the principal tasks of international tax rules. In this context, the international tax disciplines have been created in different levels, but the most widely recognized international standards for relieving double taxation are those recorded in the OECD Model Tax Convention on Income and Capital (hereinafter "the OECD Convention").[121] The US uses in its own treaty practice as a variation of the OECD Convention.[122] The OECD Convention forms the basis of the vast majority of double taxation treaties concluded between countries exercising their taxing rights and the two basic methods developed in the Convention to deal with the issue of double taxation, the credit method and the exemption method, are also commonly used as means of providing unilateral relief under the national legislation of practically all industrialized countries.

187. The US refers to the OECD Convention for guidance on the meaning of 'measures to avoid the double taxation of income'. The EC would first of all point at a fundamental principle reflected in the double taxation provisions of the OECD Convention.

188. The first paragraphs of Article 23A and Article 23 B of the OECD Convention state:

> Article 23A
>
> *EXEMPTION METHOD*
>
> 1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Conven-

[121] The US provides extracts from the OECD Convention in its Exhibit US-7. The EC provides the full text in Exhibit EC-12.

[122] The US Model Tax Convention is Exhibit EC-13.

tion, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

and

Article 23B

CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:

a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;

b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

189. A common feature of both of these paragraphs is the presence of the words:

which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State

190. Measures for the avoidance of double taxation relate to measures that may legitimately (hence "in accordance with the provisions of this Convention") be taxed in another State.[123] If a country provides a reduction of the tax burden for income that may not legitimately be taxed by another country, that is *single taxation relief*, not double taxation relief. Such a relief is clearly not required by any policy based on the relief from double taxation since double taxation by definition does not exist.

191. This point demonstrates a fundamental flaw in the US defence. That the FSC Replacement scheme income excludes from tax income that *cannot* be taxed by any other country. It is indeed an internationally embraced principle, that no country can tax the business profits of an enterprise resident in another country unless the enterprise resident in the other country carries on its business in the first mentioned country through a permanent establishment situated therein.

192. Indeed, Article 7 of the OECD Convention[124] reflects this principle when it states:

Article 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the

[123] The EC notes that in paragraph 182 of its first written submission, the US omits referring to the critical principle when it quotes selectively from the OECD Convention stating:

… the Commentary provides that, "[u]nder the principle of exemption, the state of residence R does not tax the income which ... may be taxed in [another country]."

[124] Full text in Exhibit EC-12.

other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

193. The taxing right over the business profits of an enterprise resident in any other country is thereby made dependent on the existence of a permanent establishment[125], which in the OECD Convention is defined in its Article 5;[126]

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop, and

a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

194. Under the FSC Replacement scheme the excluded income is derived from: [127]

- the sale, exchange, or other disposition of qualifying foreign trade property;

[125] In the Commentary to Article 7 of the OECD Convention it is further explained that "This Article is in many respects a continuation of, and corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular type of income shall or shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules of reference to which the profits made by the permanent establishment, or by an enterprise trading with a foreign member of the same group of enterprises, are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9." (paragraph 1).

[126] In the Commentary to Article 5 of the OECD Convention it is further explained that "the main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Under Article 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein." (paragraph 1).

[127] As enumerated in paragraph 118 of the first written submission by the US.

- the lease or rental of qualifying foreign trade property for use by the lessee outside the United States;
- the provision of services which are related and subsidiary to any sale, exchange, or other disposition of qualifying foreign trade property;
- the provision of services which are related and subsidiary to any lease or rental of qualifying foreign trade property;
- the provision of engineering or architectural services for construction projects located (or proposed for location) outside the United States; or
- the performance of managerial services for a person other than a related person in furtherance of the production of foreign trading gross receipts.

195. All these transactions can well be performed physically from within the territorial limits of the US and in so far as such activities are not carried out through a permanent establishment situated in another country, that other country will not have a legitimate right to tax the income that is excluded under the rules of the FSC Replacement scheme. The FSC Replacement scheme is therefore single taxation relief, not double taxation relief.

196. It is in principle possible, subject to a number of preconditions, for an US enterprise to benefit from the exclusion provided for in the FSC Replacement scheme by carrying out manufacturing outside the US through a branch situated in a foreign country, but as explained before such situations are in practice rare.[128]

197. Similarly, it is in principle possible that the above enumerated activities are carried out through a permanent establishment situated in a country other than the US, but here again it should be recalled that doing so would only entail an additional administrative burden and could indeed result in adverse tax consequences for the US taxpayer in question, which is why it is much more likely that such operations are carried out from within the territorial limits of the US.

198. In addition, it is important to note that the FSC Replacement scheme in no way requires as a precondition of the exclusion such foreign economic processes that would under the internationally accepted standards, constitute a permanent establishment for an US enterprise wishing to earn such excluded income.

4.6.3. The income excluded by the FSC Replacement scheme is not 'foreign source'

199. The last sentence of footnote 59 is expressly limited to the avoidance of double taxation of *foreign-source income.*

200. As a taxation term, the EC submits that the meaning to be attributed to the term 'foreign-source income' is that which it has in the field of taxation.

201. In tax treaties the source of income is usually referred to in an indirect manner. The term is not expressly defined in the OECD Convention, but its meaning can be deduced from the provisions of that Convention.

202. For example, Article 10 (Dividends) of the OECD Convention applies to 'dividends paid by a company which is a resident of a Contracting State'. The impli-

[128] See Section 4.3.3.2 above.

cation is that the company's residence determines the source of the dividend. Paragraph 5 of the same Article of the OECD Convention forbids imposition of tax on dividend in a Contracting State on the sole ground that the company's profits are derived from that state.

203. When it comes to business profits the source of income is commonly understood to mean the place in which the activities giving rise to these profits have taken place. Article 7 (Business Profits) quoted above makes this clear when read in conjunction with Article 5 also quoted above.

204. Thus, and as explained in more detail before, the taxing rights over business profits depend on the fact of whether and to what extent the activities have been carried out (are attributable to the activities) within the geographical limits of which Contracting States.

205. The US attempts to derive a definition of foreign-source income from its reading of the dictionary as follows:

> foreign-source income would appear to include money (or other assets) originating outside the borders or territory of the WTO Member instituting a measure to avoid double taxation.[129]

206. By substituting the words 'money' and 'assets' for 'income', the US introduces a confusion that, when revealed, well illustrates the unfoundedness of its defence. The tax that is concerned by the FSC Replacement Act is tax on income in the sense of profit. While it is true that the *money* to pay for exports comes from (has its source) outside the US, the same is not true of the *profit*. The profit on an export sale derives from the *economic activity*, which is conducted in the exporting country. Thus when the word 'income' in the term 'foreign-source income' is correctly understood as referring to *profit*, rather than *price*, it is clear that although the FSC Replacement Act undoubtedly only applies to foreign sales, the income it is excluding from tax is not foreign-source income.

207. There are many other instances of confusion between profit and price in the US first written submission leading ultimately to the manifestly wrong statement in paragraph 192 that:

> "extraterritorial income" under the Act is income derived from non-domestic sources. As such, it comes within the ordinary meaning of "foreign-source."

208. The EC would also point out that 'extraterritorial income' and 'qualifying foreign trade income' are also not foreign source income as this term is used in US legislation. This is made perfectly clear by section 943(c) of the IRC concerning source rules. This provision sets a *limit* to the amount of income from the sales of qualifying foreign trade property that may be considered as "from sources without the United States", that is, foreign source.

[129] First written submission of the US, paragraph 167

4.6.4. FSC Replacement scheme was not intended to and is not necessary for the avoidance of double taxation in the US and may create double taxation and in some cases over-compensates for 'double taxation'

209. The EC has noted in its factual comments above[130] that the US Congress did not understand the FSC Replacement Act as a measure to avoid the double taxation of foreign-source income but only referred to this notion in connection with the exclusion of foreign tax credits.

210. In this section the EC would simply refer to a number of more objective reasons that further confirms that the FSC Replacement Act is not a measure to avoid the double taxation of foreign-source income.

211. First, the US has no need of the FSC Replacement Act to avoid double taxation. Its system of foreign tax credits is a comprehensive means of avoiding double taxation. Indeed, the FSC Replacement Act, by providing a partial exemption from tax for 'extraterritorial income' and then only under certain conditions cannot solve problems of double taxation. The amount of "excluded income" under the FSC Replacement scheme being limited companies may still need to claim foreign tax credits to relieve double taxation in some cases.

212. The foreign tax credit provisions of the US Internal Revenue Code have not been repealed by the FSC Replacement Act and still provide the basic approach used by the US to relieve double taxation with respect to income subject to tax in other countries. If, as the United States allege, the exclusion of "extraterritorial" income is a measure to avoid double taxation, then it cannot, at the same time, be argued that the exclusion constitutes "a defined normative benchmark for taxing income earned on foreign transactions", since there cannot be two benchmarks. Canada submits that the US taxation of foreign income subject to a foreign tax credit remains the true benchmark despite the enactment of the FSC Replacement Act, and that the latter cannot be regarded as a "new" benchmark for the taxation of foreign income in the US.

213. Indeed the FSC Replacement Act, fits uneasily with the US arrangements for avoiding double taxation. Apart from failing to relieve double taxation completely, in some circumstances, it can lead to over-compensation of 'double taxation' in other circumstances. This arises as follows:

214. The provision of the FSC Replacement Act that is presented as preventing the cumulation of the foreign tax credits and excluded income under the FSC Replacement Act two is the new section 114(d) of the IRC which generally disallows credit for foreign tax paid with respect to extraterritorial income that is excluded from gross income. However the new section 943(d) of the IRC states that, for purposes of section 114(d), any "withholding tax" shall not be treated as paid or accrued with respect to excluded income.

215. As a result, a US taxpayer will be able to claim credit against its US taxes for a foreign tax imposed on its excluded income provided that the tax is a "withholding tax."

[130] Section 3.6 above.

216. The new section 943(d) of the IRC defines a "withholding tax" as "any tax which is imposed on a basis other than residence and for which credit is allowable under section 901 or 903."

217. If a US corporation is engaged in selling goods in a foreign country, one would generally expect the foreign country to subject those sales to its net income tax, not to a gross-basis withholding tax, and do so only in the case where that US corporation carried out its business through a permanent establishment situated in that foreign country. At the same time, the US corporation, while engaged in business in the foreign country, will not typically be considered a "resident" of that country and in fact normally for the purposes of double taxation treaties would not be accorded such resident status. In such a case, the foreign tax would appear to come within the definition of "withholding tax" now in new section 943(d). Thus, the US corporation would be entitled to credit for such withholding tax even though a portion of its sales income is excluded from gross income under new section 114(a).

218. 'Double' relief from 'double taxation' cannot in any circumstances be considered a means of avoiding double taxation and further demonstrates that the purpose of the FSC Replacement Act is the granting of tax benefits to US exporters.

219. Second, the FSC Replacement Act, rather than avoiding double taxation actually creates it since it requires foreign corporations that are subject to the tax jurisdiction of other countries but wish to benefit from the FSC Replacement Act to make a 'domestication election' to become subject to US tax jurisdiction as if they were US corporations and to waive all rights under treaties and in particular under bilateral tax treaties.

220. Another indication of the fact that 'avoiding of double taxation' of foreign-source income cannot be the real objective of the FSC Replacement Act is that it applies formulaic rules to calculate the excluded part of the income. In doing so the amounts excluded do not correspond to the arm's length apportionment of the profits that would be considered to relate to the part of profit which another country would seek to tax in case that there was such possibility for the other country to do so. The foreign economic processes preconditions for the applicability of the exclusion are variable and require different levels of inputs to be made outside the US, but the rules for calculating the amount of excluded income remain the same irrespective of the nature of the foreign economic processes. Anyway, none of the required foreign economic processes would imply that the country of destination of the exported goods would have the right to tax the income derived from the export transactions. They would not establish effective connection with trade and business and thereby a permanent establishment in that country.

4.6.5. Even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) because it gives exporters a choice that is not available to other operators

221. Even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) of the *SCM Agreement* because it gives exporters a *choice* that is not available to other operators. Allowing exporters the choice between two alternative methods of double taxation relief gives such companies an export-contingent advantage which is not available to other companies. This additional advantage would also be a subsidy, but

would not be an "exemption, remission or deferral of tax," which is the only kind of measure that item (e) covers.[131]

222. An additional complaint that can be made against the FSC Replacement Act is that it can give rise to 'double' double taxation relief as explained in the previous section. This unwarranted *overcompensation* is also a subsidy that is contingent upon export performance and specifically related to exports.

4.6.6. Comment on the view expressed by Canada that the income exempted under the extended FSC Replacement subsidy may be foreign-source income

223. As mentioned above, the EC has one final comment to make on the double taxation defence. Canada expressed the view in its third party submission that

> the "foreign income" component of "extraterritorial income" is the type of income typically subject to a measure designed to avoid double taxation.[132]

224. It immediately went on to say that

> However, in Canada's view, the United States has added this new category of income to the measure in question in an attempt to confuse the domestic tax situation that would otherwise apply to the "domestic export income" component of "extraterritorial income".

225. Canada is clearly of the view that the income covered by the extension of the scheme to the foreign sales of foreign goods is of a different nature than that earned by the sale of US goods. The EC agrees and that is in fact why is considers that there are two subsidies arising under the FSC Replacement Act.

226. But the EC does not agree with Canada's apparent view that the income covered by the extended FSC Replacement subsidy will be foreign source and potentially benefit from the last sentence of footnote 59.

227. The reason for this is that, as the US points out in a different context, US companies can earn 'extraterritorial income' by selling goods made abroad by a foreign producer (provided they satisfy the conditions of the FSC Replacement Act, notably by making a domestication election and respecting the foreign content limitation). The income earned by a US company by distributing foreign goods may in large part be earned within the US. Indeed as observed above[133], the Section 943(e)(4)(C) of the IRC *limits* the extent to which this income may be foreign-source income for US tax purposes.

228. Accordingly, not even the extended FSC Replacement subsidy can in any event be considered to come within the last sentence of footnote 59 to the *SCM Agreement*.

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[131] As the US rightly observes, footnote 59 is attached to item (e), not to any other provision of the *SCM Agreement* and would not therefore be able to save the FSC subsidies. See e.g. paragraphs 103 and 110 of the US Appellant's Submission.

[132] Third party submission of Canada, paragraph 33.

[133] At the end of Section 4.6.3.

4.7. The FSC Replacement scheme provides treatment less favourable to products imported into the US than that accorded to like US products, contrary to Article III:4 of GATT 1994

229. The US response to the EC claim under Article III:4 of GATT 1994 is limited to two points. The first is again the argument that the FSC Replacement Act does not contain an affirmative requirement to use US goods. The second relates to the burden and standard of proof.

4.7.1. The "affirmative requirement" argument

230. As the Panel will know by now, the US has repeated throughout its submission that the FSC Replacement Act does not require use of US-origin goods but provides that no more than 50 per cent of the value of goods may be attributable to foreign content (articles and direct labour).

231. As explained in its first written submission[134], the EC submits that in all cases, the requirement will act as an incentive to source inputs domestically because this will enhance the chances of a US producer intending to export its goods to qualify for the tax benefit. This is sufficient to violate Article III:4 of GATT 1994, which guarantees equality of competitive opportunities and foreign markets undistorted by discriminatory internal regulations. In addition, in some cases (like the ones in the Annex to the first written submission of the EC), depending on the cost structure of a given product type, the foreign content limitation will *necessitate* use of domestic goods.[135] It will thus be even more than an *incentive* for the use of US goods, which is the standard under Article III:4.

232. In the *Canada – Automobiles* case the panel was confronted with a similar argument. Canada argued that the Canadian value added ("CVA") requirements did not provide less favourable treatment within the meaning of Article III:4 since "these requirements [did] not affect the "internal sale,… or use" of imported products because they [did] not in law or in fact require the use of domestic products and therefore play[ed] no role in the parts sourcing decisions of manufacturers."[136] However, the panel noted the broad interpretation given by the Appellate Body to the term "affecting" [137] and concluded that

> a measure which provides that an advantage can be obtained by using domestic products but not by using imported products has an impact on the conditions of competition between domestic and imported products and thus affects the "internal sale,… or use" of imported products, *even if the measure allows for other means* to obtain the advantage, such as the use of domestic services rather than products. Consequently, the CVA requirements, which confer an advantage upon the use of domestic products and deny that advantage in case of the use of imported products, must be regarded as measures which "affect" the "internal sale,… or use" of imported products, *notwithstand-*

[134] First written submission of the EC, Section 3.7.
[135] First written submission of the EC, Section 3.5; rebuttal submission of the EC, *supra*, Section 4.6.
[136] Panel Report, *Canada - Automobiles*, DSR 2000:VII, 3043, paragraph 10.79.
[137] *Ibid.*, paragraph 10.80.

> *ing the fact that the CVA requirements do not in law require* the use of domestic products.[138]

The panel report was not appealed on this point.

4.7.2. The EC has made a prima facie case which stands unchallenged

233. More fundamentally, the US response fails to undermine the EC case because it is premised on an incorrect view of the standard of proof in cases brought under Article III:4 of GATT 1994.

234. The US seems to assume[139] that in order to establish its case the EC should supply evidence that a particular class of imported goods will be accorded less favourable treatment than a class of domestic "like products".

235. All the US seems to do for the rest is to point to a "heightened burden" that it alleges to exist for cases where a measure of general application is challenged.[140]

236. The foregoing is unsupported by WTO rules, and does not correspond to panel or Appellate Body pronouncements in cases reviewing Article III:4 claims, including against legislation *per se* as in the present proceedings.

237. All the EC has to prove is, based on the terms of the law, that the FSC Replacement Act provides that an advantage can be obtained by using domestic products but not by using imported products, even if the measure allows for other means to obtain the advantage.[141]

238. On the contrary, the EC does not have to show the "effects" of the FSC Act. The very fact that it is easier to meet the foreign content limitation and therefore obtain the benefit if domestic products are used than if imported products are used is sufficient to find that this requirement affects internal sale.[142]

239. Whether or not Article III:4 cases were mostly brought against product specific or horizontal measures is irrelevant. What is relevant is that where a horizontal measure was challenged, the standard applied did not differ from that applied for product specific measures.

240. The *EEC - Parts and Components* case, already referred to by the EC, is in point.[143] The dispute concerned a horizontal measure of general application, Article 13.10 of the EEC's basic anti-dumping regulation in force at that time.

241. The panel reviewed the words of that provision as such.[144] It noted that they made the grant of an advantage (the suspension of certain anti-dumping proceedings against finished products) conditional on limiting the use of foreign (Japanese) components, without imposing similar limitations on the use of like EEC products,

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[138] Panel Report, *Canada - Automobiles*, DSR 2000:VII, 3043, paragraph 10.82 (emphasis added).
[139] First written submission of the US, paragraph 216.
[140] First written submission of the US, paragraph 218.
[141] Panel Report, *Canada - Automobiles*, DSR 2000:VII, 3043, paragraph 10.82.
[142] *Ibid.*, paragraph 10.83. Evidence is in any event *already* before the Panel because it is already included in the Annex to the first written submission of the EC. The EC notes that the US has not made any attempt to refute this evidence, nor has it brought evidence to the contrary.
[143] Panel Report, *EEC – Regulation on Imports of Parts and Components*, BISD 37S/132, adopted 16 May 1990 ("*EEC – Parts and Components*").
[144] *Ibid.*, paras. 5.20-5.21.

thereby according "treatment to imported products less favourable than that accorded to like products of [EEC] origin". After this analysis of the terms of the law as such, it also concluded that the individual measures taken on the basis of Article 13.10 of the basic anti-dumping regulation violated Article III:4 of GATT 1994. The Panel conducted the whole analysis without the need to compare a certain class of domestic products with the same class of imported products.[145]

242. For the above reasons, the US has not refuted the EC's claim that the foreign content limitation provides less favourable treatment to imported parts and materials than to domestic goods with respect to their internal use in the production of goods, contrary to Article III:4 of GATT 1994. Accordingly, the EC requests the Panel to uphold its claim and find that the FSC Replacement Act violates Article III:4 of GATT 1994.

4.8. The transitional provisions of the FSC Replacement Act allow companies to continue to benefit from the WTO incompatible FSC scheme beyond 30 September 2000

243. The EC explained in its first written submission that the FSC Replacement Act allows US exporters to continue to benefit from the WTO-incompatible FSC scheme until 31 December 2001 using FSCs existing on 30 September 2000 and, in certain circumstances, allows them do so for an *indefinite period* and therefore perpetuates the violations found to result from the FSC scheme beyond the period provided for in the Panel Report and confirmed by the Appellate Body.[146]

244. The US does not deny these basic facts but tries to argue that its failure to respect its obligations under Article 4.7 of the *SCM Agreement* and Article 21 of the *DSU* is 'reasonable' for a series of reasons on which the EC will now comment.

245. The first of these reasons is that it is necessary to "lessen the administrative burden and impact on taxpayers' business operations that might result due to the repeal of the FSC" and that this is customary in the US.[147]

246. The EC does not contest the policy arguments in favour of transition rules but that is precisely why it, and it assumes the Panel, agreed in the original proceedings to allow the US to have a relatively long period of time to abolish the FSC scheme. This *was* the transitional period. The Panel specified "that FSC subsidies must be withdrawn at the latest with effect from 1 October 2000."[148]

247. The Panel's findings were first known to the US on 23 July 1999 (in the Interim Panel Report) and to the whole world on 8 October 1999 (with the publication of the final Panel Report). The Panel Report was not adopted until 20 March 2000 due to the appeal, but the date of 1 October with effect from which the Panel speci-

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[145] In this connection the EC would also like to comment on the sentence taken from its first written submission which the US cites completely out of its context (first written submission of the US, paragraph 217). That sentence has of course to be read in its context. The EC was arguing that absence of a violation in respect of certain products cannot "compensate" or excuse cases where domestic products will or can be preferred. Article III:4 protects potential competition, not solely actual competition. This however has nothing to do with what the EC has to prove, since, as demonstrated in the text, there is no requirement to show the effects of a measure challenged under Article III:4.

[146] First written submission of the EC, paragraphs 234 to 241.

[147] First written submission of the US, paragraphs 224 to 227.

[148] Panel Report, paragraph 8.8.

fied that the FSC subsidies must be withdrawn (at the latest), was not the subject of appeal. That date was chosen, as the Panel will recall, because it was argued that it would be unduly disruptive to change tax rules in the middle of a tax year.

248. The usual period of time for abolishing a prohibited export subsidy is just 90 days.[149] The US had more than twice this period, following the adoption of the Panel Report by the DSB and an extra 8 months to prepare itself from the date of the Interim Panel Report.

249. The deadline of 1 October 2000 therefore took into account the need for a transitional period and the US did not object to the length of this period. Even if the US had raised in the original proceeding in a more explicit way the arguments that it is now making about the need to avoid disrupting 'business operations' this would not have justified any longer period.

250. First, it is well known that tax rules are subject to revision at least every year and companies are well aware that they cannot assume that tax breaks will be available indefinitely. They therefore arrange their affairs so as to minimize the disruption that changes may cause. In the present case they had almost a full tax year in which to adjust.

251. Second, disruption to private contracts has already been rejected by the Appellate Body as well as panels as a reason for not applying WTO rules. In the Article 21.5 proceeding concerning *Brazil – Aircraft*, the Appellate Body rejected an argument that private contractual obligations could be relevant to the question of fulfilling an obligation to withdraw a prohibited export subsidy.[150] In the Article 21.5 proceedings concerning *Australia – Automotive* leather the panel ruled more generally that:

> Many situations can be envisioned, and not only in the subsidies area, in which a Member's actions to implement a ruling of the DSB might result in some interference with private rights, and result in domestic legal claims. This possibility does not, in our view, limit our interpretation of the text of the SCM Agreement.[151]

252. Finally, on this point, the EC would note that the US is perfectly capable of adopting tax legislation that interferes with private rights. As the US later states itself[152], the FSC Replacement Act was adopted on 15 November 2000 and prevented the creation of new FSCs retroactively to the 1 October 2000. There were no howls of protest, because taxpayers knew that the rules were likely to change and took their precautions.

253. The second reason given by the US why the Panel should excuse its failure to withdraw the FSC subsidies with effect from 1 October 2000 is that WTO rules should, according to it, be 'construed flexibly'.[153] It cites the Appellate Body Report

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[149] Panel Report, *Australia – Automotive Leather*, WT/DS126/R, adopted 16 June 1999, DSR 1999:III, 951, para. 10.7; Panel Report, *Canada – Aircraft*, WT/DS70/R, adopted 20 August 1999, DSR 1999:IV, 1443, para. 10.4; Panel Report, *Brazil – Aircraft*, WT/DS46/R, adopted 20 August 1999, DSR 1999:III, 1221, paragraph 8.5.

[150] Article 21.5 Appellate Body Report, *Brazil – Aircraft*, WT/DS46/AB/RW, adopted 4 August 2000, DSR 2000:VIII, 4067, para. 46.

[151] Article 21.5 Panel Report, *Australia – Automotive Leather* WT/DS126/RW, adopted 11 February 2000, DSR 2000:III, 1189, para. 6.23.

[152] First written submission of the US, paragraph 231.

[153] First written submission of the US, paragraph 227.

in *Japan – Alcoholic Beverages*, as authority for this proposition. The US is not of course asking for rules to be 'construed flexibly' but to be *enforced leniently*. The Appellate Body was considering in that case the flexible notions of 'like product' and 'directly competitive or substitutable product' which clearly have scope to be construed flexibly. In the present case, however, the rules are perfectly clear.

254. The final arguments that the US throws into the pot are that the EC waited a long time before challenging the FSC scheme and that the year 2000 was a presidential election year.[154] The first point was already made before the Panel and the Panel knows the EC's and its won response to it. The second point is true, but was also known at the time of the original proceeding. If elections can be relevant at all, the EC would have thought that the fact that the incumbent president was leaving office and not seeking re-election would have made overcoming vested business interests and complying with WTO obligations easier rather than more difficult.

255. Accordingly, the EC maintains that the US has failed to implement the relevant DSB recommendations and rulings.

4.9. The US failed to implement the rulings and recommendations of the DSB by 1 November 2000

256. The US response to the EC's claim that the US failed to comply with the DSB recommendations and rulings within the period of time specified by the DSB and has therefore also failed to comply with Article 21 *DSU* is based on a fundamental error. The US claims in paragraph 231 of its first written submission that:

> The DSB recommended that the United States withdraw the FSC subsidies with effect from 1 October 2000, which the DSB then extended to 1 November 2000.

257. The first part of the quoted sentence is correct because the DSB adopted the Panel's ruling that the FSC subsidies must be withdrawn at the latest with effect from 1 October 2000. The second part of the sentence is not correct. The powers of the DSB under Articles 16.4 and 17.14 of the *DSU* and 4.9 of the *SCM Agreement* are only to adopt or not adopt (that is reject) panel and Appellate Body reports. It cannot modify them.

258. What the DSB did on 12 October 2000 was to modify the time period for implementing measures to be adopted, *not* the date from which they were to take effect, which was specified in the Panel Report.

259. Accordingly, the retroactive repeal of the FSC scheme with effect from the 1 October 2000 would (if it had really repealed the FSC scheme, withdrawn the FSC subsidies and not introduced measures inconsistent with the covered agreements) have implemented the Panel's ruling in paragraph 8.8 of the Panel Report but not the requirement in Article 21 of the *DSU* to do so within a reasonable period of time, which the DSB had specified would end on 1 November 2000.[155]

260. The US also argues that

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[154] First written submission of the US, paragraphs 228 and 229.

[155] Australia states (in paragraph 10 of its Third Party Submission) that the EC agreed to the extension to 1 November 2000. This is not correct. The EC simply supported the consensus in the DSB to grant the extension.

> Panels typically refrain from examining measures that cease to be in existence or in effect before a panel's terms of reference are set.[156]

261. The EC would simply point out that it is not asking the Panel to examine a measure that is no longer in effect. It is asking it to find that there was a *failure* to act by a certain deadline. A finding on such an issue is necessary to ensure that in future all WTO deadlines are not *de facto* extended by the length of time necessary to have a panel established and its terms of reference set.

5. CONCLUSION

262. For the above reasons, the EC maintains the conclusions set out in its first written submission.

[156] First written submission of the US, paragraphs 232 to 233.

ANNEX

THE COST OF MATERIALS AS A PERCENTAGE OF THE FAIR MARKET VALUE OF PRODUCTS

Section 943(1)(C) of the IRC, introduced by the *FSC Repeal and Extraterritorial Income Exclusion Act*, defines qualifying foreign trade property to be, *inter alia*,

property—

(C) not more than 50 per cent of the fair market value of which is attributable to—

(i) articles manufactured, produced, grown, or extracted outside the United States, and

(ii) direct costs for labour (determined under the principles of section 263A) performed outside the United States.

The cost of materials as a percentage of the final price of any product varies according to a number of factors, e.g. the market price of the materials, the relative cost of other factors of production (e.g. labour, overheads, depreciation), the level of integration of the producer concerned, and the expected level of profit.

Nevertheless, there are some products, produced or assembled in certain ways, for which the materials are so important an input that it is difficult to believe that their contribution to fair market value could ever be below 50 per cent.

The EC's main legal argumentation in respect of this requirement is developed in the text of its submissions to the Panel. In addition, and for purely illustrative purposes of that general argumentation, the EC gathered some data relating to the production in certain sectors (and has cross-checked them with information obtained from certain European industries and in the course of various trade investigations).

The most obvious examples are fairly basic products, with little or no brand value, having a low level of processing and attracting a low profit margin. Some examples are as follows.

For some products (heavy steel plate, stainless steel fasteners, aluminium household foil and PET bottle chip) more precise cost figures for individual firms are given. The firms involved are not identified and the currency is not specified. If the Panel wishes to see the source information, this could be made available at the meeting with the Panel.

In the calculations for individual firms, the selling price is based on a profit margin of 10 per cent. This is a generous figure, since it is in excess of target profit for each of the products concerned, and well above the actual profit margin for the products. It is also above the 8 per cent figure used in the US Tariff Act of 1930. The 10 per cent profit margin normally results in a more conservative percentage of raw materials for the individual firms than is found in the section on the general cost assumptions for the product.

1. The Steel industry

(a) Hot-rolled coils

Hot-rolled coils are manufacturing in steel mills and are the pre-material for many types of steel products e.g. wide and narrow strips, cold-rolled products, tubes. The normal cost of production (including SGA expenses) of hot-rolled coils is around 207 Euro per tonne; on this basis fair market value is around 220 Euro per tonne.

The cost of materials involved in production is:

Iron	109 Euro per tonne
Steel scrap	15 Euro per tonne
Others	8 Euro per tonne
Total	**132 Euro per tonne**

The contribution of materials to the fair market value of hot rolled coils is around 60 per cent.

(b) Heavy Steel Plate

The normal cost of production (including SGA expenses) of heavy plate is 290 Euro per tonne; on this basis the fair market value is around 310 Euro per tonne.

The cost of materials involved in production:

Steel slab	200 Euro per tonne
Steel scrap	-10 Euro per tonne (recovered)
Total	**190 Euro per tonne**

The contribution of materials to the fair market value of steel plate is around 61 per cent.

A cost breakdown in a specific example of a producer of heavy steel plate is as follows:

Cost of production - Heavy steel plate	
1999	
Raw materials	55.324.999
Total Iron	106.342.592
B. BOF plant*	57.743.638
Input coefficient (t)	0,8223
Liquid steel	164.086.230
C. Continuous casting*	36.078.324
Input coefficient (t)	1,0386
Slabs	200.164.554
D. Quarto mill	
Rolling mill*	30.427.365
Input coefficient (t)	1,0132

Cost of production - Heavy steel plate	
1999	
Finishing*	43.509.319
Input coefficient (t)	1,1302
E. Total cost of manufacturing	274.101.238
F. SG+A**	20.776.874
G. **Total cost of production**	294.878.112
H. Quantity produced to which	57.204
these costs are related	
I. Unit cost per tonne	5.155

* Including direct labour, energy, maintenance and repair

** Including selling expenses, general + administration, financing cost, depreciation, etc

Thus, the cost of raw materials to the firm concerned is 200 million. Assuming a recovery rate of 5 per cent for steel scrap, this makes the net total cost of materials 190 million. The total cost of production is 295 million. Assuming a 10 per cent profit, the selling price is equivalent to 325 million. This means that, in the case of this firm, raw materials account for 58 per cent of the final selling price.

(c) Stainless Steel Fasteners

The raw material for making stainless steel fasteners is stainless steel wire rod. The cost of the raw material accounts for between 55 and 61 per cent of the fair market value (normal selling price) of the final product.

A cost breakdown in a specific example of certain producers of Stainless Steel Fasteners is as follows:

All companies	1996	1997	1998	1999	Average
Full cost all products	81.619	94.133	102.566	99.691	94.502
Cost of raw material purchases	47.134	64.119	64.843	58.456	58.638
Cost of salaries	8.585	9.696	10.721	10.584	
Cost of social benefits	4.058	4.655	4.787	4.748	
Depreciation of tangible fixed assets	3.409	3.304	3.663	3.716	
Cost of raw material purchases as a % of full cost	57.7%	68.1%	63.2%	58.6%	
Cost of salaries as a % of full cost	10.5%	10.3%	10.5%	10.6%	
Cost of social benefits as a % of full cost	5.0%	4.9%	4.7%	4.8%	
Depreciation of fixed assets as a % of full cost	4.2%	3.5%	3.6%	3.7%	
Total	77.4%	86.9%	81.9%	77.7%	

Thus, the average cost of raw materials to a number of firms over a four-year period is 58.638. The total cost of production is 94.502. Assuming a 10% profit, the

selling price is equivalent to 103.952. This means that, in the case of these firms, raw materials account for 56 per cent of the final selling price.

2. Other metal products

Aluminium household foil

The main raw material for aluminium household foil is aluminium slabs. The cost of the raw material accounts for between 58 and 63 per cent of the fair market value (normal selling price) of the final product.

A cost breakdown in a specific example of a producer of Aluminium Household Foil is as follows:

ALUMINIUM HOUSEHOLD FOIL 1999

	CONVERTER
SALES TONNES	3.797
GROSS SALES	7.555
DEDUCTIONS	357
NET SALES	7.198
COST 0 Materials	**4.900**
COST 0 TONNE	1.290
CONT 0	2.298
CONT 0 TONNE	605
COST 1 Variables	1.713
COST 1 TONNE	451
CONT 1	586
CONT 1 TONNE	154
COST 2A Fixed Mftg	303
COST 2B Depreciation	447
COST 3A Selling	61
COST 3B R&D	3
COST 3C Admin	114
CONT 3 (Before Man Fee)	(343)
MANAGEMENT FEE	55
CONT 3	(397)
Other	
Profit (Loss)	**(397)**

Thus, the cost of raw materials to the firm concerned is 4900. The total cost of production (the sum of items 1,2&3) is 7596. Assuming a 10 per cent profit, the selling price is equivalent to 8356. This means that, in the case of this firm, raw materials account for 59 per cent of the final selling price.

3. Woven glass fibre fabrics

The raw material for producing woven glass fibre fabrics is glass fibre yarn. The cost of the raw material accounts for between 55 and 60 per cent of the fair market value (normal selling price) of the final product.

4. Chemicals and synthetic fibres

Polyethylene Terephthalate Bottle Resin

The raw materials for producing this product, which is used for the production of plastic bottles, are purified terephthalic acid, mono ethylene glycol, diethylene glycol and isophthalic acid. Together these can account for up to 70 per cent of the fair market value (normal selling price) of the final product.

A cost breakdown in a specific example involving a producer of PET Bottle Chip is as follows:

Cost of production of product concerned PET Bottle Chip

FINANCIAL YEARS	**IP 01/10/98-30/09/99**
Raw materials :	
Terephtalic Acid PTA	59 236 670
Ethylene Glycol	19 844 039
Other	3 862 167
Total raw materials	**82 942 876**
Power and electricity	5 025 906
Direct labour	2 378 949
Total direct costs (a)	90 347 731
Manufacturing overheads	
Indirect labour	9 488 430
Maintenance	1 437 219
Depreciation	7 508 704
Other	154 976
Total overheads (b)	18 589 329
Total manufacturing (a+b)	108 937 061
SG&A expenses	
Transport	3 789 123
Other selling expenses	2 282 316
General and administration	2 484 857
Financial costs	1 551 716
Total SG&A (c)	10 108 013
Research & development (d)	1 435 111
Full cost (a+b+c+d)	**120 480 185**
Quantity produced	25596
Unit cost per tonne	4706.992703

Thus, the cost of raw materials to the firm concerned is 82.9 million and the full cost of production (including SGA, finance costs and R&D) is 120.5 million. With a profit margin of 10 per cent, the selling price of PET is equivalent to 132.6 million. This means that, in the case of this firm, raw materials account for 63 per cent of the selling price of this product.

5. Aircraft

Even without looking at the aluminium and alloys used for the production of airframes, the engines of an aircraft can account for 30 per cent of the final price of the finished product. Similarly, the avionics and other equipment on a modern aircraft can also cost 30 per cent of the final value.

Engines, avionics and other equipment are typically purchased from outside suppliers. Together they can account for 60 per cent of the final price.

NOTE

Assembly always involves direct labour costs, which can be quite high. This means that, to take the example of aircraft where bought-in engines, avionics and other equipment account for 60 per cent of the final value, the 10 per cent that must be sourced in or from the US in order not to exceed the 50 per cent limitation is increased by the amount of the foreign direct labour costs also incurred by the producer.

LIST OF EXHIBITS

EC-10	Article: *US Treasury Official Denies FSC Repeal Signals Move to Territoriality* Tax Notes International, 18 December 2000, pp 2749 to 2752.
EC-11	Extract from the US Treasury Budget estimates for Financial Year 2001 entitled Total Revenue Loss Estimates in the Income Tax (providing FSC revenue loss figures for financial years 1999 to 2005).
EC-12	OECD Model Tax Convention on Income and Capital.
EC-13	The US Model Tax Convention.

ANNEX C-2

SECOND WRITTEN SUBMISSION OF THE UNITED STATES

(27 February 2001)

TABLE OF CONTENTS

I. INTRODUCTION

1. In accordance with the scheduled established by the Panel, the United States submits this second submission in this proceeding arising from the recourse by the European Communities ("EC") to Article 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* ("DSU"). Because the rebuttal comments of the EC are due to be submitted simultaneously with these comments, the United States will present its response to the EC's rebuttal at the Panel meeting. Thus, these comments are limited to developments that have occurred in this proceeding since the filing of the first written submission of the United States in this

proceeding ("*First US 21.5 Submission*"). Specifically, these comments address arguments contained in the third-party submissions.

2. A number of the arguments and positions expressed in the third-party submissions are the same or similar to those presented by the EC, arguments to which the United States previously has responded. To the extent the third parties raise arguments not presented by the EC, such arguments cannot serve to meet the EC's burden in this proceeding. With this overriding consideration in mind, the United States addresses below certain arguments and issues raised in the third-party submissions.

II. ARTICLE 3.1(A) OF THE SCM AGREEMENT

3. In providing their views on Article 3.1(a) of the SCM Agreement, Australia and Canada first discuss whether the Act's exclusion constitutes a subsidy under Article 1 of the SCM Agreement, and then give their views on whether the exclusion is export contingent within the meaning of Article 3.1(a). Accordingly, the United States first takes up the subsidy issue and then proceeds to examine export contingency.

A. Australia and Canada err in their Subsidy Analysis

1. Australia's Argument

4. Australia argues that the Act's exclusion constitutes a subsidy under Article 1 because, in its opinion, *all* tax exclusions constitute subsidies. Australia states that "'foreign trading gross receipts' [are] excluded from gross income on which tax liability is calculated. The effect of the exclusion is to reduce the tax liability of the beneficiary corporation."[1] Australia reaches this conclusion based on the premise that the reduction in tax liability flowing from the exclusion of extraterritorial income "represents a departure from the rules of taxation that would otherwise apply to such gross income."[2]

5. Australia's analysis is flawed in several respects. First, Australia fails to recognize that the Act's exclusion of extraterritorial income is an integral part of the definition of "gross income", a concept which forms the outer boundary of US taxing jurisdiction. The exclusion is, in the words of the Appellate Body, the "prevailing domestic standard" or "normative benchmark" under US law against which any particular measures must be evaluated.[3] Accordingly, Australia's assertion that the Act's exclusion "represents a departure from the rules of taxation that otherwise apply" is simply incorrect.

6. Second, Australia's erroneous characterization of the effects of the Act seem to result from its misunderstanding of how the US tax system operates. Australia states in its submission that, "[a]s a general rule, the United States asserts the right to tax all income earned worldwide by its citizens and residents."[4] This statement fails

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[1] *Australia Third-Party Submission*, para. 14.
[2] *Ibid.*
[3] *United States - Tax Treatment for "Foreign Sales Corporations"* ("*FSC (AB)*"), WT/DS108/AB/R, Report of the Appellate Body adopted 20 March 2000, DSR 2000:III, 1619, para. 90.
[4] *Australia Third-Party Submission*, para. 4.

to recognize that the Act fundamentally altered the manner in which the United States treats foreign income. It is incorrect to argue that "the effect of the exclusion is to reduce ... tax liability" because no such liability exists in the first place under the US tax system with respect to excluded extraterritorial income.

7. Third, Australia's test for subsidization apparently would condemn any tax reform that results in a contraction of a Member's tax base. According to Australia, any measure that reduces tax with respect to a category of income confers a subsidy. Taken to its logical conclusion, this argument would transform a mere reduction in tax rates into a subsidy because the revenue foregone by the rate reduction was "otherwise due" before the reduction went into effect. Such reasoning conflicts with the Appellate Body's holding in *FSC* that WTO obligations do not compel any particular kind of tax system, and that Members have the sovereign authority to tax or not to tax particular categories of revenue.[5]

2. *Canada's Argument*

(a) Canada Offers No Principled Basis for Applying Article 1

8. Canada begins its analysis of whether the Act's exclusion confers a subsidy within the meaning of Article 1 by acknowledging that the Act passes the *FSC* Panel's "but for" test.[6] Canada then argues that the "but for" test "is not determinative of whether the [US] government has foregone revenue otherwise due" and that "a more complete analysis of domestic tax rules must be conducted in order to determine what situation would apply to the revenues in question absent the contested measure."[7]

9. Canada, however, does not provide any framework or principles for conducting such an analysis, nor does it explain what factors would lead to a determination that revenue "otherwise due" is foregone. Instead, Canada appears to merely point to aspects of the Act that it does not like, or that seem unusual to Canada, and from this concludes that the Act's exclusion comes within the scope of Article 1.

10. Such *ad hoc* reasoning cannot be a basis for interpreting and applying provisions of WTO agreements. The *FSC* Panel and Appellate Body made clear that the appropriate inquiry is whether income that is not taxed under a challenged measure would "otherwise" be "due" under other provisions of the tax laws of the country in question.[8] In order to determine whether taxes would be "otherwise due," it is necessary to compare the challenged measure with a "normative benchmark."[9] Canada's

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[5] *FSC (AB)*, DSR 2000:III, 1619, para. 90. In this regard, Australia seems to assume that in the absence of the Act's exclusion, excluded income necessarily would be taxed. However, as demonstrated in the *First US 21.5 Submission*, paras. 100-106, this assumption is not warranted.

[6] *Canada Third-Party Submission*, paras. 27-28.

[7] *Ibid.,* para. 29.

[8] The *FSC* Panel explained that "there is in the WTO Agreement no theoretical 'correct' benchmark for taxes that would represent the norm for taxes and duties 'otherwise due.'" *United States - Tax Treatment for "Foreign Sales Corporations"* ("*FSC (Panel)*"), WT/DS108/R, Report of the Panel, as modified by the Appellate Body, adopted 20 March 2000, DSR 2000:IV, 1675, para. 7.42.

[9] *FSC (AB)*, DSR 2000:III, 1619, para. 90 (determining whether taxes are "otherwise due" requires a "defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised otherwise"); *see also FSC (Panel),* DSR 2000:IV, 1675, para. 7.43 ("the determination whether revenue foregone is 'otherwise due' must

ad hoc approach is especially inappropriate in the present context given the Appellate Body's statement that "the word 'foregone' suggests that the government has given up an entitlement to raise revenue that it could 'otherwise' have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax all revenues."[10] Thus, the Act must be assessed against an articulated and clear standard, and not on the basis of conclusory reasoning.

(b) No Negative Inference Can Be Drawn from the Fact that the Act Passes the "But For" Test

11. Canada does not attempt to make the comparison contemplated by the *FSC* decisions. Instead, Canada effectively complains that by revising its laws, the United States was too successful in satisfying the "but for" test.[11] Although Canada does not appear to dispute the fact that by excluding extraterritorial income from "gross income" the United States redefined the outer boundary of its tax system, Canada alleges that this redefinition somehow constitutes a "circumvention" of the "but for" test. Canada argues that, because the United States does not have "a rule formally taxing the revenues in question," the Panel should examine the size and nature of the exclusion.[12]

12. Canada is wrong on all counts. First, it was entirely appropriate for the United States to craft the Act so as to avoid creating a situation where, "but for" the existence of the Act, foregone revenue would be due. As the United States explained in its first submission, complying with the *FSC* Panel and Appellate Body decisions was one of the underlying purposes of the Act.[13] Had the United States not done so, it would have ignored the Panel's central statement regarding the definition of a subsidy. WTO Members implementing WTO decisions must be permitted to structure new measures specifically to comply with those decisions.[14]

13. Second, it also was entirely appropriate for the United States to modify its tax system by redefining its jurisdictional boundaries. As the Appellate Body has explained, WTO obligations do not dictate what type of tax system a Member must have. So long as they do not contravene specific WTO obligations, Members have "the sovereign authority to tax any particular categories of revenue" and are "also free *not* to tax any particular categories of revenue []".[15]By excluding extraterritorial income from US taxation, the United States simply exercised this sovereign right.

14. Third, despite Canada's suggestion to the contrary, the absence of "a rule formally *taxing* the revenues in question" indicates that the Act does not confer a subsidy. Stated differently, what matters in the present context is whether the challenged

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involve a comparison between the fiscal treatment being provided by a Member in a particular situation and the tax regime otherwise applied by that Member ... .").

[10] *FSC (AB)*, DSR 2000:III, 1619, para. 90 (emphasis in original).

[11] *Canada Third-Party Submission*, para. 27.

[12] Canada argues that US foreign tax credits were a preexisting benchmark and that the United States cannot create a "new" benchmark. *Ibid.,* note 19. However, US foreign tax credits are inapplicable to excluded extraterritorial income, and therefore cannot be a relevant benchmark in this context. The United States explains in this section why there is no restriction against a WTO Member modifying its system of taxation and thereby establishing a "new" benchmark.

[13] *First US 21.5 Submission*, paras. 22-23.

[14] If this were not so, then it would be contrary to the role of the dispute settlement system as a central element in providing security and predictability to the multilateral trading system.

[15] *FSC (AB)*, DSR 2000:III, 1619, para. 90 (emphasis in original).

measure foregoes revenue when compared against a "normative benchmark" under US law. Canada has identified no such benchmark and, like Australia, has failed to explain what provision of US law necessarily would capture income that is excluded because of the Act.

(c) Canada's Analysis of the Act is Flawed

15. Canada raises several aspects of the Act that are not relevant to determining whether the Act confers subsidies under Article 1.

(i) It is Irrelevant that Only Certain Categories of Extraterritorial Income are Excluded from Tax

16. Canada maintains it is inappropriate that "only certain categories of 'extraterritorial income' are excluded from tax."[16] However, nothing in the language of Article 1 suggests that the size or comprehensiveness of a tax exclusion is relevant to whether a subsidy has been provided. Many exemption systems, for example, impose complicated conditions on the non-taxation of foreign income. Canada does not explain how the scope of the exclusion is relevant to whether taxes on extraterritorial income are "otherwise due".

17. In addition to being irrelevant, Canada's assertion that the Act's exclusion is insufficiently comprehensive is false. The exclusion of extraterritorial income applies broadly to individuals, partnerships, and corporations, irrespective of whether they are located in the United States or abroad. The exclusion applies to a broad range of foreign transactions – *i.e.*, foreign sales, foreign leases, and foreign rentals.

(ii) For Purposes of Article 1, it is Irrelevant Whether the Act Excludes Export-Related Income or is a Measure to Avoid Double Taxation

18. Canada next contends that the Act confers subsidies under Article 1 because its exclusion applies to export-related income and that the exclusion of such income does not constitute, in Canada's opinion, a measure to avoid double taxation.[17] These considerations are wholly irrelevant to a determination of whether a measure confers subsidies within the meaning of Article 1. The Appellate Body has made clear that the definition of a subsidy is free standing – that is, it applies throughout the SCM Agreement and does not turn on whether the measure at issue involves exports.[18] Moreover, Article 3.1(a), the provision of the SCM Agreement specifically focused on exportation, applies only to subsidies "within the meaning of Article 1". Article 3.1(a)'s export-contingency is only relevant to measures that first confer subsidies under Article 1.

19. As for Canada's assertion that the Act's exclusion is not a measure to avoid double taxation, that issue also has no bearing on whether the exclusion constitutes a subsidy. The United States previously made a similar argument in the *FSC* dispute,

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[16] *Canada Third-Party Submission*, para. 30.
[17] *Canada Third-Party Submission*, paras. 31-35.
[18] *FSC (AB)*, DSR 2000:III, 1619, para. 89.

contending that footnote 59, including the fifth sentence (which deals with measures to avoid double taxation), forms part of the context for interpreting the "otherwise due" language of Article 1. The Appellate Body, however, rejected that argument, finding footnote 59 to be relevant to Article 3.1(a) and not Article 1.[19] Therefore, whether or not the Act constitutes a measure to avoid double taxation is not relevant to determining whether or not it can be deemed a subsidy.[20]

(iii) It is Irrelevant Whether the Act Relies on the FSC's "Arithmetic"

20. Finally, Canada contends that the Act constitutes a subsidy because it "corresponds arithmetically to the exempt foreign source income of the FSC scheme."[21] To the extent Canada is suggesting that the FSC provisions were not repealed, Canada is wrong, because the Act repealed the FSC provisions. To the extent Canada really is arguing that the Act uses the same percentages as the FSC provisions, Canada is dwelling upon an irrelevant point. Neither the Panel nor the Appellate Body in *FSC* found objectionable the percentages used by the FSC provisions. Moreover, such a comparison between the provisions of the FSC and the Act is neither accurate nor meaningful. As a general matter, challenged measures can be modified to remedy WTO deficiencies. In this case, the FSC provisions have been repealed, and the Act is significantly different.[22]

B. The Act's Exclusion is not Export-Contingent within the Meaning of Article 3.1(a)

21. Canada and Australia argue that the Act's exclusion is contingent upon export performance and therefore violates Article 3.1(a) of the SCM Agreement. Together, Canada and Australia present four main arguments regarding Article 3.1(a). First, both argue that the foreign-use requirement in the Act, in and of itself, renders the Act and its exclusion of extraterritorial income an export-contingent subsidy. Second, Canada argues that the application of the exclusion to non-export transactions is not enough to save the Act from the prohibition of Article 3.1(a). Third, Canada and Australia claim that the inapplicability of the exclusion to income earned in domestic transactions demonstrates the export-contingency of the Act. Fourth, Australia claims that the Act's 50-percent rule on certain foreign value makes the exclusion of income of foreign entities export-contingent. None of these arguments, however, find support in the language of Article 3.1(a), as interpreted by the Appellate Body.

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[19] *FSC (AB)*, DSR 2000:III, 1619, paras. 93-94. The United States responds to Canada's contention that the Act is not a measure to avoid double taxation in section II.C.2, below.

[20] Should the Panel find the double taxation argument relevant to the issue of whether the Act confers a subsidy, the United States renews its argument that the Act does not confer a subsidy under Article 1.1(a) because it constitutes a measure for the avoidance of double taxation.

[21] *Canada Third-Party Submission*, para. 32, quoting *EC First 21.5 Submission*, para. 35.

[22] See *US First Art. 21.5 Submission*, paras. 47-55 for a discussion of the differences between the Act and the FSC.

1. *The Foreign-Use Requirement Does Not Render the Exclusion of Extraterritorial Income Export Contingent*

22. Australia and Canada claim that the Act's foreign-use requirement – *i.e.*, that property involved in a transaction giving rise to excluded extraterritorial income must be "held for use, consumption, or disposition outside the United States" – renders the exclusion of extraterritorial income export contingent.[23] Contrary to these arguments, the foreign-use requirement does not make the exclusion export contingent.

23. The Act provides in general for the exclusion of income arising in foreign transactions. As noted in the *First US 21.5 Submission*, the foreign-use requirement is but one characteristic of a "foreign" transaction, and the exclusion applies regardless of whether the products involved are manufactured or produced in the United States. While foreign transactions giving rise to excluded extraterritorial income include export transactions, they also include transactions that take place entirely within another country, or that involve multiple countries other than the United States. The applicability of the exclusion to income earned in a wide range of foreign transactions reflects the export-neutral principle underlying the exclusion. Exporting is merely one way of conforming to that principle.

24. Thus, the foreign-use requirement in the Act does not render the exclusion of extraterritorial income export contingent. If that were not so, then the Panel would in effect be holding that a tax exemption for foreign sales income is necessarily an export subsidy. Such a result would come as a quite a surprise to countries employing territorial tax systems or tax systems providing territorial exemptions.

2. *The Availability of the Exclusion of Extraterritorial Income Earned by Foreign Entities is Relevant under Article 3.1(a)*

25. As discussed above, Canada focuses on export transactions in the context of the foreign-use requirement, arguing that the availability of the exclusion for income earned in foreign, non-export transactions is irrelevant.[24] However, bifurcating the Act in this way is not consistent with the way the Act operates and results in a distorted analysis under Article 3.1(a).

26. With respect to foreign sales transactions, the Act does not distinguish between export transactions and non-export transactions or between exporters and non-exporters. With one exception, there is no distinction in reporting by taxpayers, whether they be branches or subsidiaries of US corporations or foreign corporations. The only distinction in the identity of taxpayers is that foreign taxpayers must be subject to US tax on their manufacturing income in order to earn excluded income. As explained in the *First US 21.5 Submission*, this distinction merely equalizes the US tax treatment of foreign branches and corporate subsidiaries. The Act applies neutrally and broadly to income derived from foreign transactions – that is, where the goods subject to the transactions are purchased and used outside the United States.

27. Contrary to Canada's argument, the Appellate Body in *Canada-Aircraft* did not determine that subsidies provided to non-exporters are irrelevant for purposes of evaluating a measure under Article 3.1(a).[25] *Canada Aircraft* was a *de facto* ex-

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[23] *Canada's Third Party Submission*, para. 40; *Australia's Third Party Submission*, para. 16.
[24] *Canada's Third Party Submission*, para. 41; *see also Ibid.*, para. 44.
[25] *Canada's Third Party Submission*, paras. 45-47.

port-contingency case. As the panel noted in that case, Brazil did "not claim that the TPC programme is *de jure* export contingent. Rather, Brazil asserts that TPC contributions in the regional aircraft sector are 'contingent ... in fact . . .upon exportation', within the meaning of Article 3.1(a) of the SCM Agreement."[26] As support for its claim of *de facto* export contingency, Brazil provided extensive factual information relating to particular TPC contributions and established that these contributions would not have been provided to the Canadian regional aircraft sector but for the sector's export orientation. Thus, when the Appellate Body reviewed the panel's decision in *Canada Aircraft*, the Appellate Body confirmed that, in a *de facto* export contingency case, only those subsidies claimed to be export-contingent are relevant for the panel's consideration.

28. *Canada Aircraft* is distinguishable from this case. The EC has not made a *de facto* export contingency claim or presented any evidence that would support such a claim. The only evidence presented by the EC is the Act itself. Ignoring the export-neutral aspect of the definition of extraterritorial income would be to ignore one of the most important issues in this case. In contrast to the Appellate Body's finding in *Canada Aircraft* that the TPC program would not have contributed to the regional aircraft sector "but for" that sector's export orientation, the Act is indifferent as to how *any* taxpayer earns extraterritorial income. The Act does not create any sub-categories of taxpayers whose eligibility to earn extraterritorial income is "tied" to actual or anticipated exportation or export earnings. Thus, the Panel should consider the Act as whole in evaluating whether the exclusion of extraterritorial income is export contingent.

3. The Inapplicability of the Act's Exclusion to Income Derived from Domestic Transactions is Irrelevant under Article 3.1(a)

29. Canada and Australia contend that the inapplicability of the exclusion to income earned in purely domestic transactions renders the exclusion export-contingent.[27] As Canada stated in its submission, "the proper basis for comparison must necessarily be with the tax treatment of domestic sales of domestic goods."[28]

30. This argument is not grounded in the language of Article 3.1(a) as interpreted by the Appellate Body. Whether a domestic transaction is eligible for a tax exclusion has no bearing on whether that exclusion is "contingent on", "conditioned upon", or "dependent for its existence on" export performance. In providing a framework for evaluating a measure under Article 3.1(a), the Appellate Body has never indicated that any comparison is required, let alone a comparison between the tax treatment of export transactions and the tax treatment of domestic transactions. If the drafters of Article 3.1(a) had wished to adopt a test for export contingency that compared the treatment of foreign sales with the treatment of domestic sales, they would have done so in the text of the agreement. However, they did not.

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[26] *Canada - Measures Affecting the Export of Civilian Aircraft*, WT/DS70/R, Report of the Panel, as modified by the Appellate Body, adopted 20 August 1999, DSR 1999:IV, 1443, para. 9.330.

[27] *Canada's Third Party Submission*, paras. 43-44; *Australia's Third Party Submission*, para. 16.

[28] *Canada's Third Party Submission*, para. 44.

4. *The 50-per cent Rule Does Not Render the Act's Exclusion Export-Contingent*

31. While Canada appears to take the view that the Act's exclusion is not export-contingent with respect to sales of foreign-produced property, Australia argues that the Act's 50-percent rule "requires the export of United States product" with respect to such transactions. Australia's argument is based entirely on the false premise that "at least 50 per cent of [the property's] fair market value must be attributable to United States content and United States direct labour costs."[29]

32. The 50-percent rule in the Act does not require *any* US content. Qualifying foreign trade property may include property with 100 percent foreign content. Furthermore, the 50-percent rule does not require that any portion of a final product's fair market value be attributable to US-produced inputs and US direct labour costs. Instead, the Act provides a cap on the amount of the fair market value of a product that is attributable to *foreign* inputs and labour. Thus, Australia's argument is based upon a basic misunderstanding of the operation of the Act. As reflected by the attached statement from a US taxpayer ("X") intending to rely upon the Act, the 50-percent rule does not require that US content be included in products subject to the Act. This taxpayer explains that it will not need to include US content in products whose sale will generate extraterritorial income:

> The [merchandise] sold by the foreign branches of this [X] Swiss subsidiary is considered "qualifying foreign trade property" under the Act. [This merchandise does] not contain any US-produced inputs and [is] not manufactured with any US direct labour. The 50-percent rule in the Act is satisfied by the significant amount of the fair market value of the [] product that is attributable to US intellectual property rights, notably [X's] process patents that are licensed to foreign manufacturers. In no case is [X's] ability to exclude extraterritorial income dependent or conditioned upon the use of US goods exported outside the United States.[30]

Accordingly, the 50-percent rule does not require the exportation of US goods and the Act cannot be said, for that reason, to be contingent upon export performance.

C. *The Act's Exclusion Constitutes a Measure to Avoid Double Taxation within the Meaning of Footnote 59*

33. Australia and Canada both argue that the Act does not constitute a measure to avoid double taxation pursuant to the fifth sentence of footnote 59 of the SCM Agreement.[31] In reaching this conclusion, however, they propose conditions and limitations on what constitutes a measure to avoid double taxation that are not supported

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[29] *Australia's Third Party Submission*, para. 18.

[30] Exhibit US-9, para. 8. Pursuant to paragraph 3 of the *Working Procedures of the Panel*, the United States designates US-9 as confidential. In the quotation from US-9 in the text, the United States has deleted material – identified in brackets – in order to summarize the information in a manner that can be disclosed to the public.

[31] Neither Australia nor Canada appears to dispute the legal consequences that would flow from finding the Act's exclusion to fall under footnote 59; *i.e.*, that by virtue of footnote 5 of the SCM Agreement, the exclusion would not be prohibited by any provision of the Agreement.

by the text of footnote 59 and that are not consistent with methods used to avoid double taxation around the world.

1. Australia's Argument

34. Australia bases its argument on two points. First, it asserts that the Act's exclusion cannot be a measure to avoid double taxation under footnote 59 because "United States tax rules already provide income tax credits to minimize double taxation" and because "[t]he United States has also entered into agreements with other countries to avoid double taxation of income."[32] Second, Australia claims that the Act is not a measure to avoid double taxation because its exclusion is "not calculated on, or limited to, the amount of foreign taxes paid on 'extraterritorial income'."[33]

(a) WTO Members May Rely on Alternative Methods for Avoiding Double Taxation of Foreign-Source Income

35. In the context of international commerce, relief from double taxation generally is provided through an exemption of foreign income, through a credit for foreign taxes paid, or through an income tax convention pursuant to which each jurisdiction cedes taxing rights over particular categories of income. As the EC has recognized, most if not all Members employ all three of these mechanisms, in varying proportions, for the relief of double taxation.

36. According to its legislative history, the Act establishes an alternative measure for the relief of double taxation for a particular category of income defined by the Act. According to that legislative history, "the extraterritorial income excluded by this legislation from the scope of US income taxation is parallel to the foreign-source income excluded from tax under most territorial tax systems."[34] In other words, the Act implements certain aspects of the exemption systems employed by other countries, including EC member states. Reflective of its nature as an alternative mechanism for the relief of double taxation, the Act disallows foreign tax credits and deductions otherwise allocable to excluded extraterritorial income.[35]

37. Nothing in the SCM Agreement prohibits Members from using this type of alternative mechanism for the relief of double taxation. To the contrary, the OECD and the UN endorse the use of this mechanism.[36] Footnote 59 leaves the choice of mechanism to WTO Members, stating that the ban against export-specific direct tax exemptions, remissions, or deferrals set forth in paragraph (e) of the Illustrative List of Export Subsidies "is *not intended to limit* Members from taking *measures* to avoid ... double taxation ... ." (Emphasis added). This language is particularly flexible, imposing no *limit* on WTO Members in fashioning double tax relief *measures*.[37] More-

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[32] *Australia Third-Party Art. 21.5 Submission*, para. 21.

[33] *Ibid.*, para. 22.

[34] *Senate Report* (US-2), page 5.

[35] The Act § 3, amending IRC § 114(c)-(d).

[36] *Model Tax Convention on Income and Capital* (OECD 1992) ("OECD Model Tax Convention") (Exhibit US-7); *see also United Nations Model Double Taxation Convention Between Developed and Developing Countries*, Pub. No. ST/ESA/102 (1980).

[37] It is instructive that the drafters of the SCM Agreement used the word "measures" in footnote 59 and did not attempt to identify particular methods of avoiding double taxation. The term "measure"

over, the Appellate Body in *FSC* did not condition the sovereign right of Members to exempt a category of income on some requirement that they only do so through a unitary measure. Therefore, the United States may adopt alternative mechanisms for the avoidance of double taxation.[38]

38. The same is true with respect to US bilateral tax treaties. These treaties provide relief from double taxation in conjunction with or parallel to US domestic legal provisions, but these agreements are confined by their terms to circumstances where the two signatory governments can claim the right to tax the same income. As a general rule, bilateral tax treaties are entered into to supplement domestic legal measures designed to avoid double taxation. Almost every country entering into such a treaty has its own mechanism for avoiding double taxation, and these domestic mechanisms often differ in some way – *i.e.*, in terms of methodology or scope of application – from that of the treaty. Thus, a treaty might provide relief to taxpayers where the laws of a given treaty party otherwise would not. However, a treaty does not preclude the need for a domestic measure to avoid double taxation.

(b) A Measure to Avoid Double Taxation Does Not Have to Be Limited to the Amount of Foreign Taxes Paid

39. Australia next argues that the Act is not a measure to avoid double taxation because the exclusion is not limited to the amount of foreign taxes paid. This argument also is meritless.

(i) The Exemption Method is Tied to the Tax Rates of the Countries Involved

40. The premise underlying the exemption method is that the same income of a taxpayer should not be subjected to the tax systems of two sovereign nations. This stands in contrast to the tax credit method, which presumes that taxpayers will be taxed twice on the same income but which offsets any foreign taxes paid after the fact.

41. As the United States explained in its first submission, a natural consequence of the exemption method is that the overall effect on the tax liability of a given taxpayer is determined by the tax rate applied by the country of source for exempted foreign-source income. To the extent that the tax rate applied by the country of source is *higher* than that of the country of residence, a taxpayer *will pay more* in taxes on the income in question than if that income were earned in the country of

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has been found to be a rather broad term in other contexts. As the *Japan Film* Panel explained, "GATT panels dealing with the related issue of what may constitute 'all laws, regulations and requirements' ... under GATT Article III:4 ... . Panels have taken a broad view of when a governmental action is a law, regulation or requirement ... . Given that the scope of the term *requirement* would seem to be narrower than that of measure, the broad reading given to the word *requirement* ... supports an even broader reading of the word measure in Article XXIII:1(b)." *Japan - Measures Affecting Consumer Photographic Film and Paper*, WT/DS44/R, Report of the Panel adopted 22 April 1998, DSR 1998:IV, 1179, para. 10.51.

[38] In this regard, the EC previously has acknowledged that both the credit and the exemption method are proper methods of avoiding double taxation, and that it is internationally accepted that both methods may be used in combination. Annex EC-2, page 2 (US-5).

residence. Conversely, if the country of source applies a *lower* rate, then the taxpayer *will pay less* than if the income were earned in the country of residence.

(ii) An Example

42. The Commentary to the OECD Model Convention demonstrates that an overall savings in taxes is natural byproduct of the exemption method, but nonetheless is permissible. The Commentary does so through an example in which a taxpayer obtains a tax savings because the taxpayer's country of residence imposes a higher tax rate than the other country involved. The example assumes that (1) the total income of a taxpayer is $100,000, (2) the first $80,000 of the $100,000 is taxable only in the country of residence, (3) the other $20,000 is subject to tax in both countries, (4) the tax rate in the country of residence is 35% at $100,000 and 30% at $80,000, and (5) the foreign country's rate of taxation is 20%. Absent a measure to avoid double taxation, the taxpayer would be subjected to taxes of $35,000 on his worldwide income of $100,000 by the country of residence, plus a tax of $4,000 levied by the country of source on the $20,000 earned there – resulting in a total tax of $39,000.[39]

43. The OECD Commentary then explains that under the exemption method[40], the $20,000 in foreign-source income would not be considered for tax purposes by the country of residence. This would result in the country of residence taxing the remaining $80,000 at a 30 percent rate, yielding a tax of $24,000, while the other country would levy its tax of $4,000 on the $20,000 earned within its territory. The exemption method would thus yield a total tax of $28,000, relieving the taxpayer of $11,000 in taxes (the double tax of $39,000 minus the revised amount of $28,000).

44. The Commentary shows this example graphically as follows:

Tax in County of Residence (30% of $80,000)	$24,000
Plus Tax in Foreign Country	$4,000
Total Taxes	$28,000
Relief Given by Country of Residence	$11,000

45. To summarize these results, under the exemption method, the taxpayer would owe only $28,000 in combined taxes and $24,000 in country-of-residence taxes. This amounts to a savings of overall and country-of residence taxes of $11,000.

46. Despite the overall savings in taxes, the OECD approves of the exemption method. The EC appears to agree, having informed the *FSC* Panel that, "[t]o the extent that foreign taxes are lower than domestic taxes, resident taxpayers with exempt foreign-source income are treated more favourably than other residents."[41]

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[39] US-7, pages C(23)-5 to C(23)-7.

[40] This example relies on what the OECD refers to as the "full exemption" method. An alternative method, "exemption with progression", would yield different but similar results.

[41] Annex EC-2 (US-5), page 2. The EC went on to note that some countries apply a partial exemption system in order to limit the advantages a taxpayer may reap. These countries exempt income only if it is "derived from countries that are committed to imposing taxes at rates and under conditions that are roughly comparable to [their] own rates and conditions." *Ibid.*

(iii) The Credit Method Does Not Offer Perfect Results

47. It is important to note that, while the credit method may in theory be better suited to calibrating the impact of double taxation and can more easily prevent a tax savings from occurring[42], tax credits in practice are not a perfect method for avoiding double taxation. Tax credits are often complicated in their application, raising substantial questions about their effect in situations where companies suffer foreign losses, roll credits over to subsequent tax years, or pay taxes in a foreign jurisdiction that are not subject to crediting (*e.g.,* payment of excise or value-added taxes instead of income taxes). Like exemption, credits may not result in an exact dollar-for dollar offset of foreign taxes paid. However, unlike exemption, credits may result in taxpayers continuing to be subject to double taxation on the same income by two nations.

48. In view of the complexities involved with each method, it is not surprising that countries have adopted one or the other, or both, and that the major model treaties have approved both. The model treaties in this regard follow the long and widespread acceptance of both methods by nations around the world, including many EC member states as well as many other WTO Members.

2. *Canada's Argument*

49. Canada begins its analysis of whether the Act constitutes a measure to avoid double taxation for purposes of footnote 59 by distinguishing between the treatment of what it refers to as "foreign income" and "domestic export income". Canada states that it "agrees that the 'foreign income' component of 'extraterritorial income' is the type of income typically subject to a measure to avoid double taxation."[43] Canada, however, posits that "the United States has added this new category of income to the measure in question in an attempt to confuse the domestic tax situation that would otherwise apply to the 'domestic export income' component of 'extraterritorial income'."[44] Canada goes on to say that "income earned from export transactions is income that would generally be taxable only in the United States. The fact that the proceeds of sales are from foreign sources does not transform the export income into 'foreign income' for tax purposes."[45] Finally, Canada argues that "[e]xporting goods in a foreign country does not create a sufficient nexus to trigger taxation in the importing country, even when one takes into consideration the 'foreign economic processes' required under the [Act]."[46]

50. These unsubstantiated assertions lack a foundation in the text of the SCM Agreement and reflect a misunderstanding of how measures to avoid double taxation are used throughout the world.

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[42] This is because tax credits are applied *ex ante* and thus can theoretically be calculated with precision to offset taxes actually paid in the country of source.

[43] *Canada Third-Party Submission*, para. 33.

[44] *Ibid.*

[45] *Ibid.*

[46] *Ibid.*

(a) Canada Draws a False Distinction Between "Foreign" and "Domestic Export" Income

51. At base, Canada is arguing that the mere application of the Act's exclusion to income from export sales renders it export-contingent, regardless of the fact that the exclusion applies to a much broader category of income. As the United States has explained, a broad range of foreign transactions may give rise to excluded extraterritorial income. To the extent that exporting may give rise to extraterritorial income, that is merely the result of the fact that export sales are one form of foreign transaction. The Act in no way treats exports differently or more generously than other types of foreign sales. A statement from a US taxpayer ("X") illustrates this point:

> None of the extraterritorial income earned by [X's] Swiss subsidiary is generated through exports from the United States. The amount of income that [X] will exclude under the Act bears no relationship to whether and to what extent [X] engages in export transactions. Indeed, the Company's decision to elect to become a US taxpayer is completely unrelated to whether and to what extent [X] engages in export transactions.[47]

Therefore, Canada's distinction between "foreign" and "domestic export" income is illusory at best.

(b) The United States Did Not Include Wholly Foreign Transactions to "Confuse the Situation"

52. Canada admits "that the 'foreign income' component of 'extraterritorial income' is the type of income typically subject to a measure to avoid double taxation." Canada nevertheless objects to the application of the Act's exclusion to foreign income derived from export transactions. Among other things, this statement fails to recognize how US taxpayers can rely on the Act's exclusion for non-export transactions.

53. The United States explained in its first submission and above that the Act applies to a wide array of foreign transactions.[48] All of these transactions can be performed without any goods or services originating in the United States; *i.e.*, these transactions need not involve exportation from the United States at all. As one company has explained, extraterritorial income can be earned by foreign companies and can be "earned exclusively through non-US or foreign transactions".[49]

54. Thus, contrary to Canada's assertion to the contrary, the Act applies meaningful double taxation relief with respect to non-export transactions. It applies with full force to non-export transactions and will be used by US taxpayers earning income from sales occurring entirely outside the United States, including foreign companies.

(c) Canada Improperly Narrows the Fifth Sentence of Footnote 59

55. In its submission, Canada attempts to narrow the meaning of the fifth sentence of footnote 59 or add conditions that are not contained in its text. Canada first

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[47] US-9, para. 7.

[48] The Act § 3, amending IRC § 941(a)(1), describes the types of transactions covered.

[49] Exhibit US-9, para. 6.

argues that foreign-source income for purposes of footnote 59 is *only* income attributable to economic processes occurring outside a taxpayer's country of residence. Canada also argues that double taxation relief may be provided only to taxpayers having "permanent establishments" in jurisdictions other than their country of residence. As the United States demonstrates below, neither proposition is correct.

(i) Canada's Definition of Foreign-Source Income is Erroneous

56. Canada appears to disagree with the definition of foreign-source income advanced by the United States – that is, an assessment based on all facts and circumstances that could lead to characterizing income as foreign. Canada appears to be arguing that income is "foreign source" only to the extent that it is attributable to economic processes occurring outside a taxpayer's country of residence. Canada even goes so far as to assert that the United States is arguing that extraterritorial income is "foreign source income" within the meaning of footnote 59 just from "[t]he fact that the proceeds of sales are from foreign sources."[50] Canada oversimplifies the US position, and offers no explanation for how its definition comports with the relevant text.

57. As the United States explained in its first submission, a foreign source of payment is but one of many factors that could make income "foreign source". The ordinary meaning of the term "foreign-source income" for purposes of footnote 59 is profits or proceeds originating outside the borders or territory of the WTO Member instituting a measure to avoid double taxation.[51] The United States further explained that the essential characteristics that would indicate whether profits or proceeds originate outside the borders or territory of a country might include: the goods or services in question are sold outside the territory of the taxing authority, the purchaser is located outside the territory of the taxing authority, title to the merchandise is transferred outside the territory of the taxing authority, payment is made or issued outside the territory of the taxing authority, or economic activities giving rise to the sale occur (at least in part) outside the territory of the taxing authority. These attributes are factors that can render income subject to taxation in two jurisdictions. It is important to note that this definition includes income attributable to foreign economic processes, but the language of the fifth sentence of footnote 59 does not appear to make foreign economic processes the sole factor for determining what is, or is not, meant by "foreign source income".

58. "Extraterritorial income" under the Act involves all of these foreign attributes that can result in such income being subjected to double taxation.[52] The central premise of the Act is to provide a tax exclusion for income from foreign transactions. With regard to the types of transactions that may generate excluded income, the Act provides that the goods involved must be used, consumed, or disposed of outside the

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[50] *Canada's Third-Party Submission*, para. 34.

[51] See US First Art. 21.5 Submission, para. 166-67.

[52] For example, one company has stated, "[t]he extraterritorial income earned by this [X] Swiss subsidiary is subject to tax in Switzerland. The election of the Swiss subsidiary to become a US taxpayer does not relieve the Swiss subsidiary from paying taxes to the government of Switzerland. However, because extraterritorial income is excluded from gross income under the ETI Exclusion Act, excluded income earned by this [X] Swiss subsidiary will not be subject to double taxation but, rather, subject only to Swiss tax." US-9, para. 10.

United States.[53] As such, the purchasers of these goods typically will be located outside the United States, they generally will authorize or make payment for the goods in another country, and in many instances title will pass in that country as well. The goods may be produced outside the United States[54], and certain required levels of foreign economic activities must be performed with respect to the sales and distribution functions associated with qualifying transactions.[55]

59. To find that the Act's exclusion does not constitute a measure to avoid double taxation, there must be something more than a bald assertion that foreign economic processes are the sine quo non of "foreign source income". There would have to be a showing as to why extraterritorial income, which has a number of foreign characteristics, cannot be subjected to tax in two jurisdictions, cannot give rise to double taxation, and in turn cannot be protected from such double taxation through the Act.

(ii) There is no Requirement for a "Permanent Establishment"

60. Canada appears to argue that, even if extraterritorial income is sufficiently foreign in nature, it is not subject to double taxation because US taxpayers relying on the Act are not required to maintain a "permanent establishment" in a foreign taxing jurisdiction. Canada argues that, absent a "permanent establishment" requirement, the Act's mandated foreign economic processes "do not create a taxable presence abroad, and, therefore, would not be considered foreign business income subject to double taxation."[56]

61. Canada's argument glosses over the fact that, just as there is no international consensus on what constitutes foreign-source income, there are divergent views and practices among countries as to what brings a non-resident enterprise within a country's taxing authority. The United States, for example, does not, as a general matter, subscribe to the requirement that a non-resident enterprise must have a "permanent establishment" within the United States in order to be subjected to US taxation. Instead, the United States looks to see if there is a sufficient amount of business activity occurring within the United States with respect to a given transaction or series of transactions to find that a taxpayer has engaged in "a trade or business in the United States."[57] Income "effectively connected" with that trade or business is subject to US

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[53] The Act § 3, amending IRC § 943(a)(1)(B).

[54] The Act § 3, amending IRC § 943(a)(1)(A).

[55] The Act § 3, amending IRC § 942(b).

[56] Canada Third-Party Submission, para. 34.

[57] All that is required to establish a US trade or business is "considerable, continuous and regular" economic activity. For example, a US trade or business has been found to exist where a foreign individual's export business in the United States solicited orders, inspected merchandise, made purchases, completed sales, and maintained an office and a bank account. United States v. Balanovski, 236 F.2d 298 (2nd Cir. 1956), cert. denied, 352 U.S. 968 (1957) (Exhibit US-10). The mere ownership and active management of US real estate has been found to constitute a US trade or business. See De Amodio v. Commissioner, 34 T.C. 894 (1960), aff'd, 299 F.2d 623 (3rd Cir. 1962) (Exhibit US-11); Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), aff'd, 221 F.2d 227 (9th Cir. 1955) (Exhibit US-12). Moreover, the US taxing jurisdiction generally reaches a broader category of income with respect to a US trade or business ("effectively connected" income) than the category of taxable income attributable to a US permanent establishment. See Rev. Rul. 91-32, 1991-1 C.B. 107 (Exhibit US-13); Rev. Rul. 81-78, 1981-1 C.B. 604 (Exhibit US-14), amplified by Rev. Rul. 84-17, 1984-1 C.B. 308 (Exhibit US-15).

taxation. In short, the United States does not require the existence of a fixed or enduring business operation.

62. The United States is not alone in relying on a standard more flexible than something amounting to a "permanent establishment". Section 253 of the Canadian Income Tax Act provides that soliciting orders or offering items for sale in Canada through an agent or servant (whether or not the contract or transaction is to be completed inside or outside of Canada) may be deemed to be carrying on business in Canada for tax purposes.[58] Similarly, to use one EC member state as an example, UK. tax laws take into account a number of factors, including where a contract is made, in determining whether "trading income" is taxable by the United Kingdom.[59]

63. The Act takes account of the varied approaches for determining tax jurisdiction throughout the world. It recognizes that other countries rely on different standards that can turn on subtle factual distinctions in determining whether income is subject to their tax regimes. The Act therefore requires that transactions giving rise to extraterritorial income must have a variety of foreign attributes that can result in a sufficient nexus to a foreign taxing regime as to render US taxpayers subject to foreign taxation.

64. It is true, as Canada asserts, that certain US bilateral tax treaties rely on the OECD standard that a non-resident is not to be subject to taxation in the absence of a "permanent establishment". However, as explained above, bilateral tax treaties serve as an additional layer of double tax avoidance in addition to domestic laws. A number of nations have broader jurisdiction under their domestic tax laws to reach income of non-residents than that prescribed by most tax treaties. In fact, one reason for a nation to enter into a bilateral tax treaty is to secure double tax relief from these more aggressive standards. That nations rely on bilateral tax treaties to prevent their businesses from being subjected to a foreign tax in the absence of a "permanent establishment" does not in any way mean that lower thresholds cannot be relied upon in domestic double tax avoidance measures (especially with regard to situations in which no such treaty exists).

(iii) The FSC Decisions Cast Doubt on Foreign Economic Processes as the Test of "Foreign Source Income"

65. One reason the United States adopted the foregoing approach – and chose not to rely exclusively on foreign economic processes as the test of "foreign source income" under footnote 59 – is that the FSC Panel and Appellate Body decisions cast doubt on whether such a narrow standard is appropriate.

66. As the Panel may recall, the United States predicated its arguments in the FSC dispute in large part on the 1981 Understanding of the GATT Council. The Understanding begins by stating:

> "The Council adopts these reports on the understanding that with respect to these cases, and in general, *economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxa-*

[58] See Exhibit US-16.

[59] Tax Management, Foreign Income Portfolios, Business Operations in the United Kingdom, 989-2nd (1999 Bureau of National Affairs), at A-80 to A-81 (Exhibit US-17).

> *tion by the exporting country and should not be regarded as export activities* in terms of Article XVI:4 of the General Agreement."[60]

The United States cited this language in support of the proposition that footnote 59 allowed WTO Members to refrain from taxing export-related income attributable to foreign economic processes and the failure to tax such income does not constitute an export subsidy.

67. The FSC Panel and Appellate Body, though, ruled that the Understanding has no relevance to the SCM Agreement in general or to footnote 59 in particular. As the Appellate Body stated, "[t]he 1981 Council action related to a different provision, Article XVI:4 of the GATT 1947, and not to the export subsidy disciplines established by Articles 1.1 and 3.1(a) of the SCM Agreement."[61]

68. As a result, the notion that "foreign source income" under footnote 59 can be directly equated to income derived from foreign economic processes, as Canada appears to contend, cannot be derived from the language of the 1981 Understanding. Such an interpretation must emanate from the language of footnote 59 itself. However, as the United States has explained in its first submission and above, the text of the fifth sentence of footnote 59 is not susceptible to such a narrow construction.

III. THE FIFTY-PER CENT RULE DOES NOT VIOLATE ARTICLE 3.1(B) OF THE SCM AGREEMENT

69. Australia argues that the Act makes the exclusion of extraterritorial income contingent on the use of domestic over imported goods and thus violates Article 3.1(b) of the SCM Agreement.[62] As discussed above, this argument is based on an erroneous description of the Act. Australia states:

> for property to constitute "qualifying foreign trade property" under the Act, at least 50 per cent of its fair market value must be attributable to articles manufactured, produced, grown or extracted *within the United States* ... . Given the tax exemption only arises on the meeting of a 50 per cent local content requirement, it is contingent upon the use of domestic over imported goods.[63]

70. However, contrary to Australia's argument, the Act does not require that any portion of the value of a final product be "attributable to articles manufactured ... within the United States." In addition, the Act does not contain a "local content requirement."

71. The Act defines "qualifying foreign trade property" as "property not more than 50 percent of the fair market value of which is attributable to articles manufactured, produced, grown, or extracted outside the United States, and direct costs for labour ... performed outside the United States."[64] Australia appears to be misreading this language to state that 50 percent of the fair market value of property be attributable to articles manufactured within the United States. Rather, the 50-percent rule

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60 Tax Legislation Cases, adopted December 7-8, 1981, BISD 28S/114 (1982) (emphasis added).
61 *FSC (AB),* DSR 2000:III, 1619, para. 119.
62 Australia's Third Party Submission, para. 19.
63 *Ibid.* (emphasis in original).
64 The Act § 2, amending IRC § 943(a)(1)(C).

takes into account only the value of foreign articles and foreign direct labour used in producing a finished product. The rule does not limit other foreign value. Thus, property can meet the fifty-percent rule even if 100 percent of its content is foreign.

IV. THE UNITED STATES COMPLIED WITH THE DSB'S RECOMMENDATIONS AND RULINGS

72. Australia argues that the United States has not withdrawn the FSC subsidies by the 1 November 2000 deadline, as extended by the DSB. The United States explained in its first submission that the Act complies with the DSB's recommendations and rulings because the Act repeals the FSC provisions with effect from 30 September 2000, and provides that no FSCs may be created after that date.

73. The Act provides limited transition relief to lessen the administrative burden and impact on taxpayers' business operations that might result due to the repeal of the FSC provisions. As the United States explained in its first submission, providing limited transition rules to allow taxpayers to adjust to a new regime is customary practice in the United States and in other countries when repealing significant tax legislation. In addition, permitting limited transition rules is reasonable in this case in light of the reliance of taxpayers on the FSC rules – reliance caused, in part, by the EC's delay of thirteen years after the FSC was enacted before challenging it.

74. Australia completely ignores the arguments presented by the United States in its first submission with respect to the appropriateness of the Act's transition rules. Consequently, the United States respectfully refers the Panel to these arguments in its first submission.[65]

V. CONCLUSION

75. For the reasons set forth above and in the *First US 21.5 Submission*, the United States respectfully requests that the Panel reject the EC's claims and arguments, and make the findings requested in paragraph 239 of the *First US 21.5 Submission*.

[65] First US 21.5 Submission, paras. 37-38, 223-39.

US EXHIBIT LIST

Number	*Document*
9	Confidential Taxpayer Statement
10	*United States v. Balanovski*, 236 F.2d 298 (2nd Cir. 1956)
11	*De Amodio v. Commissioner*, 34 T.C. 894 (1960)
12	*Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953)
13	Rev. Rul. 91-32, 1991-1 C.B. 107
14	Rev. Rul. 81-78, 1981-1 C.B. 604
15	Rev. Rul. 84-17, 1984-1 C.B. 308
16	Section 253 of the Canadian Income Tax Act
17	*Tax Management, Foreign Income Portfolios, Business Operations in the United Kingdom*, 989-2nd (1999 Bureau of National Affairs), pages A-80 to A-81

ANNEX D

Oral Statements of the Parties

ANNEX D-1

ORAL STATEMENT OF THE EUROPEAN COMMUNITIES

(13-15 March 2001)

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Mr Chairman, Members of the Panel,

1. The EC knows that you have carefully studied the submissions in this case and will be brief in its introductory remarks.

2. We will endeavour to assist the Panel by highlighting what we consider to be the most important points.

1. What are we discussing

3. First, to put the other issues in context, the EC would like to recall that the matter before this Panel is whether the US has correctly implemented the recommendations of the Panel in the original proceeding – indeed whether it has **withdrawn the subsidy** – within the time period set by the DSB.

4. The immediate and easy answer to this question is clearly No. The FSC subsides have not been withdrawn with effect from the 1 October 2000 and are, indeed, still available in their original form - and will remain so indefinitely. It is not clear that anyone is yet relying on the FSC Replacement scheme. The implementing regulations and guidance have not yet been issued and there is no date fixed for this to happen.

5. The latest news that the EC disposes of is a report in BNA Daily tax report of 8 March 2001, where Dirk Suringa of the International Tax Counsel's Office at the US Department of Treasury is reported as saying: [1]

> … it was too early to say when proposed regulations would be issued but assured practitioners that Treasury considered them an important project and would be seeking public input on their development.

6. The EC is reminded of the statement in the *Australia-Salmon* 21.5 proceeding, where the panel said:

> In our view, a new regime of implementing measures can be said to "*exist*" when this regime sets out all requirements and criteria under which the product concerned can enter the market of the implementing member. For products to be able to enter the market, the new measures setting out these requirements and criteria also have to be in force. *We do not consider a framework regulation setting out the basic, but not all, requirements and criteria sufficient for a new regime to "exist"...* "[2]

7. That is why the EC is of the view that the FSC subsidies have not been withdrawn.

8. But the Panel's mandate also covers the consistency of the new measures with the WTO and its is therefore also confronted with a less immediate but, in the view of the EC not much less easy question: would the new FSC Replacement scheme, when truly operational, be compatible with the WTO.

9. If one stands back from the detail and examines what the US has done, this question can be put in other terms. That is: does the WTO simply prohibit export subsidies that are **packaged** in a certain way; can a prohibited export subsidy be **repackaged** – or **rebundled** – so that its effects are the same but it is no longer prohibited; is the WTO about form over substance? The answers to these questions are, the EC submits, obvious. The rest of this statement will be devoted to explaining that one reaches the same answers when looking at the detail.

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[1] Attached as Exhibit EC-14.

[2] Article 21.5 Panel Report, *Australia – Measures Affecting Importation of Salmon ("Australia – Salmon")*, WT/DS18/RW, adopted 20 March 2000, DSR 2000:IV, 2031, paragraph 7.28 (emphasis added).

2. Exclusion or Exemption

10. It seems to the EC that the US is not attempting to argue that the mere presentation of the FSC Replacement scheme as an "exclusion" rather than an "exemption" is determinative of its status as a subsidy. The US states in paragraph 88 of its first written submission that:

> … the semantic distinction between an exclusion and an exemption would not, in any event, be determinative. Rather, the test under subparagraph (ii) is whether tax on the income now excluded would be otherwise legally owed to the government.

11. That is indeed the test, as the EC has insisted in its written submissions. The EC awaits with interest to see whether the US will finally admit the existence of a subsidy when it comes to answer the first question to it from the Panel, in which the Panel correctly points out that the term "qualifying foreign trade income" – and thus the exclusion from tax – is defined as an amount "which, if excluded, will result in a reduction of the taxable income of the taxpayer" by a defined amount. (These amounts being, as the EC has explained[3], arithmetically identical to the amounts excluded under the FSC scheme.)

3. What is a category of income?

12. The FSC Replacement Act is constructed around the statement of the Appellate Body[4] that

> A Member, in principle, has the sovereign authority to tax any particular categories of revenue it wishes. It is also free *not* to tax any particular categories of revenues.

13. The Panel may have noticed that the US omits[5] the words "in principle" when quoting the Appellate Body and that it also omits to mention that the Appellate Body immediately went on to say:

> But, in both instances, the Member must respect its WTO obligations.

14. The US contention is therefore that "extraterritorial income" is a category of income and that it has the sovereign authority not to tax it.

15. The EC does not accept that "extraterritorial income" can be considered a "category of income" in the sense this term was used by the Appellate Body. It does not agree that any arbitrarily defined category of income can be excluded from tax, since otherwise Article 1.1(a)(1)(ii) of the *SCM Agreement,* which makes "revenue forgone" a form of subsidy, would be devoid of meaning.

16. As we have said in our second written submission[6], the correct meaning of "category" in this context is "classes of income" or "types of income". For the EC, this means income created in different ways.

17. Textual support for this position can be found in the *SCM Agreement* where different types of direct taxes are listed as:

> taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property;[7]

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4 Appellate Body Report, DSR 2000:III, 1619, paragraph 90.

5 See e.g. first written submission of the US, paragraphs 64 and 74.

18. The EC notes that a similar categorization of different types of income is found in section 61 of the IRC. [8]

19. These are the different types of income that WTO Members have *in principle* the sovereign authority to tax or *not* to tax.

20. For example, if a Member decides not to levy taxes on the ownership of real property – or even business profits – it would not in this way be creating a subsidy.

21. But "extraterritorial income" is not such a category of income. Even less so is the truly "excluded income", "qualifying foreign trade income". In reality, the US has introduced a conditional exemption – or exclusion – from tax on some of the business profits that would otherwise be taxable under the US system.

4. He who can do more cannot always do less

22. The next fundamental error of the US is to assume that if it can exclude the whole of a category of income – in its view "extraterritorial income", in the EC's view business profits – then it must be able to exclude part of it. This leads the US to proclaim a fundamentally erroneous principle when it states

> That an exclusion is qualified or moderated, however, does not convert it into a subsidy under Article 1. [9]

23. As the EC has pointed out, the very essence of a subsidy is that a government gives to some but not to others. The principle "he who can do more can do less" may apply to the *amount* of an exemption but it does not apply to the *scope* of exemptions - or, indeed to the conditions attached to an exemption (just as it cannot justify discrimination). [10]

5. What is the correct analytical framework (or benchmark) for assessing export contingency?

24. The US is correct when it says that there is a difference in " analytical framework"[11] between the EC and the US in considering whether the new scheme is contingent upon export performance or not.

25. As the EC has explained in its second written submission, it is the US analytical framework that does not correspond to the *SCM Agreement*, not that of the EC. [12]

26. Just as the essence of a subsidy is a difference of treatment, and it is necessary to compare one situation to a relevant benchmark, so can contingency only be understood if one situation is compared with another.

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[7] Footnote 58 to the *SCM Agreement*, which reads:

> For the purpose of this Agreement:
>
> The term "direct taxes" shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property;

[8] See Exhibit US-4.

[9] Second written submission of the US, paragraph 91.

[10] Second written submission of the EC, paragraphs 79 to 80.

[11] First written submission of the US, paragraph 130.

[12] First written submission of the EC, Section 3.3.2 (paragraphs 74 to 103) and second written submission of the EC, Section 4.3.1 (paragraphs 98 to 110).

27. The US claims that there is no textual basis in Article 3.1(a) of the *SCM Agreement* for the EC approach of comparing the treatment of an export transaction with a domestic sale. But the US approach also requires a comparison. The comparison the US is urging the Panel to make is between the sale of US-produced goods for export and the sale of foreign-produced goods for final consumption outside the US. Where, the EC would ask, is it said in the text of Article 3.1(a) that this is the relevant comparison?

28. It is clear there must be a comparison. Both parties in fact accept this.

29. The correct approach must be established by correctly construing the *SCM Agreement* and correctly applying it to the circumstances of the case.

30. The EC will not repeat its detailed arguments but simply develop its point that one must compare like with like. The US is comparing like with unlike. Let us explain.

31. The FSC Replacement scheme is a *transaction-based* subsidy. The subsidy operates through the reduction in the amount of tax payable on the profit arising from a particular transaction. In addition, a taxpayer is entitled to choose transaction by transaction whether or not to use the FSC Replacement scheme at all [13] and which method he will use to calculate the amount of "excluded income". [14]

32. Accordingly, it is necessary to look to the transaction that the taxpayer is conducting. A US producer of goods has, in the normal course of its business, a choice between selling to a domestic purchaser or to a foreign purchaser. In the former case he does not receive the subsidy, in the latter, he does. That is the correct analysis and clearly shows the export contingency of the subsidy; the subsidy is only received if the goods are exported.

33. The US would have you compare the sale by the US taxpayer of a good he has produced in the US to a foreign purchaser with the sale by the US taxpayer of a foreign-produced good to a foreign purchaser in order to conclude that there is no export contingency.

34. That this is not the correct comparison is already evident from the fact that, if the US taxpayer opts to sell the foreign-produced good, he still has the US-produced good. What is he to do with it? The answer is simple. He will either sell it domestically or export it and so is confronted with the real choice – that which the EC has argued is relevant! Accordingly, the subsidy is contingent upon export performance.

6. There may be export-contingent subsidies within a broader programme

35. The US would have us believe that because there are, at least in theory, a number of ways to obtain the FSC Replacement subsidy, other than by exporting, this absolves the whole programme from a finding of export contingency. However, the *SCM Agreement* prohibits "subsidies" which are contingent upon export performance as well a subsidy programmes. In the case of the FSC Replacement subsidy, the EC does not dispute the theoretical possibility for the benefit to become available without exporting. However, the fact that this possibility exists does not mean that all subsidies granted under the Act are not export-contingent.

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[13] See new section 942(a)(3) of the IRC.
[14] See new section 941(a)(2) of the IRC.

36. The Appellate Body, in *Canada-aircraft*[15], stated that benefit does not exist in the abstract. In the same way, export contingency does not exist in the abstract; it must be analyzed with regard to the recipient, transaction and product concerned. The US approach would render the SCM disciplines completely ineffective.

37. The EC has cited the example of the Technology Partnerships Canada programme, the subject of the *Canada –Aircraft* proceeding, as an illustration of a case where an export contingent subsidy was included within a broader programme. The US, having ignored this argument when responding to the EC's first written submission, replied to the same argument brought by Canada saying that that the TPC was a *de facto* export contingent subsidy and asserting, wrongly, that the EC has not brought a *de facto* claim. [16] But the US argument is misconceived in any event. For one thing the Appellate Body has said that the standard of contingency is the same for both *de jure* and *de facto* cases. Further, how would the US have analyzed the Technology Partnerships Canada programme if there had been a *de iure* requirement for aircraft manufacturers to export?

38. The Panel will recall that the EC gave further hypothetical examples in its first written submission to illustrate the how untenable the US position is.

7. Article 3.1(b) of the SCM Agreement must be given meaning

39. The EC's main point relative to its Article 3.1(b) claim is that Article 3.1(b) must **be given meaning in all** its constituent parts.

40. The meaning of Article 3.1(b) must be assessed having regard to the objective pursued by the drafters when they proposed to include it in the *SCM Agreement* – namely to avoid the use of subsidies to promote the substitution of domestic goods for imported goods. [17]

41. Article 3.1(b) starts from the notion of "contingency", and the EC has explained the meaning of this term. [18] However, the crucial question before you is: **contingency on what?**

42. The word "contingent" is not isolated in Article 3.1(b), but is immediately qualified by the clause "upon the use of domestic *over* imported goods".

43. That clause - to which the US has given no meaning - means: "use of domestic *in preference to* imported" ("*de préférence* à des produits importés" in the French version of the *SCM Agreement*; "*con preferencia* a los importados" in the Spanish version). The EC has made this clear in its first written submission as well.[19]

44. Accordingly, "contingent ... upon the use of domestic over imported goods" means that for a subsidy scheme to be caught by Article 3.1(b), such scheme must be *contingent upon a requirement that gives preference* to the use of domestic goods.

45. In this case, the foreign content limitation is a requirement that gives rise to a preference.

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[16] Second written submission of the US, paragraph 28.

[17] See MTN/GNG/NG10/W/29, 22 November 1989; MTN/GNG/NG10/W/25, 28 June 1989; MTN/GNG/NG10/W/27, 6 October 1989.

[18] First written submission of the EC, paragraphs 199 and 83.

[19] First written submission of the EC, paragraph 165.

46. Under the foreign content limitation the use of US goods will be **necessary in some cases**. This flows as a matter of simple logic from the words, the structure and the design of the measure in dispute. As the Appellate Body found in *Canada – Aircraft*, contingency in law "is demonstrated on the basis of the words of the relevant legislation or other legal instrument ". [20] Therefore, the fact that the use of US goods will be necessary in some cases is sufficient for a *de iure* violation of Article 3.1(b) to be found. Furthermore, the EC has shown with the examples in the Annex to its first written submission cases where use of US goods will indeed be necessary.

47. In addition to the cases where the cost structure for the finished products is such that use of US articles will be necessary, there are cases where, to **minimize the risk** of not meeting the foreign content limitation, for example because the price of the final product may decrease, or because the price of foreign component "articles" may increase, the foreign content limitation will make US producers *prefer* US "articles".

48. This "preference" is also covered by Article 3.1(b)'s prohibition, through the language "use of domestic *over* imported goods".

49. The EC has given a meaning to all the clauses in Article 3.1(b), as required by the *Vienna Convention on the Law of Treaties* and by the principle of effective treaty interpretation. The EC notes that the US has not given meaning to the clause "use of domestic *over* imported goods". It has merely replied that (in some cases) the FSC Replacement Act does not require the use of domestic products [21] and this, in its view, is enough to rule out a case under Article 3.1(b).

50. If a maximum limitation on the use of foreign "articles" were found not to be caught by Article 3.1(b), WTO Members would be given a clear indication on how to circumvent the prohibition that they themselves wanted to be written in the *SCM Agreement*. It would not be difficult at all to repackage an "affirmative" requirement to use domestic goods into a requirement not to use more than a certain amount or value of foreign goods.

8. The double taxation defence – international practice

51. We come now to the US' double taxation defence. The EC gave in its first written submission a whole series of reasons why the FSC Replacement scheme is a measure to avoid single taxation rather than double taxation. It will not repeat them now but will respond to the arguments that the US has added in its second written submission.

52. First, the US suggests in its second written submission that the OECD, the UN, the WTO and the EC approve or "endorse" the use of both the credit and exemption methods for the avoidance of double taxation and that the US is thus entitled to use them in any combination. [22]

53. The US forgets to mention the context in which the use of these methods is accepted or "endorsed." None of the quoted parties endorse the use of either of these two methods in situations where there is no international double taxation present. The aim of the "endorsed" methods is to avoid such double taxation where there is such

[20] Appellate Body Report, *Canada - Aircraft*, DSR 1999:III, 1377, paragraph 167.
[21] Second written submission of the US, paragraph 200.
[22] Second written submission of the US, paragraphs 35 to 37.

double taxation of the same income by two or more sovereign taxing jurisdictions, not to provide subsidies by using one or the other or both.

54. What is unprecedented in the FSC Replacement scheme, and turns it into a subsidy, is to grant double taxation relief in situations where there is no such double taxation. As the EC has explained in its written submissions, the FSC Replacement Act excludes income from tax where other countries do not seek to tax that income. [23]

55. It is true that income excluded from tax as a result of the *extended* FSC Replacement subsidy, may be liable to foreign taxation in some cases. The unprecedented aspect of the extended FSC Replacement subsidy is not only that it also applies where the economic activity is in the US but that it can give rise to *overcompensation* of foreign taxes paid and therefore not only constitutes a subsidy but also cannot be considered a measure to avoid double taxation. [24]

56. Moreover, although countries sometimes consider it more appropriate to use one or the other method for different types of income or in different circumstances, it seems unprecedented to allow taxpayers to choose *transaction by transaction* to use one or other method.

9. The Purpose of the last sentence of footnote 59

57. The last sentence of footnote 59 to Item (e) of Annex I to the *SCM Agreement* speaks of "measures *to* avoid the double taxation of foreign-source income " not "measures *that* avoid the double taxation of foreign-source income". The word "to" implies a *purpose* that is pursued by the measure and, for the EC, it goes without saying that this must be a *bona fide* purpose.

58. What, the EC would ask, would be the *bona fide* purpose of allowing taxpayers to choose *transaction by transaction* between two systems of double taxation relief? And if there should be a good reason for this, why subject the right to make a choice to conditions such as the obligation to sell "not for ultimate use in the US" and the obligation not to exceed a 50 per cent foreign content, or exclude from the scheme sales of oil gas or unprocessed timber? The US has supplied no answers to these questions, which confirms that the purpose of the FSC Replacement scheme is not double taxation avoidance but the provision of a tax exemption - single taxation avoidance.

10. The fact that some countries might tax some extraterritorial income is no excuse to use such a system against WTO Members that do not

59. Another argument to which the US has attempted to respond is that the FSC Replacement scheme cannot be a measure to avoid the double taxation because it provides relief from tax on business profits that is not generated by a foreign "permanent establishment," the standard used in double taxation treaties, and therefore could not be subject to taxation in the other jurisdiction. [25]

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[23] Second written submission of the EC, Section 4.6.2, (paragraphs 186-198).

[24] Second written submission of the EC, section 4.6.4, (paragraphs 213 to 218 and 220).

[25] Third Party Submission of Canada, paragraph 34; second written submission of the EC, paragraphs 193 to 198.

60. Here, the US argues that "there are divergent views and practices among countries as to what brings a non-resident enterprise within a country's taxing authority" and that therefore it is entitled to exempt from tax a broad category of income, suggesting that it may somewhere be subject to tax. [26]

61. The EC notes that the US has not cited a single example of a country that would tax "extraterritorial income" earned by US companies. The references that it makes to the tax systems of the UK and Canada are unconvincing since both of these countries have bilateral tax treaties with the US.

62. In any event, the legal position in the only EU Member States mentioned, the UK, would not lead it to tax "extraterritorial income" even if there were no tax treaty with the US.

63. It can already be seen from a more careful reading of the extract from the treatise which the US attached to its second written submission [27] that, whatever the situation may have been in the 19th Century:

> The approach now generally taken by the courts is to ask whether "the operations from which the profits in substance arise" take place in the United Kingdom".

64. Thus the principle applied in the UK is that a non-resident may be liable to tax on business profits if its profits "in substance arise" in the UK. The conclusion of sales contracts in the UK may still be *one indicator* of trading and therefore of liability to pay tax on business profits in the UK but the same treatise goes on to say:

> if a foreign company sets up an office in the United Kingdom which merely carries out administrative activities (e.g., the preparation of the foreign company's internal accounts in respect of sales and purchases) or representative activities (e.g., the supply of information to potential customers, but not the making of offers for sale or the negotiation or execution of contracts), the foreign company *will not be* regarded as carrying on a trade within the United Kingdom.

65. It does not therefore appear that US "extraterritorial income" would be taxable in the UK even if the double taxation treaty were to disappear.

66. Finally, the EC would note that even if the US is able to find a country somewhere in the world that would tax extraterritorial income, this would only justify measures for the avoidance of double taxation with respect to that country – not with respect to the vast majority of countries that have committed themselves by treaty not to tax business profits unless there is a nexus in the form of a permanent establishment in their territory.

11. The last sentence of footnote 59 is limited to foreign-source income

67. An even clearer reason why the FSC Replacement scheme cannot benefit from the alleged defence in the last sentence of footnote 59 is that this can in any event only apply to *foreign-source income*.

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[26] Second written submission of the US, paragraphs 61 to 64.
[27] Exhibit US-17.

68. The limitation in footnote 59 to foreign-source income is clearly no accident. It is only foreign-source income that is susceptible to being subject to double taxation and therefore this is the only case in which the clarification is needed.

69. It is interesting to note that the US definition of foreign-source income [28] is inspired by precisely the desire to describe a category of foreign-generated income that is *likely to be taxed* by foreign countries. Thus the General Explanation of the Tax Reform Act of 1986 by the Staff of the US Congress' Joint Committee on Taxation states that Congress intention was:

> to ensure that ... with respect to US persons, [the US] will treat as foreign-source income only that income which is generated within a foreign country and which is likely to be subject to foreign tax.[29]

70. In answering the arguments of Australia and Canada, the US persists in confusing income and receipts. [30] The fact that the price for goods sold "not for ultimate use in the US" is received from foreigners may mean that the receipts are foreign but not that the income, that is profit, from such sales is foreign.

71. This confusion is all the more puzzling when one considers that the FSC Replacement Act distinguishes itself between income and receipts by providing in new section 941(a)(1) that the tax exclusion can be calculated either as 1.2 per cent of receipts or as 15 (or 30) per cent of income, that is profit.

72. This deliberate confusion between income and receipts allows the US to pretend that the profit which it is sheltering from tax somehow has its *source* outside the US. Again it is only the receipts that may have a foreign source (because they derive from sales "not for ultimate use in the US"), whereas the profit is allowed to be generated entirely from economic activities conducted in the US.

12. Article III:4 of GATT prohibits incentives to domestic products

73. Mr Chairman, distinguished Members of the Panel, since in our view the foreign content limitation violates Article 3.1(b), we may be relatively brief in our discussion of Article III:4 of GATT 1994.

74. It seems to us that there is not much to add on the EC claim under Article III:4 of GATT 1994. The US has hardly replied to it. To the extent that it replied, it has not addressed the substance of the EC claim, but has rather (1) alleged that the EC incorrectly described the foreign content limitation – in fact itself mischaracterizing the EC's arguments, and (2) alleged lack of evidence – in fact setting a standard of proof both vague and unsupported. We will thus only mention the following points:

- Article III:4 applies to incentives to the use of domestic products
- There is no "heightened evidentiary burden" for Article III:4 claims addressing a measure of general application

[28] There is no express definition of this notion in US law but it is implicit in sections 861 to 865 of the US IRC.

[29] See Exhibit EC-15, at page 918.

[30] The US goes as far as saying that "export sales are one form of foreign transaction" – second written submission of the US, paragraph 57.

- The local content limitation is a requirement concerning goods, not firms. As this latter issue is touched upon by one of your questions, we will further elaborate on it in our reply.

75. The US takes the view that the FSC Replacement Act does not "require" the use of US manufactured goods. [31]

76. The US however does not deny that there is a foreign content limitation, which it calls itself the "50 per cent rule", [32] or even "requirement". [33] The US has also not contested that the tax benefit provided for in the FSC Replacement Act can only be obtained if this rule is observed.

77. As we have recalled in the EC first written submission, the term "requirement" in Article III:4 does not only cover measures whereby "an enterprise is legally bound to carry out" a requirement, but also cases where "an enterprise voluntarily accepts [to do something] in order to obtain an advantage from the government". [34] Requirements falling within the latter group were reviewed e.g. in *EEC – Parts and Components*, *Canada – FIRA* and most recently *Canada – Automobiles*. [35]

78. Given that there is no dispute that the "50 per cent rule" must be met in order to obtain the tax benefit, there is thus no disagreement between the parties that there is a "*requirement*" within the meaning of Article III:4 of GATT 1994.

79. For the record we would like to correct the US quotations from the EC's first written submission. [36] The first two of these quotations use the word "requirement" in the sense that this word is given under Article III:4. The third quotation does not refer to the FSC Replacement Act, as the US indicates, but to one of the items in the *TRIMS Agreement* Annex.

80. The EC in any event has made clear that in its view the Act dos not contain an express obligation for US producers to use US "articles". [37] Its arguments quoted by the US cannot therefore be taken to mean the contrary.

81. The foreign content limitation is a requirement that **affects** the "sale ... purchase ... or use" of goods and affords less favourable treatment to imported goods than US goods. The EC has shown, in connection with its claims under Article 3.1(a) and 3.1(b) of the *SCM Agreement*, that limiting the use of foreign articles will, in fact, effectively necessitate the use of US products for goods for which the value of raw materials and components accounts for more than 50 per cent of the total price. But it would recall that Article III:4 also covers hypotheses where, short of a necessity to use domestic goods, **a producer will be induced** to do so. Any requirement that "affects" the sale .. purchase ... or use" of goods is caught by Article III:4. As indicated by the Appellate Body in *EC – Bananas*, the word "affecting" "implies a measure that has 'an effect on', which indicates a broad scope of application."[38]

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[31] Second written submission of the US, paragraph 200.

[32] Second written submission of the US, Sections E and F.

[33] Second written submission of the US, paragraph 200.

[34] Panel Report, *EEC - Parts and Components*, quoted in footnote 69 of the First written submission of the EC; First written submission of the EC, paragraphs 191 to 195.

[35] First written submission of the EC, paragraph 201.

[36] First written submission of the US, paragraph 213, referring to paragraphs 203, 206 and 217 of the first written submission of the EC.

[37] See e.g. in paragraph 194 of the first written submission of the EC.

[38] Appellate Body Report, *EC - Bananas*, DSR 1997:II, 591, paragraph 220.

82. The foreign content limitation affords "less favourable treatment" to foreign "articles" which can compose "qualifying foreign trade property" because it places "articles" of US origin at a competitive advantage vis-à-vis the like products of foreign origin. When all other competitive conditions are equal, the purchase of domestic products will offer the additional advantage of facilitating the US production to be considered as "qualifying foreign trade property" and obtain the benefit of the FSC replacement scheme.

83. A similar situation was before the panel in the *Canada - FIRA* case. At issue there were certain purchase undertakings, the offering of which was a condition for foreign investors to have their investments in Canada authorized. [39] Some of these undertakings concerned offers to source Canadian products only if available at competitive conditions with the like imported products ("competitively available"). The panel found these undertakings contrary to Article III:4 because

> where the imported and domestic product are offered on equivalent terms, adherence to the undertaking would entail **giving preference** to the domestic product. Whether or not the foreign investor chooses to buy Canadian goods in given practical situations, is not at issue.[40]

84. These considerations can *a fortiori* apply in this case. As explained, the fact that, by using domestic inputs, a US producer is sure not to be excluded from the possibility to obtain the tax benefit, is an advantage that is conferred by the government to US products and that discriminates against like imported products.

85. The only other reply of the US to the EC's Article III:4 claim is the creation of a new standard of proof for cases involving measures of general application (as opposed to product specific measures). Contrary to the US contention, however, **there is no "heightened evidentiary burden"** for challenges of general measures under Article III:4 of GATT 1994.

86. The EC will simply refer the Panel to previous panel reports which it has relied upon in its first written submission [41] and which likewise reviewed measures of general application. These are:

- Canada - FIRA
- US - Section 337
- EEC - Parts and Components

87. In none of the above cases did a panel set out a different, let alone "heightened", evidentiary burden of the type advocated by the US in its first written submission. At any rate, Panels addressing claims under Article III:4 have referred indifferently to previous cases where general measures or product specific measures had been reviewed. Moreover, they have pointed out that

> the requirement of Article III:4 is addressed to 'relative competitive opportunities created by the government on the market …';

and that

> "a determination of whether there has been a violation of Article III:4 does not require a separate consideration of whether a measure affords protection to domestic production"[42]

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[39] Panel Report, *Canada – FIRA*, paragraph 5.4.
[40] Panel Report, *Canada – FIRA*, paragraph 5.4 (emphasis added).
[41] First written submission of the EC, paragraphs 191 ff.

It is not by chance that the US has not been able to refer to any authority in support of its newly created standard of proof.

88. Even assuming, *arguendo*, that some reference to the functioning of a "requirement" of general application in respect of classes of products were to be provided, the EC has furnished evidence in its Annex as to sectors where the use of US inputs is necessary. *A fortiori* this evidence will be enough to support beyond doubt that the "requirement" under review affords less favourable treatment because it makes, all other conditions being equal, domestic inputs more attractive than foreign ones.

13. Confidential Exhibit US-9

89. The EC's immediate reaction to confidential Exhibit US-9 is: So what?

90. The EC does not doubt that there must be one or other company in the world that might consider domesticating, depending on the precise conditions that are eventually adopted by the US. The EC's case on Article 3.1(a) is, as the Panel well knows by now, not that no foreign company will use the extended FSC Replacement subsidy but that the basic FSC Replacement subsidy is still contingent upon exportation and that in many cases the use of the extended FSC Replacement subsidy will require the use of US articles by foreign companies.

91. If the Panel does consider the information in exhibit US-9 to be relevant to its decision in this case, the EC has a number of clarifications and questions to ask on it which it would ask the Panel to put to the US and to the company making the statement in Exhibit US-9 under the powers available to it under Article 13 *DSU*.

92. For the time being, the EC would simply note that the US has only produced a statement from one company with an intent to use the extended FSC Replacement subsidy and that that company is only one of 50 significant foreign subsidiaries[43] of the US parent.

Thank you for your attention.

[42] Panel Report, *Canada – Automobiles*, DSR 2000:VII, 3043, paragraph 10.78; first written submission of the EC, paragraph 201 and footnote 73.

[43] Source: The US parent corporation's report to the US Securities and Exchange Commission, files 29 March 2000.

LIST OF EXHIBITS

EC-14 Extract from the BNA Daily tax report of 8 March 2001 (quoting Dirk Suringa of the International Tax Counsel's Office at the US Department of Treasury).

EC-15 Extract from the General Explanation of the Tax Reform Act of 1986 by the Staff of the US Congress' Joint Committee on Taxation.

ANNEX D-2

CLOSING STATEMENT OF THE EUROPEAN COMMUNITIES
(16 March 2001)

Mr Chairman, Members of the Panel,

1. Thank you for listening to us so carefully these last days and for your stimulating questions. We attach a written version of the answers that we have already given and will provide fuller and more refined answers by your deadline of 27 March.

2. We would like to make a number of concluding remarks to highlight a number of key issues arising out of the debate.

1. The objectives and effects of the FSC Replacement Act

3. One frustrating – yet illuminating – feature of our debate has been the extent to which the US has responded that it does not know the reasons for and the effects of many provisions of the FSC Replacement Act.

4. It is worth passing in review these US avowals of lack of justification, explanation and analysis:

- The *estimated effects on tax revenue* of the new legislation;[1]
- The factors that were considered to give rise to the increased tax expenditure;[2]
- The reasons certain products cannot give rise to excluded income;[3]
- The reasons why is the President allowed to exclude other categories of products in short supply;[4]
- The reasons for and anticipated effects of the so-called 50 per cent rule;[5]
- Whether and how the FSC Replacement Act applies to foreign-produced agricultural products, in particular crops and commodities.[6]

5. The legislative history makes clear however that the US administration was closely involved in the passage of this bill and should have been able to provide ex-

[1] [Question 2] How does the increased expenditure compared to the FSC indicated by the Congressional Budget Office arise? Answer: The US does not know.

[2] [Question 3] What part of the increased tax expenditure is attributed to a wider product coverage of the current law (defence products), and how much to other factors (e.g. transactions involving goods manufactured abroad)? The US does not know.

[3] [Question 6a] Why are there five categories of products (e. g. such as oil and softwood timber) which cannot give rise to excluded income? The US does not know.

[4] [Question 6b] Why is the President allowed to exclude other categories of products in short supply? The US does not know.

[5] Question 12: What are the *objectives* of the 50 per cent rule? The US does not know.
[Question 13] What are then the *effects* of the 50 per cent rule? The US does not know.

[6] [Question 16] Is there any guidance on how the FSC Replacement Act applies to foreign-produced agricultural products, in particular crops and commodities? US does not have any guidance.

planations of the purposes and effects of the FSC Replacement Act. This is already evident from the following statement of US President Clinton on signing the FSC Replacement Act into law:

> …Enactment of this legislation is possible due to extraordinary bipartisan cooperation between the Congress and my Administration and the strong involvement of the business community.[7]

6. In the light of this unhelpful attitude of the US, the EC provides the Panel with the following elements of legislative history contained in the documents we have attached to this statement which further illustrate the attention that was paid to the provisions, their objectives and intended effects:

7. First, Government Press Release "Committee passes FSC Repeal and Extra-territorial Income Exclusion Act of 2000 ", 27 July 2000 (Exhibit EC –17).

> We are considering one of the most important bills of this Congress. It is critical for continued US competitiveness in the global marketplace. It is critical for our economy. And most important, it is critical to preserve tens of thousands of jobs for American workers and their families. I believe the approach in this legislation is the best way to comply with the decision, continue honour our trade agreements consistent with the obligations they impart, and maintain our global competitiveness. This is a complex issue, but we must succeed for the most basic reason," said Chairman Bill Archer (R-TX).
>
> We've had a group of top tax and trade experts led by Deputy Secretary Eizenstat working non-stop for months to find a way to satisfy the WTO dispute resolution body…" said ranking Minority Member Charles Rangel (D-NY). [8]

8. Second an extract from Worldwide Tax Daily, 24 July 2000, "US Congressional taxwriters discuss FSC legislation", Goulder, Robert; Donmoyer, Ryan J; Tax Analysts (Exhibit EC – 18).

> US Treasury Department officials met with US Congressional taxwriters late on 21 July to discuss the draft legislation that would revise the foreign sales corporations (FSC) statutes and make the tax regime WTO-compliant.
>
> The purpose of the closed-door discussions was to advice key legislative assistants on the details of the FSC draft before the House Ways and Means Committee considers the measure…
>
> The draft legislation is largely based on the proposed FSC replacement that US Deputy Secretary Stuart Eizenstat presented to EU Trade officials in May. During the past week, the US Joint Committee on Taxation has translated Treasury's proposal into statutory language… [9]

9. Next the exhibit we distributed this morning, an extract from the Congressional Record, House of Representatives, 14 November 2000 (Exhibit EC-19)

On page H11891, Congressman Levin explains:

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[7] Exhibit EC–16: Clinton Statement on signing FSC Repeal Legislation into law – The White House office of the Press Secretary, Hanoi (Vietnam), 17 November 2000.

[9] Exhibit EC-18 – Worldwide Tax Daily, 24 July 2000, "US Congressional taxwriters discuss FSC legislation", Goulder, Robert; Donmoyer, Ryan J; Tax Analysts.

> "At the same time, and I emphasize this, as it is clear from the bill itself in the committee report, this bill does not provide an incentive for US producers to move their operations overseas. It carefully defines the property that can be involved in transactions subject to the new tax regime. No more than 50 per cent of the fair market value of such property can consist of (a) non US components, plus (b) non-US direct labour. This provision has been carefully reviewed by those of us on the Committee on Ways and Means as well as the Department of Treasury, and I might add, minority leader."

On Page H11893, Congressman Rangel explains:

> "Mr Speaker, let me thank the chairman of the Committee on Ways and Means, the gentleman from Texas (Mr Archer), my fellow Democrats, and join my colleagues on the floor in asking support for this piece of legislation, which is supported by the President and which our official Secretary Stuart Eizenstat, assistant Secretary Jon Talisman, have worked on, as well as the Senate, which has made some changes."

On page H11894, Congressman English states:

> "This is a critical legislation to protect the jobs of working families who have members who work in some of our best paying export oriented jobs in America…"

On page H11896, Congressman Defazio states:

> "Apparently not bothered by the hypocrisy, immediately after the ruling by the WTO appeals panel, the Clinton Administration, a few members of Congress, and the business community openly declared the need to maintain the subsidy in some form and began meeting in secret to work out the details on how to circumvent the WTO ruling and maintain these valuable, multi-billion dollar tax incentives."

2. The Existence of a Subsidy

10. The US is asking the panel to accept the proposition that a WTO Member has an apparently unlimited right to exempt any type of income from taxation and then claim that it is not granting a subsidy because it has changed the prevailing benchmark against which the existence of a subsidy must be measured. Taken to its logical conclusion, this approach would mean that revenue would never be foregone under Article 1 of the SCM Agreement, because such revenue would never be "otherwise due", the Government in question having already moved the "outer boundary" of its tax jurisdiction to accommodate it. In these circumstances, there would be no subsidies derived from tax exemptions, which would come as quite a shock to many people in the US, notably the Import Administration of the Department of Commerce, which regularly imposes countervailing duties against such measures taken by third countries. The EC has given examples of such measures in its questions to the US.

11. The US claims that by exempting extraterritorial income (or at least some of it) from US tax, it is exercising its sovereign right not tax certain income. What it is in fact doing is exercising its sovereign authority to grant a subsidy. There is nothing

inherently wrong with this, except that, as explained later, these subsidies fall into the prohibited category.

3. The Export Contingency

12. The Act requires goods to be sold for ultimate us e outside the US. The US continues to overlook the obvious fact that there is only one way for the subsidy to be obtained in respect of transactions involving US goods - by exporting. In its oral statement, the US even went as far as saying that US producers are not obliged to export in order to obtain the subsidy, since they could, for example, decide to produce abroad and thus generate excluded income.

13. On the basis of this logic, all SCM Agreement disciplines would be reduced to inutility. For a start, no subsidy would ever be specific. There would be no regional specificity, since any firm could move to an eligible region. There would be no sectoral specificity, since any firm could diversify into the eligible sector. Yet the US Department of Commerce, in its CVD practice, maintains that subsidies limited to certain regions or sectors are specific. We have no reason to disagree with their approach.

14. As we have said, contingency, like benefit, does not exist in the abstract. The question of export contingency has to be determined with regard to the actual recipients of the subsidy.

15. The US, in adopting this law, knew that it was adopting a measure to promote exports – as evidenced by the statements above. This is also clear from the terms of the Act. The US has not been able to explain why products in short supply are excluded. The answer we submit is simple – because the US does not want to promote the export of such products.

4. The Foreign Content Limitation

16. We have noted above that an explanation for the foreign content limitation is contained in the legislative history - Mr Levin's statement that*:*

> … this bill does not provide an incentive for US producers to move their operations overseas. It carefully defines the property that can be involved in transactions subject to the new tax regime. No more than 50 per cent of the fair market value of such property can consist of (a) non US components, plus (b) non-US direct labour. This provision has been carefully reviewed by those of us on the Committee on Ways and Means as well as the Department of Treasury, and I might add, minority leader.

5. The Act mandates the granting of prohibited subsidies

17. This brings us to a more legal point. That is that the Act is inconsistent with the *SCM Agreement* because it mandates the granting of prohibited subsidies if taxpayers fulfil the conditions. The text does not preclude that these subsidies will be granted. The US tax authorities have no discretion not to allow it where, for example, the subsidy would be contrary to Article 3.1(b).

6. The Double Taxation defence

18. The first point the EC has highlighted in connection with the US double taxation defence is the absence of any indication in the legislative history of any double taxation problem. The EC would refer you again to the extracts from the legislative history in the exhibits; nowhere is there any talk of a double taxation problem.

19. One reason why the defence is untenable because of the fact that under the FSC Replacement Act a US exporter does not need to perform any activities outside the US that could give rise to income that other countries would seek to tax.

20. In this context, the EC has emphasized the significance of the internationally recognized rule that business profits of non-resident enterprises may only be taxed if they arise in connection with a 'permanent establishment.'

21. This rule is evidenced by Articles 5 and 7 of the OECD Model Tax Convention, which both the EC and the US rely on as evidence of international practice.

22. Since excluded income may only arise from business activities, countries other than the country of the taxpayer's country of residence may only legitimately tax the profits from such activities if they are derived from business activities carried on through a permanent establishment.

23. The US has suggested that Article 5.5 of the Convention would somehow establish a lower threshold for the existence of a permanent establishment, even in the absence of a permanent character of the foreign activities. In support of these arguments the US has made incomplete quotations of the said paragraph of Article 5 and its Commentary. The EC considers that both Article 5.5 and its Commentary merit to be read in full.

> Notwithstanding the provisions of paragraphs 1 and 2, where a person – *other than an agent of an independent status to whom paragraph 6 applies* – is acting on behalf of an enterprise and has, *and habitually exercises*, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, *unless the activities of such person are limited to those mentioned in paragraph 4* which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. (Article 5.5 emphasis added)

24. In addition, the Commentary to Article 5.5 [10] clearly points out that

> The use of the term 'permanent establishment' in this context presupposes, of course, that that person (the dependent agent) makes use of his authority repeatedly and not merely in isolated cases.[11]

25. The Commentary further notes that

> It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State"[112].

[10] Exhibit US-18.
[11] Commentary to Article 5.5 (paragraph 32).
[12] Commentary to Article 5.5 (paragraph 35).

26. Thus, Article 5.5 only establishes an alternative test to that present in paragraphs 1 and 2, and by no means suggests that a permanent establishment would exist without a substantial degree of permanence.

27. Contrary to the US claim that the EC in its second written submission had omitted parts of Article 5 and implied that the concept of permanent establishment in it is limited to the existence of a fixed place of business the EC, when making its second written submission, had carefully considered the full scope of Articles 5 and 7 of the Convention and concluded that the FSC Replacement Act does not in any way require the performance of such foreign activities which would constitute a permanent establishment for a US taxpayer eligible for the subsidy.

28. It is indeed of utmost importance to bear in mind that the foreign economic processes requirement in the FSC Replacement Act is based on a percentage cost test and that it can be met without undertaking any activities outside the US. In this context it is equally important to bear in mind that US taxpayers wishing to be eligible for the subsidy can outsource to independent third parties all the activities, if any, that are to be performed outside the US. It follows that foreign jurisdictions would not seek to assert any taxing rights on the excluded income as defined under the FSC Replacement Act, and that it is not meant to serve as a measure to avoid double taxation.

7. Footnote 59

29. The EC has explained that the exact status and meaning of footnote 59 does not have to be established in this case. It is sufficient to note that the FSC Replacement Act is not a measure for the avoidance of double taxation and is not limited to foreign-source income.

30. Whether one considers that this is a reference to a WTO standard or must be assessed, like revenue forgone, by reference to the tax system of the country concerned, the FSC Replacement Act does not satisfy the condition.

8. Article 3.1(b) of the *SCM Agreement* and Article III:4 of GATT 1994

31. The best way to sum up on Article 3.1(b) is to recall what you have asked the US in question 9.

32. Article 3.1(b) as we have said, prohibits conditions that give preference to domestic products in *any* cases.

33. The US itself admitted that there can be cases where use of US articles will be needed.

34. This *a fortiori* will mean that the foreign content limitation will provide an incentive to domestic products within the meaning of Article III:4.

LIST OF EXHIBITS

EC-16	President Clinton Statement on signing FSC Repeal Legislation into law – The White House office of the Press Secretary, Hanoi (Vietnam), 17 November 2000.
EC-17	Government Press Release "Committee passes FSC Repeal and Extra-territorial Income Exclusion Act of 2000", 27 July 2000.
EC-18	Worldwide Tax Daily, 24 July 2000, "US Congressional taxwriters discuss FSC legislation" , Goulder, Robert; Donmoyer, Ryan J; Tax Analysts.
EC-19	Congressional Record, House of Representatives, 14 November 2000.
EC-20US	Regulation on the operation of the FSC scheme dated 6 March 2001.

ANNEX D-3

ORAL STATEMENT OF THE UNITED STATES

(13 March 2001)

I. INTRODUCTION

1. Mr. Chairman, Members of the Panel: On behalf of the US delegation, I want to thank you for the opportunity to appear before you today. We are aware of the large number of issues before the Panel, the volume of materials submitted to the Panel, and the gravity of the issues the Panel must weigh. We are grateful for your willingness to take on this considerable challenge and appreciate your service in trying to resolve this dispute and advance the aims of the multilateral system.

2. As the Panel well knows by now, the United States does not believe that the EC has met its burden of establishing that the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 – which I will hereafter refer to as "the Act" – is inconsistent with US WTO obligations. From our perspective, the EC appears to view the Act as somewhat unusual and for that reason maintains that it must somehow be inconsistent with WTO rules. The EC appears to think that the Act is different from measures it is familiar with that attempt to achieve similar ends. The EC objects to the fact that it borrows aspects of European tax regimes only in part, or follows OECD guidelines only in part. And, the EC just doesn't think the Act is sufficiently different from the FSC.

3. However, these are not reasons to find a measure to be incompatible with treaty obligations. Instead, they are *ad hoc, ex post facto* justifications for reaching a desired outcome.

4. This type of "I know it when I see it" approach advocated by the EC, while convenient for the EC in terms of its immediate objectives, cannot serve the DSU' s objective of providing "security and predictability to the multilateral trading system."[1] It also is ill-suited to "achiev[e] a satisfactory settlement of the matter".[2]

5. For these reasons, the DSU requires that disputes be governed by the "customary rules of interpretation under public international law".[3] Indeed, it is extremely ironic that in the first round of this dispute, the EC insisted on strictly adhering to the text of the relevant agreements as interpreted in accordance with customary rules of interpretation. The EC chided the United States for relying on material other than the text, such as the 1981 Understanding. The Panel and the Appellate Body essentially agreed with the EC.

6. Now, however, the situation appears to be reversed, and it is the United States, not the EC, that is adhering to the text. As discussed in the US submissions, the United States followed the text and the decision of this Panel and the Appellate Body in designing the Act. Yet, after doing so, the United States finds itself subjected to arguments that are non-textual or extra-textual in nature. These arguments attempt

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[1] DSU, Article 3.2.
[2] DSU, Article 3.4.
[3] DSU, Article 3.2.

to expand WTO rules beyond their ordinary meaning and, if accepted, would add new requirements and conditions to WTO provisions that simply do not exist.

II. FUNDAMENTAL ISSUES RAISED BY THIS CASE

7. To reach a decision in this case that comports with proper methods of interpretation and that will promote the aims of the dispute settlement system, the United States respectfully submits that the Panel must answer certain essential questions posed by this case about the meaning of the relevant WTO provisions. The United States will discuss these key questions briefly, and then will respond to some of the specific arguments raised by the EC in its submissions.

8. In the view of the United States, the major issues are these

First, does the Act confer a subsidy within the meaning of Article 1 of the SCM Agreement because, while it generally excludes extraterritorial income from taxation, it taxes some extraterritorial income?

Second, is the Act export contingent under Article 3.1(a) of the SCM Agreement because exporting is one way, but not the only way, of generating excluded extraterritorial income?

And third, does the Act not constitute a measure to avoid double taxation under footnote 59 of the SCM Agreement because it does not limit its exclusion to the amount of foreign taxes paid?

9. The United States respectfully submits that the answer to each of these questions is no.

A. A Tax Exclusion may be Partial and not a Subsidy

10. Turning to the question of the partial nature of the Act's exclusion of extraterritorial income, it appears to be beyond dispute that a WTO Member can refrain from taxing any category of income it chooses. As the Appellate Body has explained, Members have "the sovereign authority ... not to tax any particular categories of revenue."[4] The question before the Panel, though, is whether a Member can choose not to tax a category of revenue in part.

11. The difficulty in answering this question is how to define what is a category of income and under what circumstances might a partial exclusion of a category result in the conferral of a subsidy. The Appellate Body noted the difficulty of resolving these issues in the abstract, stating that "the word 'foregone' suggests that the government has given up an entitlement to raise revenue that it could 'otherwise' have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues."[5] The Appellate Body explained that a tax exclusion must be compared against the "prevailing domestic standard" of the Member in question in order to determine whether revenue "otherwise due" has been foregone.[6] Therefore, if the "prevailing domestic standard" of a Member's tax system would not tax a category of income that is excluded by a challenged measure, then no revenue can be said to be "otherwise due".

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4 *FSC (AB)*, DSR 2000:III, 1619, para. 90 (emphasis in original).
5 *FSC (AB)*, DSR 2000:III, 1619, para. 90 (emphasis in original).
6 *Ibid.*

12. The Act does not forego revenue when compared against any prevailing US standard. There is no "normative benchmark" that would tax extraterritorial income, unless one presumes in contravention of the Appellate Body's reasoning that the United States taxes *all* income. The Act provides a definition of excluded extraterritorial income, and that definition, like all definitions, implies a category of items that meet its terms and a category of items that do not. However, the mere fact that the statutory definition of excluded extraterritorial income does not describe all income that the United States could theoretically subject to tax does not render the Act a subsidy. If the Panel were to conclude otherwise, then any defined category of income that is not subject to tax would constitute a subsidy. A 95 per cent participation exemption for repatriated foreign dividends would be a subsidy since it results in a tax on the remaining five per cent. And certainly a 75 per cent exemption for foreign branch income would appear to be a subsidy because the remaining 25 per cent is subject to tax.

13. If the Panel were to adopt the EC's circular test of "general rule" versus "exception," the consequences would be far reaching. Accordingly, if the Panel were to accept the EC's reasoning, it would be incumbent upon the Panel to articulate some standard for determining when a rule of taxation is a "general rule" and when it is not.

14. With respect to the Act, its structure and legislative history indicate that the United States intended to make the extraterritorial income exclusion part of its "general rule" for US income taxation. Therefore, it would be necessary for the Panel to explain why the United States did not, or could not, amend its domestic laws in this manner. In other words, it would be incumbent on the Panel to provide guidance to the United States – as well as to other WTO Members – as to the criteria to be applied in writing domestic tax legislation in order to ensure that measures are sufficiently "general" to avoid an inadvertent subsidy classification. Only in this way would the United States and other WTO Members have the benefit of understanding where the boundaries of Article 1 begin and end in this regard.

B. Exporting may be one Way of Satisfying a Neutral Principle

15. Turning next to the question of whether exporting may be one way of satisfying a neutral principle without creating an export contingency, the United States has explained that the Act applies to a broad array of foreign transactions involving goods destined for use or consumption outside the United States, regardless of where such goods are manufactured. It would seem that this aspect of the Act, without more, is not sufficient to implicate Article 3.1(a). Exportation may be one way of satisfying the prerequisites for a number of subsidies that presumably all Members of the WTO would agree are not prohibited export subsidies.

16. It is unclear to what extent any companies would necessarily have to export in order to satisfy the requirements of the Act, but that is an incidence of a tax exclusion for foreign or extraterritorial income. The fact that exporting may be one way of satisfying the export-neutral conditions of the Act does not make the Act "conditioned" or "dependent for its existence" on export performance.

17. The EC, however, has suggested that the group of companies who will export in order to earn extraterritorial income is relatively large because the EC believes non-export transactions under the Act are limited by the 50-per cent value rule. The

United States has disputed this unsubstantiated assertion. However, if the Panel were to give the EC's allegations credence, and were to find that it results in a violation of Article 3.1(a), the United States submits that the Panel must make clear whether any such violation is the result of the application of the 50-per cent rule or whether the exclusion of extraterritorial income in and of itself is export contingent.

18. One last point on export contingency must be raised. The EC has alternatively complained that the Act's exclusion of extraterritorial income is improper because, in the EC 's view, the United States has merely added a limited class of non-export transactions to the exports covered by the FSC. The EC maintains that this is inadequate because a WTO Member cannot remedy an export subsidy by expanding its application. At the same time, the EC charges that the Act is deficient because it also is not broad enough, since it does not apply to imports.

19. Clearly, one of these arguments cannot be correct. The United States has explained that neither is correct. The Act does not require exportation at all and therefore is not export contingent. Because these issues go to the heart of this case, the United States requests that the Panel clarify: (a) whether the fact that exporting is merely one way of earning excluded income under the Act is not enough to condemn the Act under Article 3.1(a); or (b) whether the fact that the Act does not apply to imports does condemn the Act under Article 3.1(a).

C. A Measure to Avoid Double Taxation may be Preventive in Nature

20. Another area that demands full and reasoned analysis by the Panel is the question of what footnote 59 means when it refers to measures to avoid double taxation of foreign-source income. As is the case with regard to subsidies and export contingency, clear guidance is needed in this important area in order to secure a quick and final resolution of this dispute.

21. The EC has asked the Panel to impose a number of conditions on what constitutes a measure to avoid double taxation that cannot be found in the text of footnote 59. It has said that such measures must require taxpayers to have "permanent establishments" in foreign jurisdictions. It has claimed that such measures can only apply to income directly attributable to foreign economic processes of taxpayers. It has argued that WTO Members cannot use both exemptions and credits. It has even gone so far as to maintain that a Member must show a "necessity" for instituting such a measure and that Members must adhere to the details of the OECD Model Convention.

22. The United States will address these points later but, at the risk of oversimplifying things, the issue may be reduced to the following: are Members precluded by the SCM Agreement from taking prophylactic steps to prevent their taxpayers from being subjected to taxation both at home and in a foreign jurisdiction? The language of the fifth sentence of footnote 59 suggests that such a preventive approach is permitted, because that sentence begins by saying that paragraph (e) of the Illustrative List does not "limit the ability of Members" to "avoid" double taxation.

23. The United States does not contend that the Act provides a narrowly tailored, dollar-for-dollar offset of foreign taxes paid. However, such limited relief is not all that is allowed by footnote 59, and measures to avoid double taxation around the world are not so limited. The United States has explained that the exemption method is prospective in nature and provides for exemption irrespective of the amount of

foreign tax actually imposed. The United States is unaware of any country applying the exemption method that requires taxpayers to show that they have been taxed on all income eligible for exemption and that application of the exemption would not result in an overall tax savings. It is instructive to note that in this dispute, only Australia – a third party – has proposed such a narrow reading. EC member states do not prevent their taxpayers from netting an overall tax savings, and, for that reason, it is not surprising that the EC has not advocated Australia's argument. Instead, the EC has attempted to read into footnote 59 narrowing conditions that cannot be found in the ordinary meaning of the relevant text.

24. The key issue in this context is whether a measure comes within the scope of footnote 59 if it excludes from taxation income that could be subjected to foreign taxation and thus doubly taxed. The United States believes that excluded extraterritorial income legitimately could be subject to taxation in a foreign jurisdiction. At the same time, the Act is sufficiently flexible to meet the varying criteria that foreign nations rely upon in asserting taxing jurisdiction. Accordingly, the United States believes that the Act comes within the fifth sentence of footnote 59.

25. To the extent that the Panel finds that footnote 59 does not allow Members to take a preventive approach to avoiding double taxation, the United States respectfully requests that the Panel explain what conditions or limitations it finds to be in the footnote. In particular, the United States requests that the Panel explain whether WTO Members must ascertain on a transaction-by-transaction basis whether income has in fact been subjected to foreign taxation and whether relief from double taxation is capped by the amount of foreign taxes paid.

III. THE UNITED STATES HAS RESPONDED TO ALL OF THE EC'S CLAIMS

26. The United States now will address specific points raised by the EC, beginning with a rebuttal of the EC's unfounded assertions in its Second Submission that the United States has failed to address certain EC claims and arguments.

A. The Availability of the Exclusion of Extraterritorial Income to Non-Exporting Taxpayers Demonstrates the Act's Export-Neutrality

27. The EC incorrectly alleges that the United States did not respond to its argument that the inclusion of non-export income within the Act' s exclusion of extraterritorial income does not place the Act beyond the reach of Article 3.1(a).

28. To the contrary, the United States explained in its First Submission that the availability of the exclusion of extraterritorial income for exporters and non-exporters alike reflects the export neutrality of the Act and that this export neutrality means that the Act does not involve an export contingency under Article 3.1(a). More specifically, the United States explained at paragraphs 115 to 127 of its First Submission that the Act applies to a wide array of foreign transactions and that the rationale for the Act's exclusion is to treat all foreign transactions alike, regardless of where goods involved in the transaction are manufactured. The United States also explained that the amount of the exclusion was in no way dependent on the existence of export sales.

29. In addition, at paragraphs 133 to 136 of its First Submission, the United States explained that it is not sufficient for the EC to allege that exportation may be one way of earning excluded income. Because the Act provides for an exclusion even where no exportation is involved, the Act's exclusion is not contingent, either "solely or as one of several other conditions", upon export performance. Therefore, the United States clearly responded to the EC's claim that application of the exclusion to non-exporters was irrelevant to export contingency.

B. US Persons can Earn Extraterritorial Income Without Exporting

30. The EC further claims that the United States left unanswered the EC's argument that "goods produced in the US can only obtain the benefit in one way – if exported".[7]

31. The United States has explained that US taxpayers need not export in order to earn extraterritorial income. Paragraphs 118-120 and accompanying footnotes of the US First Submission describe the wide range of foreign transactions that give rise to extraterritorial income. In this regard, the United States explained that US-based taxpayers may earn extraterritorial income through export sales *and* wholly foreign transactions involving offshore branches of those US-based taxpayers.

32. In these paragraphs, the United States also explained that the mere fact that exporters may avail themselves of the exclusion of extraterritorial income does not render the Act export-contingent. The United States illustrated this point by way of analogy. The United States explained that the presence of exporters in the universe of beneficiaries of a general production or sales subsidy would not transform that production or sales subsidy into one that is export contingent. Indeed, footnote 4 of the SCM Agreement confirms this analysis as it makes clear that the mere receipt of a subsidy by exporters does not render such subsidy export contingent.

C. The United States Established that the 50-Per Cent Rule does not Render the Exclusion of Extraterritorial Income Earned by Foreign Corporations Export Contingent

33. The EC claims that the United States "fails to comment at all" on the EC's argument that the 50-per cent rule makes the tax exclusion for foreign manufacturers export contingent. However, the United States, in footnote 102 of its First Submission, directly responded to this point by stating that the 50-per cent rule does not involve an export contingency because it does not require the use of any goods exported from the United States. The United States elaborated on the EC's misunderstanding of the 50-per cent rule in paragraphs 199-203 of its First Submission, explaining why no US inputs need be included in qualifying foreign trade property and, thus, why no exports of US goods is required by the rule.

D. The United States Rebutted the EC'S Claims under the Agriculture Agreement

34. The EC's final complaint regarding issues the US purportedly did not respond to concerns the EC's claims under the Agriculture Agreement. The EC argues that the

[7] *EC First 21.5 Submission*, para. 125.

US defense is "limited" because the United States did not dispute the EC's position that the analysis under the Agriculture Agreement is for present purposes the same as under the SCM Agreement.

35. No matter how the US response is characterized, the United States made clear at paragraphs 220 and 221 of its First Submission that the Act is not an export subsidy within the meaning of Articles 8 and 10.1 of the Agriculture Agreement. The United States, however, agrees with the EC that the SCM analysis does apply to the Agriculture Agreement.

IV. THE EC'S COMPLAINTS REGARDING THE FACTUAL BACKGROUND PROVIDED BY THE UNITED STATES

36. The United States would now like to draw the Panel's attention to certain errors in the EC's Second Submission regarding the EC's critique of the description of the Act contained in the US First Submission.

A. The Exclusion under the Act is not Essentially the Same Subsidy as the FSC

37. The first such error is one that the United States has pointed out previously. The EC continues to claim that the Act provides "essentially the same subsidy" as the FSC. As support for its position, the EC cites to the size of the exclusion and the presence of transition rules.

38. The United States would first note that the *FSC* decisions did not address the size of the "subsidies" granted by the FSC and in no way did these decisions suggest that the formulae contained in the FSC legislation were relevant to whether revenue was otherwise due or whether the FSC was export contingent. Thus, even assuming the EC is correct in its arithmetic, the formulae used in the Act do not render the exclusion an export subsidy.

39. The United States would also point out that the formulae in the FSC legislation served a different purpose than they do in the Act. The formulae in the FSC legislation allocated income between related parties in the same transactions. Taxes were then calculated upon such allocated income based on applicable rates. Under the Act, formulae are used to determine what portion of a taxpayer's extraterritorial income may be subject to tax. If related parties are involved in a transaction, US arm's-length pricing practices under section 482 of the Internal Revenue Code are used.[8]

40. With respect to the transition rules, the EC states that the presence of such rules in the Act proves that the Act "replaces the FSC." To the extent that the United States repealed the FSC and enacted different, WTO-consistent tax legislation in its place, the United States does not dispute the argument that the Act "replaces the FSC." Stated more simply, the United States replaced a measure found to be an export subsidy with a tax exclusion that is not an export subsidy. Indeed, if the United States had in fact enacted "essentially the same subsidy", no transition rules would have been necessary.

[8] *See, e.g., Senate Report*, page 4 (US-2).

B. The Act Fundamentally Changes the US Tax System

41. The EC also challenges the US position that the Act makes a "fundamental change" to US tax laws by amending the definition of the key term "gross income" to exclude extraterritorial income. In support of this allegation, the EC states that the United States continues to maintain a "fundamentally worldwide" approach to taxation and excludes, subject to certain conditions, only part of extraterritorial income.

42. First, the United States has not argued that it now has a territorial tax system. Instead, the US position is that it has incorporated elements of the territorial system of taxation. The fundamental change embodied by the Act was the incorporation of territorial limitations on US worldwide taxing authority where essentially none previously existed. As the United States explained in its First Submission, the US Congress made clear in two legislative reports that the imposition of territorial limitations constituted "fundamental" changes to US taxing authority.

43. Second, whether an exclusion is partial and whether it is subject to certain conditions is irrelevant to whether the exclusion itself represents a fundamental change in the US tax system. As we will discuss later, a limited or conditional exclusion does not render that exclusion a subsidy.

44. In addition, the EC cites to an article appearing in *Tax Notes International* to support its claim that the Act's exclusion "is a narrow exception from the traditional US tax model based on reaching the worldwide income of each tax payer, regardless of where such income is derived."[9] The EC's reliance on this selected quotation is misplaced.

45. First, the quotation provided by the EC is a quotation of an editorial comment by a journalist, not a quotation of the US Treasury representative, who never made the statement quoted by the EC. Second, the EC takes the quotation out of context. As the article notes, the Treasury representative in question was in the process of dispelling the suggestion "that the new law replacing the foreign sales corporation tax regime should be interpreted as suggesting that the United States will abandon its global tax structure and move to a *purely* territorial system."[10] Thus, the Treasury representative was stating that the United States does not intend, in effect, to repeal the foreign tax credit and adopt a purely territorial tax system. Thus, the Treasury official's statement does not endorse the view that the Act represents an exception to otherwise applicable US tax law.

46. Third, the EC's comment suggests that the EC would bar Members from adopting aspects of both a "worldwide" and a "territorial" tax system, notwithstanding that it previously has acknowledged that its own members states have mixed systems. Apparently, if a Member were to adopt aspects of both systems, the EC would characterize one as an "exception" to the other and, therefore, a potential subsidy. The Appellate Body, however, has rejected this approach, thereby permitting Members to adopt any tax system they choose, including a hybrid tax system.

C. The Act Excludes Extraterritorial Income Evenhandedly

47. The EC also contests the US statement that all foreign sales are treated alike and believes that the US confuses terms like "foreign transactions ", "foreign sales",

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[9] *EC Second 21.5 Submission*, para. 29.
[10] EC-10, page 2749 (emphasis added).

"foreign goods", "exports", and "foreign source income". To the contrary, it is the EC that seeks to inject an element of confusion.

48. The United States has made clear that the exclusion of extraterritorial income applies to income earned in a wide range of foreign transactions, regardless of where the goods involved are manufactured. The Act treats all US taxpayers earning such income alike. The Act applies equally to individuals, partnerships, and corporations that earn excluded extraterritorial income. The Act applies to these taxpayers irrespective of whether they are located in the United States or abroad, the only requirements being that these persons be subject to US taxation and earn extraterritorial income.[11]

49. With regard to the EC's statement that the United States attempts to blur the distinction between "extraterritorial income" and "excluded" income, the United States has explained that all income excluded under the Act is extraterritorial income, and that all extraterritorial income, except non-qualifying foreign trade income, is excluded from gross income. The United States has not attempted to blur any categories of income and believes that its position is clear.

D. The EC Misses the Point with Respect to the US Descriptions of European Tax Systems

50. Having misconstrued the US position regarding its own tax system, the EC proceeds to misportray the US description of European territorial tax systems. In particular, the EC challenges the US statement that European manufacturers may obtain the benefits of a territorial exemption only by exporting. The EC attempts to disprove this point by describing how a "foreign distribution subsidiary of a Dutch producer" can benefit from a territorial exemption by sending goods into the Netherlands.

51. The United States finds this point of argument utterly perplexing. First, the point the United States is making is that, if the EC is correct and a US manufacturer must export to rely on the Act, then so, too, must a company operating under an EC exemption system export to secure the benefits of the exemption. Thus, the correct frame of reference would be a Netherlands company operating in the Netherlands Antilles, and in such a case, exportation would be required to earn exempt income. The EC's use of a company in the Antilles sending products to the Netherlands is simply beside the point. If the goods in question initially were exported from the Netherlands to the Antilles, there would be two exportations. Either way, the EC's example merely serves to reinforce the point that the Act in its operation resembles the exemption system employed by many EC member states.

52. What the EC fails to acknowledge, however, is that under its own arguments a European manufacturer in a country with a territorial system can earn exempt foreign source income only through exporting. This is not something the United States has made up on its own. The panel in the *Tax Legislation Cases* established *as a factual matter* that Belgium, France, and the Netherlands tax exports more favorably than comparable domestic transactions, the EC's preferred choice for a benchmark in this dispute. This *factual finding* of the panel was never seriously disputed by any of the European countries involved in the General Council deliberations that eventually

[11] The Act § 3, amending IRC § 942(a)(2).

led to the 1981 Understanding. To the best of our knowledge, the panel's *factual finding* remains valid today.

53. The United States has explained why the EC's arguments are misguided, because the decision to export is one left to private actors and exporting is just one way of earning excluded income. Nonetheless, the EC has failed to explain why its systems are distinguishable from the Act insofar as the treatment of export transactions versus domestic transactions is concerned. The United States reiterates its view that the drafters of the SCM Agreement would not have intended to incriminate tax measures, such as the Act, which resemble the exemption system used by many EC member states.

V. BURDEN OF PROOF

54. Moving to the EC's legal arguments, the EC began its analysis in its Second Submission by attempting to lighten its burden of proof and even to shift its burden to the United States. It is by now clearly established in the WTO that, as the complaining party, the EC is obligated to present adequate arguments and supporting evidence to establish a *prima facie* case for each element of each violation that has purportedly taken place. Absent such a showing, the United States, as the responding party in this proceeding, need not rebut the allegations. The Appellate Body has explained that "[o]nly after such a *prima facie* determination has been made by the Panel may the onus be shifted to the [responding party] to bring forward evidence and arguments to disprove the complaining party's claim."[12]

55. This requirement has been adopted in recent Article 21.5 proceedings[13], and the EC appears to concede the point at paragraph 51 of its Second Submission. However, the EC claims that the United States is attempting to raise its evidentiary burden and, in doing so, the United States somehow concedes that the EC already has established a *prima face* case. The EC bases this position on a statement made by the United States that in "cases involving a generally applicable measure, there must be a heightened evidentiary burden for the complaining party."

56. The EC's analysis is faulty for several reasons. First, the EC fails to acknowledge that the United States made this statement only in the context of GATT Article III:4, and not as a general proposition. The EC itself recognized that the quantum of evidence required for each alleged claim can vary. It cited to the Appellate Body in *US Wool Shirts* for the proposition that, "precisely how much and precisely what kind of evidence will be required to establish ... a presumption will necessarily vary from measure to measure, provision to provision, and case to case."[14] Therefore, the quantum of evidence required to make a *prima facie* case under Articles 1 or 3 of the SCM Agreement may differ from the quantum of evidence required under Arti-

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[12] *European Communities - Measures Affecting Meat and Meat Products (Hormones)* ("*EC Hormones*"), WT/DS26/AB/R, WT/DS48/AB/R, Report of the Appellate Body adopted 13 February 1998, DSR 1998:I, 135, para. 109. *See United States - Measure Affecting Imports of Woven Wool Shirts and Blouses* ("*U.S. Wool Shirts*"), WT/DS33/AB/R, Report of the Appellate Body adopted 23 May 1997, page 14, DSR 1997:I, 323, at 335.

[13] *See, e.g., Canada – Measures Affecting the Export of Civilian Aircraft - Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/RW, Report of the Panel, as modified by the Appellate Body, adopted 4 August 2000, DSR 2000:IX, 4315, para. 5.14.

[14] *EC Second 21.5 Submission*, para. 52, *quoting United States - Wool Shirts*, page 14.

cle III:4 of the GATT 1994. As a result, the EC's burden of proof argument is inapposite and should be rejected by the Panel.

57. Second, the EC argues that, pursuant to *Argentina Textiles and Apparel*, it need only show that the Act's "structure and design" violate a WTO provision in order to satisfy its burden of proof.[15] However, the EC misquotes the Appellate Body's decision in that case. Specifically, the Appellate Body stated that, "we agree with the Panel that there are sufficient reasons to conclude that the structure and design of the DIEM will result, *with respect to a certain range of import prices within a relevant tariff category*, in an infringement of Argentina's obligations under Article II ... ."[16] The Appellate Body made that statement based upon a substantial amount of evidence supplied by the United States showing how Argentina broke its tariff bindings because products previously imported had been, and future imports necessarily would be, assessed duties greater than the maximum amounts allowed. Therefore, while the structure and design of the Argentine measures were factors in that case, the US claims were supported by specific and relevant evidence that the Panel found credible.

58. Third, the EC implicitly asserts that, whether or not it has made its *prima facie* case, the Panel may draw adverse inferences against the United States to the extent it has failed to furnish information requested by the Panel. It did so in paragraph 56 of its Second Submission, where it discusses such a negative inference drawn in the *Canada Aircraft* case. However, to date, this Panel has not requested any information from the United States. Therefore, it is wholly improper for the EC to suggest that the Panel draw adverse inferences against the United States.

59. Finally, the EC erroneously claims that the United States has "accepted ... the burden to establish its defence under footnote 59."[17] That statement is patently incorrect. There are instances where a responding party may have to bear the burden of establishing an affirmative defense – for example, under GATT Article XX. However, the relationship between violations under other provisions of the GATT and Article XX of the GATT is fundamentally different from the relationship between footnote 59 and Article 3.1(a) of the SCM Agreement. Footnote 59 "simply excludes from its scope of application the kinds of situations covered by [Article 3.1(a)] of that Agreement."[18] Even if footnote 59 were characterized as an "exception", such characterization would not shift the burden of proof or dictate a narrower or stricter approach to treaty interpretation.[19] In addition, footnote 59 merely "recognizes the autonomous right of a Member"[20] to take measures to avoid double taxation of foreign-source income. Therefore, unlike GATT Article XX, which is implicated only after a violation under another GATT article is established, footnote 59 narrows the scope of SCM Article 3.1(a), as opposed to providing a justification for a violation. Thus, the EC continues to bear the burden of proof on all aspects of its export subsidy claims.

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15 *EC Second 21.5 Submission*, para. 54.

16 *Argentina - Certain Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items* ("*Argentina Textiles*"), WT/DS56/AB/R, Report of the Appellate Body adopted 22 April 1998, DSR 1998:III, 103, para. 62 (emphasis added).

17 *EC Second 21.5 Submission*, para. 45.

18 *EC Hormones*, para. 104.

19 *Ibid.*

20 *Ibid.*

60. The United States respectfully suggests that the Panel should follow Appellate Body guidance with respect to the burden of proof and require the EC to make a *prima facie* case for each element of each alleged violation under review.

VI. THE UNITED STATES DOES NOT PROVIDE A SUBSIDY THROUGH THE ACT

61. We now will address the main legal arguments, beginning with the question of whether the Act's exclusion constitutes a subsidy under Article 1 of the SCM Agreement.

62. In its First Submission, the United States explained that the definition of gross income represents the outer boundary of US taxing jurisdiction. The exclusion of extraterritorial income from gross income therefore constitutes the "normative benchmark" or "prevailing legal standard" relevant to determining whether the exclusion constitutes a subsidy under Article 1. Because this benchmark establishes that taxes on extraterritorial income are not "otherwise due", the exclusion of such income does not constitute foregone revenue and is, therefore, not a subsidy.

63. The EC's arguments to the contrary are not grounded in the text of Article 1. To the United States, these arguments are attempts to demonstrate that, while the United States has met the letter of the SCM Agreement and the *FSC* decisions, they somehow do not meet the "spirit" of the Agreement and those decisions, as interpreted exclusively by the EC.

A. The Act does not "circumvent" the "but for" Test

64. The first way the EC tries to do so is by arguing that through the Act the United States has attempted to circumvent the Panel's "but for" test. The United States has explained that the Act was intended to comply with both the Panel and Appellate Body decisions in the *FSC* case. Contrary to the EC's suggestions, the Appellate Body did not preclude the application of a "but for" test to any new legislation. As a result, the United States sought to ensure that the Act would satisfy the "but for" test.

65. The Act passes the "but for" test because the Act's exclusion is the US "normative benchmark" with regard to tax treatment of extraterritorial income. The EC has not been able to show that but for the exclusion the United States would tax extraterritorial income, other than to make the general assertion that if the United States had not acted to limit its taxing jurisdiction, that jurisdiction might be broader than it actually is.

66. It is unclear to the United States why a good faith attempt to adhere to the language of the Panel's decision is inappropriate. The Appellate Body may have expressed reservations about the language, but it did not reject it in all cases. Indeed, if the United States had not sought to comply with the "but for" standard, the EC likely would be complaining that such a failure to comply constituted a WTO violation.

67. The real question the EC sidesteps is why the "but for" test is not at least a relevant consideration with regard to the Act. In a type of "heads I win, tails you lose" argument, the EC has given the impression that any US legislative enactment that satisfies the "but for" test in this case would constitute "circumvention." The

United States respectfully submits that the fact that the Act satisfies the "but for" test is relevant evidence indicating that the Act does not confer a subsidy under Article 1.

B. Gross Income Represents the Outer Boundary of US Taxing Jurisdiction

68. Having attempted to cast aside the Panel's "but for" test, the EC then misapplies the Appellate Body's statement that it is appropriate to compare the tax treatment under the contested measure with the tax treatment that would be due in "some other situation." While the EC correctly notes that the tax treatment in "some other situation " must be the tax treatment under a relevant normative benchmark, the EC contests the US position that the definition of gross income, which includes the exclusion of extraterritorial income, represents the relevant benchmark in this case.

69. The EC contends that the classification of income as gross income cannot be the appropriate benchmark because it "would allow Members to provide any subsidy they like ... by excluding the income concerned from the definition of 'gross income.'"[21] The United States believes that the Act is distinguishable from a measure that, for example, rebates the taxes of a particular company or industry. At the same time, however, the EC's "slippery slope" conjectures must be reconciled with the text of Article 1 and the Appellate Body's recognition that Members have the sovereign authority "not to tax any particular categories of revenue" without necessarily providing a subsidy.

70. As the United States explained in its First Submission, the semantic distinction between an exclusion and an exemption is not determinative of whether the Act confers subsidies under the SCM Agreement. Rather, the test under Article 1 is whether taxes on excluded income would be otherwise legally owed to the government. Under that standard, the EC must identify some "prevailing domestic standard" that would tax extraterritorial income. The only provision of US tax law the EC cites is the exception to the general rule that extraterritorial income is excluded from US taxation. Given that the Act specifically redefines the prevailing domestic standard, the EC points to no other specific measure to which the Act constitutes an exception. Rather, the EC appears to argue that the prevailing domestic standard for the United States is worldwide income taxation, regardless of what laws the United States may enact. Viewed from this perspective, the EC member states are fortunate, indeed, to have benefitted from the historical accident of having commenced income taxation using the exemption method.

71. What the EC ignores is that the Appellate Body chose "the tax rules applied by the Member in question" as the basis for determining the existence of a subsidy. The EC is in effect asking the Panel not only to make the tax-raising exception the general rule, it also is asking the Panel to apply the US concept of "gross income" without an integral part of its definition.

C. The EC Identifies an Erroneous Benchmark

72. Alternatively, the EC appears to be arguing that the appropriate benchmark in this case is that "corporate income from a commercial activity ... may be taxed if it is earned by a US corporation or is 'effectively connected' with a US trade or busi-

[21] *EC Second 21.5 Submission*, para. 67.

ness."[22] The "benchmark " the EC is asking the Panel to rely on is a combination of two distinct concepts – the taxation of US corporations and the taxation of income effectively connected with a US trade or business, neither of which applies here.

73. The reference to income earned by US corporations from commercial activity reflects the EC's reliance on the US worldwide tax system as it existed prior to the Act. Prior to the Act, the worldwide income of US corporations was generally subject to US tax regardless of whether the source of income was foreign or domestic. The Act, however, imposes limitations on the US worldwide tax system. Under the Act, extraterritorial income earned by US corporations is not subject to US tax because it is generally outside the taxing jurisdiction of the United States. Thus, the benchmark identified by the EC – general worldwide taxation of income earned by US corporations – no longer exists.

74. Thus, to the extent that the EC argues that the appropriate benchmark in this case is the taxation of income earned by US corporations on a worldwide basis, or is income effectively connected to a US trade or business, the EC is incorrect.

D. The EC Incorrectly Attempts to Incorporate Specificity into Article 1

75. In its Second Submission, the EC continues to argue that the Act provides a subsidy because the scope of the exclusion is too narrow. This argument is grounded in a fundamental misconception of Article 1, perhaps best reflected in the EC's statement that "the very essence of a subsidy is that a government gives to some but not to others."[23] Simply as a technical matter, this assertion is incorrect, because a government could provide a grant to every legal person in its jurisdiction and each such grant would still be a subsidy under Article 1, albeit a non-specific subsidy. More generally, the EC is saying that the Act is a subsidy because it allegedly does not apply neatly and cleanly to a category of income; *i.e.*, without conditions.

76. The EC's position with respect to the scope of the Act's exclusion, however, is inconsistent with the language of the SCM Agreement. The definition of a subsidy under Article 1 does not concern the breadth or narrowness of a government measure. Specificity becomes relevant under Article 2 of the SCM Agreement only after a subsidy has been found to exist under Article 1.

E. The EC'S Claim that Extraterritorial Income must be Defined Generally, Objectively, and Neutrally is not Supported by the Text of Article 1

77. The EC attempts to back up its specificity argument by claiming that extraterritorial income is an arbitrarily defined category of income. The EC asserts that only categories of excluded income that are defined "generally, objectively, and neutrally" can avoid being deemed a subsidy. Not only is there no basis for such a position in the SCM Agreement, but this position runs directly counter to the Appellate Body's statement that "[a] Member, in principle, has the sovereign authority not to tax any particular categories of revenues it wishes." The Appellate Body made clear that the "particular categories" that are not taxed is not a question of international law but a

[22] *EC Second 21.5 Submission*, para. 68.
[23] *EC Second 21.5 Submission*, para. 80.

determination for WTO Members, stating that this is not an issue that can be resolved "in the abstract, because governments in theory could tax all revenues". A measure that does not tax a category of income – however defined – is only a subsidy if such income would be taxed by a "prevailing domestic standard" under the tax laws of that Member. Whether or not that category would be "generally, objectively, and neutrally" defined in the eyes of the EC or another Member is irrelevant.

78. Nonetheless, even if the EC were correct in arguing that only categories of income defined "generally, objectively, and neutrally" may be taxed differently, the EC has not established that the Act does not do so in defining extraterritorial income. The United States has explained that extraterritorial income is earned on all foreign transactions involving goods used or consumed outside the United Stated, no matter where manufactured. The EC has not shown why this category is not "general", "objective", or "neutral."

F. The Congressional Budget and Treasury Reports Cited by the EC do not Indicate that a Subsidy has been Provided

79. The United States reiterates its objection to the misuse by the EC of the Congressional Budget Office study to support the allegation that the Act foregoes revenue that is otherwise due. The "cost" cited by the EC is actually a comparison of the revenue consequences under the Act versus the FSC and the former US worldwide tax system. Because the United States has established a new normative benchmark for the taxation of extraterritorial income, the cost cited by the EC does not reflect "revenue foregone." Mere repetition of this flawed argument by the EC does not render it valid.

VII. THE EXCLUSION OF EXTRATERRITORIAL INCOME IS NOT EXPORT CONTINGENT

80. Turning to the issue of export contingency, in the same way that the EC misconstrues the definition of subsidy under Article 1, it errs in its interpretation of Article 3.1(a). Significantly, the EC's arguments are bereft of references to the language of Article 3.1(a) or the Appellate Body's consistent interpretation of the term "contingent". Even after the US First Submission pointed out these shortcomings, the EC has continued to ignore the ordinary meaning of Article 3.1(a). The EC's failure to take account of the legal standards applicable to Article 3.1(a) should be fatal to its claims thereunder.

A. Article 3.1(a) does not Require a Comparison between the Tax Treatment of Export and Domestic Sales Income for Purposes of Determining Export Contingency

81. A central argument made by the EC is that the test for determining whether a tax subsidy is export contingent is whether that subsidy provides more favorable treatment to export income than income earned in comparable domestic transactions.

82. However, Article 3.1(a) does not contemplate that such a comparison be made, and the EC is unable to point to anything in the language of Article 3.1(a) that indicates that such a comparison is proper. In fact, the EC even tries to steer the

analysis away from the text of Article 3.1(a), saying that the ordinary meaning of the term "export" is "not of much help."[24] Likewise, the EC has not cited any WTO panel or Appellate Body reports that interpret Article 3.1(a) in the manner proposed by the EC.

83. The language of Article 3.1(a) focuses its attention on whether a WTO Member makes the availability of a subsidy *contingent* on export performance. For this reason, the Appellate Body has explained that export contingency is demonstrated where the provision of a subsidy is "conditioned" or "dependent for its existence" on exporting. In addition, the Appellate Body has stated that a subsidy is export contingent where "the subsidy is available only upon fulfilment of the condition of export performance."

84. The EC points to several paragraphs of the Illustrative List of Export Subsidies that do indicate that a comparison between export and domestic income may be relevant in determining the existence of an export subsidy. However, the part of the Illustrative List relevant to this dispute, paragraph (e), contains no such comparison. There is simply no basis to assume, as the EC does, that a comparison test can be generally applied to Article 3.1(a) because *some* items in an *Illustrative* List do so.

85. In any event, as the United States pointed out in its First Submission, a number of the items in the Illustrative List relied on by the EC seem to propose a comparison more for determining whether an indisputably export-specific class of beneficiaries receives a subsidy at all than for determining whether a subsidy is export contingent. Clearly, the exemption or remission of indirect taxes on exported products referred to in paragraph (g) of the List would be export-specific, but the requirement that any such exemption or remission must be "in excess of those" provided for domestic products clearly is aimed at determining whether a subsidy exists at all.

B. Exporting is not "one of several other conditions"

86. In another instance in which the EC fails to address the ordinary meaning of the language of Article 3.1(a), the EC informed the Panel that it "takes no position on the meaning of the word 'other'" in the phrase "one of several other conditions."[25] The United States submits that this is not an adequate response to the US argument regarding the meaning of Article 3.1(a)'s requirement that a subsidy must be contingent, either "solely or as one of several other conditions, upon export performance", in order for it to be a prohibited export subsidy. In its First Submission, the United States explained that the term "one of several other conditions" means that export performance may be an *additional* condition to others that also apply, but export performance must be satisfied to receive the subsidy. Article 3.1(a)'s export contingency requirement cannot be satisfied merely by showing that exporting is one of several ways of obtaining a subsidy.

87. The EC's failure to respond to this point is a major defect in its case.

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[24] *EC First 21.5 Submission*, para. 86.
[25] *EC Second 21.5 Submission*, para. 112.

C. US Manufacturers Need not Export

88. Rather than attempting to address the text of Article 3.1(a), the EC simply claims that US manufacturers must export their goods in order to earn excluded extraterritorial income, and that this is enough to demonstrate that the exclusion is export contingent. However, the EC fails to recognize that US manufacturers can, and often do, manufacture abroad through offshore branches to service foreign markets, thereby earning extraterritorial income without exporting. US manufacturers have the option of producing and selling outside the United States. To the extent that the Act provides any incentives that might affect where a manufacturing company chooses to produce its goods, the Act offers just as much incentive to manufacture goods outside the United States as to do so within it. This is another manifestation of the Act's export neutrality and its evenhanded treatment of taxpayers.

89. The EC attempts to deflect this argument by saying that, even if US manufacturers have a choice in where to manufacture and thus need not export to rely on the Act, this is not the case where parties have goods in the United States to sell. This argument, though, suffers from the same defect. Parties that sell goods in the United States can choose to source their goods from outside the United States and can choose to engage in wholly non-US transactions. Moreover, as the Appellate Body explained in the *United States - Lead Bar* case, subsidies are provided to natural or legal persons and not to productive operations or, we assume, the goods resulting from such operations.[26]

90. Thus, the relevant issue here is whether there is a condition imposed under the Act on US persons or businesses to export in order to earn excluded extraterritorial income. We submit that there is not. The Act does not require any taxpayer to export in order to invoke its exclusion for extraterritorial income.

91. It is important to note that the EC's interpretation would mean that territorial exemptions in most European countries provide export-contingent subsidies – a point the EC has steadfastly refused to respond to. This is because, under the EC's analysis, manufacturers in European countries that use the exemption method can benefit from such an exemption only by exporting. Income from sales by these manufacturers on the domestic market is not eligible for a comparable exemption. Under the EC's framework for analyzing export contingency, it is irrelevant that EC territorial exemptions cover income earned in wholly foreign transactions and imports because, according to the EC, export transactions are taxed more favorably than comparable domestic transactions.

D. The EC Cannot Substantiate a Claim of de Facto Export Contingency

92. In what the EC now terms as "subsidiary arguments"[27], the EC claimed in its First Submission that the Act was *de facto* export contingent because foreign corporations would rarely elect to become US taxpayers, thus leaving only exporters to benefit from the exclusion of extraterritorial income. The United States responded

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[26] *See United States - Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom*, WT/DS138/AB/R, Report of the Appellate Body adopted 7 June 2000, DSR 2000:V, 2595, para.58.

[27] *EC Second 21.5 Submission*, para. 114.

that such an election is not necessary where the foreign manufacture and sale of goods is performed by an offshore branch of a US corporation.

93. Presumably in recognition of the large hole in its argument, the EC now contends that the situations in which a US corporation will choose to establish a branch "are in relative terms bound to be far less common than those where the US corporation decides to establish a subsidiary in the foreign jurisdiction."[28] Thus, the EC's "*de facto*" argument has expanded such that the EC now claims that only exporters can and will benefit from the exclusion because, for different reasons, neither branches nor foreign subsidiaries will actually use the exclusion. However, the EC's arguments with respect to both branches and subsidiaries are erroneous and unsubstantiated.

1. Branches

94. The EC does not contend that US corporations cannot establish branches that manufacture and sell abroad and earn extraterritorial income, and the EC does not contend that the Act limits opportunities for US corporations to establish offshore branches. Instead, the EC simply makes the unsubstantiated assertion that "there are a number of both tax and commercial reasons for the general preference for the legal form of a subsidiary."[29]

95. In paragraphs 117 through 125, the EC produces a list of factors supposedly indicating that US companies would rarely, if ever, choose to operate through branches, as opposed to subsidiaries. The EC admits that "[u]ndoubtedly, the choice of the legal form for the foreign manufacturing operations depends on the particular circumstances present in each individual case,"[30] but then proceeds to ignore its own admonition and offers sweeping generalizations about individual business decisions.

96. The EC offers no support for its lopsided list of factors, and studiously avoids mentioning the many countervailing considerations. Contrary to the EC's assertions, there are a number of factors supporting the use of a branch. They include:

- Operation through a foreign branch offers much greater flexibility than operation through a subsidiary. A branch can be formed and dissolved often without any formalities. By contrast, there are significant transaction costs associated with forming a corporation, such as minimum capitalization requirements and incorporation and registration fees. The process of meeting these requirements often results in legal expenses.
- There are additional transaction costs associated with maintaining a corporation, such as paying a separate set of directors and executives, holding regular board meetings, and maintaining a separate set of books and records. None of these requirements apply to the conduct of business through a branch.
- Apart from the transaction costs of establishing and maintaining a separate corporation, corporations often are subject to more burdensome reporting requirements than branches. For example, they must prepare their own tax returns and financial accounting statements.

[28] *EC Second 21.5 Submission*, para. 118.
[29] *EC Second 21.5 Submission*, para. 118.
[30] *Ibid.*

97. From a tax perspective, the use of a corporation results in two levels of taxation, one at the corporate level and one at the shareholder level. Adding further layers of corporations may compound this problem unless the tax law provides for relief mechanisms, such as group consolidation. Group consolidation generally is not available for foreign corporations under US law. Moreover, with respect to the foreign tax credit, a US corporation would be entitled to a direct, current foreign tax credit with respect to branch income that is not excluded under the Act. By contrast, a US corporation would only be entitled to an indirect foreign tax credit upon receiving a dividend from its foreign subsidiary.

98. In addition to being incomplete, the EC's list of factors is misleading. For example, the EC notes that foreign subsidiaries of US corporations generally may defer payment of US taxes on their active income. However, deferral of US tax is meaningless if the foreign jurisdiction imposes tax currently on the foreign subsidiary's profits. Deferral also is meaningless if the US parent company currently needs the cash generated by its foreign subsidiaries. Finally, deferral is entirely unavailable for income that is subpart F income. Thus, the supposed vaunted benefits of deferral are not as significant as the EC suggests.

99. The EC also cites the limited liability offered by corporations. In the real world of business, however, the only real liability protection is afforded by the sovereign protection of maintaining the home office in another jurisdiction – not through local operation through a subsidiary. Moreover, jurisdictions frequently afford limited liability protection to non-corporate entities, such as limited liability corporations in the United States. Thus, a US business often can operate in a foreign jurisdiction in branch form for US tax purposes while retaining limited liability protection offered through local law.

100. The EC claims that transfer pricing presents a greater problem for branches than for corporations. This statement is untrue. Transfer pricing is just as significant an issue between incorporated entities as between a corporation and its branch. With respect to incentives, branch form also carries certain tax advantages. For example, French branches of US corporations generally may deduct their allocable share of the expenses of the home office against their French income, while French subsidiaries of US corporations cannot take this deduction.

101. In sum, the EC's list of reasons why US businesses would prefer operating through subsidiaries rather than branches is oversimplified and, in some respects, just plain wrong.

2. *Foreign Subsidiaries*

102. The EC now agrees with the United States that foreign corporations can and will elect to become US taxpayers. While the EC maintains that such situations will be "rare"[31], the United States is pleased that the EC now recognizes that foreign corporations are a legitimate class of taxpayers that may exclude extraterritorial income. Of course, whether in fact it is rare or common remains to be seen, and the EC provides absolutely no evidence either way to support its arguments.

103. By contrast, the United States has provided evidence indicating that foreign corporations will elect to become US taxpayers and exclude extraterritorial income.

[31] *EC Second 21.5 Submission*, para. 131.

The statement by a foreign corporation appended to the US Second Submission as US-9 describes one situation in which a foreign corporation would make the domestication election and exclude extraterritorial income. The significance of this statement is enhanced by the fact that it comes from one of the largest companies in the world, and it was made prior to the issuance of administrative guidance by the US Government with respect to the process by which companies will ultimately be permitted to make such an election.

104. The EC's argument that it cannot be expected to provide the Panel with evidence in support of its *de facto* theory is unavailing. If it does not have or cannot obtain sufficient evidence to back up what otherwise appears to be mere supposition and prediction, then it ought not to have asserted these claims. As the Appellate Body stated in *Canada Aircraft*, the very essence of a *de facto* export contingency claim is that it must be proven with evidence other than the challenged measure itself. It is not sufficient for the EC to make unsupported assertions and then ask the United States to disprove them. Absent the requisite quantum of proof, the Panel should reject the EC's *de facto* arguments.

E. Paragraph (e) of the Illustrative List does not Expand Article 3.1(a)

105. In its First Submission, the EC stated that paragraph (e) of the Illustrative List expands the definition of "contingent ... upon export performance " under Article 3.1(a). In response, the United States demonstrated that paragraph (e) cannot broaden the meaning of export contingency because that concept serves to define the scope and applicability of Article 3.1(a). Items included in the Illustrative List are simply examples of prohibited export subsidies. They clarify the meaning of Article 3.1(a), but do not identify prohibited subsidies that are not export contingent within the meaning of Article 3.1(a).

106. In its Second Submission, the EC appeared to back away from its initial position. The EC seemed to recognize that paragraph (e) does nothing more than identify a particular type of export subsidy that is relevant to direct taxes. The EC acknowledged that the Illustrative List is connected to Article 3.1(a) through the phrase "including those [export subsidies] illustrated in Annex I " and the plain meaning of the word "including" is to be contained within, to take into account in an inclusive way, or to incorporate. All of these definitions suggest just what the United States has maintained all along – that the Illustrative List provides examples of subsidies that satisfy the standard of Article 3.1(a)..

107. Despite recognizing this, the EC continues to hold to the notion that paragraph (e) provides "a separate source of prohibition of export subsidy".[32] To the extent that the EC is suggesting that a measure can come within paragraph (e), but not Article 3.1(a), and constitute a prohibited export subsidy, the United States disagrees. If that were the case, then the Illustrative List would do far more than *illustrate* subsidies contingent upon export performance.

108. Furthermore, the United States cannot understand how a measure, like the Act, that makes no reference to exportation, does not require exportation, and applies to a broad range of non-export transactions can be said to be "specifically related to

[32] *EC Second 21.5 Submission*, para. 149.

exports". Yet again, the EC makes arguments that are completely untethered from the text of the provision at issue.

VIII. THE EC HAS FAILED TO DEMONSTRATE THAT THE ACT IS NOT A MEASURE TO AVOID DOUBLE TAXATION

109. Thus far, the United States has highlighted a number of areas in which the EC has made arguments that are not grounded in the text of relevant WTO provisions and that are not in conformity with the correct method of interpretation under public international law. Nowhere is the EC's creative approach to interpretation more in evidence than in the context of its arguments regarding whether the Act is a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59. The EC asks the Panel to ignore the language of footnote 59 and instead attempts to incorporate into the WTO tax principles that have not been considered and adopted by the WTO's Members. The Panel should reject the EC's attempt to redraft footnote 59.

A. The EC'S Flawed Approach to Interpreting Footnote 59

110. The EC's approach to divining the meaning of the fifth sentence of footnote 59 is so extraordinary, it merits repeating here. The EC stated in its Second Submission that "the terms 'double taxation' and 'foreign-source income' are terms of art with special meanings."[33] From this, the EC concluded that "an analysis of the particular meanings these terms have acquired in the field of taxation is a more useful starting point than the dictionary definitions of the individual words of which they are composed."[34]

111. The EC is wrong in all respects. First, while it may be true that the terms "double taxation" and "foreign-source income" are terms used widely in the tax area, it is not clear that they have obtained universally agreed upon "special meanings". More importantly, there are no "special meanings" for these terms that have been accepted by the WTO. Had the Members of the WTO agreed upon such "special meanings", these definitions would have been reflected in some way in the text of the SCM Agreement or other WTO agreements. Of course, no such definitions have been included for these terms.

112. The EC's statement that the "particular meanings these terms have acquired in the field of taxation is [sic] a more useful starting point than the dictionary definitions of the individual words"[35] is not only a radical departure from the principles of interpretation established by the Appellate Body, but it also is misleading. The EC does not revert to the ordinary meaning of the language of the fifth sentence of footnote 59 at any point in its analysis, let alone as a starting point.

113. By starting – and finishing – with non-textual "special" definitions, the EC has failed to adhere to multiple pronouncements by the Appellate Body regarding treaty interpretation. The Appellate Body has explained that "the words of a treaty ... are to be given their ordinary meaning, in their context and in the light of the

[33] *EC Second Art. 21.5 Submission*, para. 183.
[34] *Ibid.*
[35] *EC Second 21.5 Submission*, para. 183.

treaty' s object and purpose."[36] The Appellate Body has further explained that "the words of a treaty form the foundation for the interpretive process: 'interpretation must be based above all else upon the text of the treaty.'"[37]

114. Moreover, under Article 31(4) of the *Vienna Convention on the Law of Treaties*, in order for a "special meaning" to prevail over the ordinary meaning of a term, it has to be "established that the parties so intended." Thus, the EC, as the proponent of a "special meaning", has the burden of demonstrating that the drafters of footnote 59 intended the "special meaning" it suggests. The EC has not even attempted to make such a demonstration.

115. An interpretation that begins with an extrinsic and unsupported "special meaning" – and that never attempts to analyze the ordinary meaning of the text – simply cannot be correct.

B. The EC Errs in Trying to Rely on OECD Rules to Give Meaning to WTO Provisions

116. The EC appears to claim that the "special meanings" it ascribes to "double taxation" and "foreign-source income" emanate from the OECD Model Convention. The EC, though, attributes significance to the Convention it cannot have in relation to the WTO. Moreover, the EC misconstrues the Convention itself.

1. The OECD Convention's Relevance

117. The United States referred to the OECD Convention to illustrate different approaches to double taxation and, more specifically, to bring to the Panel's attention the fact that the exemption (or non-taxation) method is a commonly used and widely accepted method for avoiding double taxation.[38] In doing so, the United States took care to point out that it did not consider these conventions (or any other agreements, for that matter) to be substitutes for the text of relevant WTO provisions. The United States relied on the Convention solely as an example.[39] The United States just as easily could have relied on the U.N. Model Convention, or the United States could have undertaken a review of various measures to avoid double taxation in use around the world, to achieve the same ends.

118. In contrast, the EC is invoking the OECD Convention to literally supply definitions of terms used in the SCM Agreement. In effect, the EC is asking the Panel to accept every detail of the OECD Convention as if it were incorporated into the SCM Agreement. There is no basis for doing so. Nowhere does the SCM Agreement provide that the definition of a measure to avoid double taxation of foreign-source income for purposes of footnote 59 may be supplied by the rules of another organization. Whatever the merits of the OECD Convention, its provisions cannot be en-

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[36] *United States – Standards for Reformulated and Conventional Gasoline*, ("*Reformulated Gasoline*"), WT/DS2/AB/R, Report of the Appellate Body adopted 29 April 1996, page 16, DSR 1996:I, 3, at 15. WTO panels and the Appellate Body are instructed to rely on "customary rules of interpretation under public international law". DSU Article 3.2.

[37] *Japan - Taxes on Alcoholic Beverages*, ("*Japan Alcoholic Beverages*"), WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, Report of the Appellate Body adopted 1 November 1996, page 29, DSR 1996:I, 97, at 121.

[38] *US First 21.5 Submission*, paras. 178-86.

[39] *Ibid.*, note 153.

grafted *in toto* upon the SCM Agreement where there is no indication that this was the intention of the Agreement's drafters. The fact that the second paragraph of item (k) to Annex I incorporates by reference the *OECD Arrangement on Guidelines for Officially Supported Export Credits* indicates that the drafters of the SCM Agreement knew how to incorporate OECD standards when they desired to do so.

119. Moreover, only *some* WTO Members have agreed to adhere to the Convention. The fact that "practically all *industrialized* countries" follow the Convention, as the EC asserts[40], is not a basis on which the rights and obligations of WTO Members may be altered. Undoubtedly, more than a few WTO Members would be surprised to learn that, in joining the WTO, they undertook to implement and abide by the OECD Convention. This would include the United States. As the EC noted in its Second Submission, the United States relies on certain concepts from the OECD in its own tax treaties, but not all.[41]

120. As a way to get the OECD Convention in "through the back door", the EC proposes recourse to supplemental means of interpretation. However, such recourse is appropriate only after the ordinary meaning of the text is established and only if such interpretation leaves the meaning of the provision in question "ambiguous or obscure" or leads to a result which is "manifestly absurd or unreasonable."[42] The United States respectfully submits that there is nothing in words such as "avoid", "double", "taxation", "foreign" or "source" that renders the fifth sentence of footnote 59 incompatible with the general rule of interpretation such that supplemental means are needed. Simply put, the ordinary meaning of these terms is readily ascertainable and should guide the Panel in its deliberations.

121. Even if such supplemental means were needed, the OECD Convention would not be the source to rely on. Supplemental means might include "the preparatory work of the treaty or the circumstances of its conclusion", or perhaps other relevant sources of the drafters' intentions.[43] However, there is no indication in the negotiating history that the drafters had the OECD Convention in mind, and the OECD is not one of the WTO's covered agreements and as such it does not form part of the context for interpreting footnote 59.[44]

122. Furthermore, the OECD Convention serves only as a model for bilateral treaties between nations seeking common rules for avoiding taxation of income earned by their nationals. The Convention is not a multilateral agreement that all signatories directly follow. It is merely a model that is followed in part in bilateral tax treaties that are based upon it. Significantly, the Convention is not necessarily intended to be a model for domestic legislation. Domestic measures to avoid double taxation often do not follow the OECD model. Bilateral tax treaties are often entered into, at least in part, to limit the reach of domestic tax practices.

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[40] *EC Second 21.5 Submission*, para. 187.
[41] *EC Second 21.5 Submission,* para. 186.
[42] *Vienna Convention*, Article 32.
[43] *Ibid.*
[44] *See European Communities - Measures Affecting Importation of Certain Poultry Products*, WT/DS69/AB/R, Report of the Appellate Body adopted 23 July 1998, DSR 1998:V, 2031, paras. 79-81 (Oilseeds Agreement was not a "covered agreement" and, as such, did not contain the relevant obligations of the European Community under the WTO Agreement).

2. *The EC Misstates the Definition of a Permanent Establishment Under the OECD Convention*

123. Even if the OECD Convention were a model for domestic tax laws, and even if it provided guidance for interpreting WTO provisions, it would not support the narrow reading of footnote 59 advanced by the EC.

124. The EC notes that the OECD Convention requires the existence of a "permanent establishment" in a country in order for that country to assert taxing jurisdiction over a business taxpayer's income. The EC maintains that a "permanent establishment" is in effect a fixed and continuously operating place of business.[45]

125. The EC, though, cites only part of the OECD's definition of a "permanent establishment". The EC cites Articles 5.1 and 5.2 of the Convention, which identify the most burdensome types of "permanent establishment". Articles 5.1 and 5.2 refer to a business "establishment" that is in some sense "permanent" – that is, "a fixed place of business". They also list the most "permanent" types of businesses that could create taxable income: an office, factory, workshop, or mine.

126. What the EC omitted from its discussion is the fact that the Convention includes an alternative, lower threshold for establishing a "permanent establishment". This alternative standard reflects a divergence of opinion among countries as to what may constitute a "permanent establishment". Article 5.5 of the Convention provides that a "permanent establishment" may exist where a person acts on behalf of a non-resident business and that person is authorized to "conclude contracts in the name of the enterprise". The Commentary to the Convention explains with respect to Article 5.5 that "[i]t is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State ... ."[46] The Commentary goes on to explain that the party acting on behalf of a non-resident business may be a person or a corporation and such authority need only be exercised more than in an isolated instance.[47] It is thus clear that what constitutes a "permanent establishment" under OECD rules may lack permanence and even a fixed place of business.

3. *The Act Properly Requires Sufficient Contacts with a Foreign Taxing Jurisdiction*

127. While the United States and a number of other countries rely on the concept of a "permanent establishment" in their bilateral tax treaties, they do not necessarily use that same standard in determining whether a business is to be subjected to their national income taxes. As the United States explained in its Second Submission, bilateral tax treaties serve as an *additional* layer of double tax avoidance in addition to domestic laws. A number of nations have broader jurisdiction under their domestic tax laws to reach income of non-residents than that prescribed by the concept of "permanent establishment" used in some tax treaties. Bilateral tax treaties requiring a "permanent establishment" provide double tax relief from these more aggressive standards. That nations rely on bilateral tax treaties to prevent their businesses from

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[45] *EC Art. 21.5 Second Submission*, paras. 193-97.

[46] Article 5.5 and Commentary to the OECD Model Convention, at C(5)-13. A copy of the Commentary is submitted as Exhibit US-18.

[47] *Ibid.*

being subjected to a foreign tax in the absence of a "permanent establishment" does not in any way mean that lower thresholds cannot be relied upon in establishing domestic taxing jurisdiction and, as a result, in domestic double tax avoidance measures.

128. There are differing views and practices among countries as to what brings a non-resident enterprise within a country's taxing authority. The United States, for example, does not, as a general matter, subscribe to the requirement that a non-resident enterprise must have a "permanent establishment" within the United States in order to be subjected to US taxation. Instead, the United States looks to see if a taxpayer has sufficient contacts with the United States with respect to a given transaction or series of transactions to find that a taxpayer has engaged in "a trade or business in the United States." Income "effectively connected" with that trade or business is subject to US taxation. In short, the United States does not require the existence of a fixed or enduring business operation. As the United States explained in its Second Submission, other countries, such as Canada, also do not require a "permanent establishment" to tax non-resident enterprises.[48]

129. The Act takes account of the fact that, like the United States, countries around the world may attempt to impose taxes upon foreign businesses even though they do not maintain a "permanent establishment" within the taxing country. It recognizes that countries rely on different standards that can turn on subtle factual distinctions in determining whether income is subject to their tax regimes. The Act therefore requires that transactions giving rise to extraterritorial income must have a variety of foreign attributes that can result in a sufficient nexus to a foreign taxing regime so as to render US taxpayers potentially subject to foreign taxation.

130. The EC makes a bald assertion that the foreign economic processes and other foreign attributes built into the Act are inadequate to give rise to double taxation.[49] The EC, though, is simply incorrect when it states that the Act "excludes from tax income that *cannot* be taxed by any other country."[50] The transactions and activities from which extraterritorial income may be derived can indeed subject US taxpayers to taxation abroad. Indeed, some transactions under the Act may occur entirely outside the United States. To prove the contrary, the EC must do more than give its opinion.

131. Indeed, the EC relies on suppositions that are inaccurate. In paragraph 197 of its Second Submission, the EC asserts that "it is in principle possible that the above enumerated activities are carried out through a permanent establishment situated in a country other than the United States but ... it is much more likely that such operations are carried out from within the territorial limits of the US". However, as the United States has pointed out repeatedly, the Act requires that a minimum level of foreign economic processes must occur outside the United States for each and every transaction.[51]

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48 *US Art. 21.5. Second Submission*, para. 62.
49 *EC Art. 21.5 Second Submission*, paras. 196-98.
50 *Ibid.,* para. 191.
51 The Act § 3, amending IRC § 942(b)(3).

C. The OECD Convention does not Define "foreign source income"

132. Not only does the EC attempt to give the details of the OECD Convention greater weight than they are due, the EC also tries to extrapolate rules from the Convention that are not even there. In an about face from its prior position in this dispute that "foreign source income" and "foreign economic activities" are not the same thing, the EC now argues that, as a result of the OECD Convention, "foreign source income" under footnote 59 means income directly and exclusively attributable to foreign economic activities.[52] The EC concedes that the Convention contains no such definition, but maintains that it can be "deduced from the provisions of the Convention."[53]

133. The United States has explained to the Panel that it disagrees with such a narrow approach. The United States respectfully refers the Panel to paragraphs 190 to 192 of its First Submission and paragraphs 56 to 59 of its Second Submission where it explains why the term "foreign source income", as it is used in the fifth sentence of footnote 59, is not limited solely to income attributable to foreign economic activities. The United States has explained that the language of footnote 59 does not call for such a cramped interpretation of footnote 59 and instead suggests a more flexible approach that takes into account different types of income and the complexities of determining what may make income "foreign".

134. Ironically, the provisions of the OECD Convention the EC cites do not support the EC's narrow construction, but rather confirm the US position. Article 10, which addresses dividend income, calls for double tax avoidance on a form of passive income – that is, income for which there are no directly related foreign economic processes. Like interest income and other forms of passive income, dividend income may be exempted to avoid double taxation under Articles 10.5 (and 23.2) of the Convention even though the party earning such income performs no economic activities in relation to such income – whether foreign or domestic. What can make dividend and other types of passive income "foreign" is that it is received from a foreign company or bank. In other words, the source of payment is foreign. The OECD Convention does not specify where the business activities of a company paying dividends must occur.

135. The same is true with respect to the OECD's treatment of "business profits" pursuant to Article 7 of the Convention. It applies to essentially all profits of an enterprise, not merely to profits directly attributable to economic processes of the enterprise itself that take place outside the country of residence of that enterprise.

136. Accordingly, the OECD provisions the EC cites do not support the EC's proposition that only income attributable to foreign economic processes can be "foreign source income" under footnote 59.

D. The US Congress did Intend for the Act to Serve as a Measure to Avoid Double Taxation

137. In its zeal to see the Act struck down, the EC does not confine itself to rewriting provisions of the Act, WTO rules, and Articles of the OECD Convention. The EC goes so far as to substitute its opinion for that of the United States Congress as to the

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[52] *EC Second 21.5 Submission*, paras. 203-04.
[53] *Ibid.,* para. 201.

legislative intent underlying the Act. The EC not once, but twice, asserts that the US Congress did not intend for the Act to serve as a measure to avoid double taxation.[54]

138. The United States recognizes that ascertaining the specific intent of a legislative body is not always easy, but in this case there is strong and unmistakable evidence on the point in question. Each of the two congressional committees responsible for reviewing US tax policy and for drafting US tax laws stated unequivocally that the Act was intended and designed to serve as a measure to avoid double taxation. The report of the Ways and Means Committee of the US House of Representatives, which has been submitted to the Panel as US-3, states, on pages 10, 19, and 21, that "the exclusion of ... extraterritorial income is a means of avoiding double taxation." The report also includes a discussion on page 11 noting that the Act's exclusion is to some extent designed to move the United States away from its predominant reliance on tax credits as a means for avoiding double taxation and toward the European model of exemption. Likewise, the report of the Finance Committee of the US Senate, which has been submitted as US-2, states, on pages 2, 6, and 8, that the Act's exclusion serves to avoid double taxation.

139. Furthermore, the structure of the Act demonstrates how it serves as a measure to avoid double taxation. The Act, at section 114(d), disallows tax credits on excluded income in order to avoid what the EC refers to as "'double relief' from 'double taxation'".[55] In this way, the exclusion provides the only method of double tax avoidance that is available under US law for excluded extraterritorial income. If the Act did not disallow tax credits, then US taxpayers could rely on the exclusion and credits for the same income, which might result in too much relief. To the same end, the United States limits the amount of foreign tax credits that US taxpayers may apply with respect to non-excluded income under the Act through its sourcing rules in section 943. This prevents what the EC terms "over-compensation" of taxpayers.[56] While it is true that application of such rules may result in less than full relief for double taxation under the credit method, the United States has explained that credits typically result in only partial relief of double taxation.

E. It is Irrelevant that the United States Also Relies on Tax Credits

140. In yet another effort to create a rule that cannot be found in the WTO agreements, the EC claims that the United States may not rely on an exclusion as a method to avoid double taxation because it also uses tax credits. This is one more contention that is completely divorced from the relevant language of the SCM Agreement and from common international tax practice.

141. As the United States has previously explained, it is widely accepted that relief from double taxation generally may be provided through an exemption of foreign income, through a credit for foreign taxes paid, or through an income tax convention pursuant to which participating countries cede taxing rights over particular categories of income. As the EC has recognized, most if not all Members employ all three of these mechanisms, in varying degrees, to avoid double taxation.[57] This is reflected in the fact that the Commentary to Article 23 of the OECD Convention provides with

[54] *EC Second 21.5 Submission*, paras. 41 and 209.
[55] *Ibid.,* para. 218.
[56] *Ibid.,* para. 213.
[57] Annex EC-2, page 2 (US-5).

respect to alternative use of exemption and credits, "Contracting States may use a combination of the two methods."[58] The Commentary even goes further, stating that there are instances in which credits should be used even though exemption is the general rule of a given tax system.[59]

142. The OECD Commentary is relevant only in that it reflects the fact that many countries are like the United States and offer a mix of exemptions and exclusions as well as foreign tax credits. Even France, which is reputedly the most territorial of EC tax systems, offers its taxpayers a choice of a territorial exemption or foreign tax credits. If offering such a choice constituted an independent basis for violating Article 3.1(a), as the EC alleges, then many choices available under tax laws around the world would be improper.

143. However, this is not the case, because nothing in the SCM Agreement prohibits Members from using this type of alternative mechanism for the relief of double taxation. Footnote 59 leaves the choice of mechanism to WTO Members, stating that the ban against export-specific direct tax exemptions, remissions, or deferrals set forth in paragraph (e) of the Illustrative List of Export Subsidies "is *not intended to limit* Members from taking *measures* to avoid ... double taxation". (Emphasis added). This language is particularly flexible, imposing no *limit* on WTO Members in fashioning double tax relief *measures*.

144. In contrast to what the EC asserts, footnote 59 does not allow Members to institute a measure to avoid double taxation only where such a measure is "necessary".[60] Footnote 59 in no way conditions the right to avoid double taxation on the basis of necessity. It is not a provision, like GATT Article XX, that makes certain practices allowable only upon a showing that a measure is "necessary". Footnote 59 makes clear that this right is not limited and that the method of achieving this permissible end is left to each Member to decide.

F. The EC'S Arm's-Length Principle Argument is Misplaced

145. There is one additional point that the EC makes with respect to the double taxation issue that calls for a response. The EC argues that the Act is improper because, according to the EC, it does not rely on the arm's-length principle in calculating taxes on non-qualifying foreign trade income. The EC confuses two distinct concepts.

146. The arm's-length principle is relevant for WTO purposes only in attributing income between related parties in export transactions. This derives from the second sentence of footnote 59, which provides that "Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length." The arm's-length principle is not relevant to the manner in which the amount of taxes is calculated or the tax rate is set once the income of a given taxpayer is established.

147. However, that is what the EC is complaining about here. The EC feels that the tax calculations in section 3 of the Act, which amends IRC § 941(a)(1), are somehow

[58] US-7, page C(23)-10.
[59] *Ibid.*
[60] *EC Second 21.5 Submission*, section 4.6.4.

inconsistent with the arm's-length principle. But these calculations simply establish the amount of income that may be subject to taxation. These calculations have nothing to do with how income is allocated between related parties. To the extent any such allocations are relevant or necessary in connection with extraterritorial income, they are made in accordance with a strict arm's-length test under IRC § 482. As one legislative report accompanying the Act explains, even though neither the Panel nor the Appellate Body ruled on the propriety of the FSC administrative pricing formulas for allocating income between related parties, "because there is no separate entity required, there are no transfers required between related domestic and foreign companies. If there are transfers between related parties, general arm' s-length principles apply."[61]

G. The Act does not Provide for Double Non-Taxation

148. In paragraphs 214 through 218 of its Second Submission, the EC contends that the Act provides for a "cumulation" of the foreign tax credit and the exclusion with respect to the same income – income subject to foreign withholding taxes. This contention is false.

149. The EC misstates the definition of a withholding tax. A withholding tax is a direct, source-based tax imposed upon certain types of passive income; for example, interest, dividends and royalties. Section 943(d) of the IRC is consistent with this definition because: (a) withholding taxes are direct taxes and sections 901 and 903 of the IRC provide a credit for direct taxes; and (b) withholding taxes are source-based taxes, and, thus, are imposed on "a basis other than residence." The term "withholding tax" in section 943(d) does not refer to taxes on business profits, as noted in the legislative history of the Act, which indicates that withholding taxes in section 943(d) "would be similar in nature to the gross-basis taxes described in sections 871 and 881." Sections 871 and 881 of the IRC are US gross-basis withholding taxes on passive income. Accordingly, the hypothetical presented by the EC in paragraph 217 is based upon a false premise.

150. Even if the EC were correct in its definition of withholding taxes, which it is not, the Act does not permit double non-taxation of income subject to withholding taxes. With respect to excluded extraterritorial income, the Act represents the *only* method for the relief of double taxation. Accordingly, the Act denies a foreign tax credit with respect to excluded extraterritorial income. Extraterritorial income that is not excluded, however, may be subject to both US tax and foreign tax. Therefore, foreign tax credits are available with respect to income that is not excluded.

151. Section 943(d) states that withholding taxes are attributable to extraterritorial income that is not excluded extraterritorial income. Thus, taxpayers may claim a foreign tax credit with respect to the withholding taxes imposed on this income. There is no cumulation of "benefits", as alleged by the EC, because the income with respect to which a credit is claimed is not excluded extraterritorial income.

[61] *House Report* (US-3), page 18.

IX. THE ACT'S EXCLUSION IS NOT CONTINGENT ON THE USE OF DOMESTIC OVER IMPORTED GOODS IN VIOLATION OF ARTICLE 3.1(B)

152. Turning to the EC's arguments regarding Article 3.1(b) of the SCM Agreement, Article 3.1(b) is relevant only if the Panel first finds: (a) that the Act's exclusion constitutes a subsidy; and (b) that the Act does not constitute a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59. The United States respectfully submits that, for the reasons previously discussed, neither finding would be warranted.

153. Nevertheless, should the Panel reach Article 3.1(b), the United States has demonstrated that the Act's exclusion is not contingent on the use of domestic over imported goods. The 50-per cent rule does not require that US goods be substituted for foreign goods. In fact, products involved in transactions earning extraterritorial income need not incorporate any US-produced inputs and can consist entirely of foreign inputs. Simply put, the exclusion of extraterritorial income is not contingent, conditioned, or dependent for its existence on the use of domestic over imported goods.

154. The EC has challenged the United States' position in four respects. First, the EC argues that Article 3.1(b) does not require a complaining party to prove a local-content contingency in all cases. Second, the EC contends that the Appellate Body decision in *Canada Autos* is inapposite to this case. Third, the EC contends that the information contained in its Annex substantiates its claim under Article 3.1(b). Fourth, the EC challenges the United States' argument that the principle of origin diminishes the impact of the 50-per cent rule.

A. The EC'S Article 3.1(b) Claim is Based on an Erroneous Legal Standard

155. As to the EC's first point – that it does not have to establish a local-content contingency on a product-by-product basis – the EC states that "Article 3.1(b) prohibits local-content contingency to any degree, even a slight bias in favour of domestic goods."[62] The EC continues by stating that it "merely has to establish, based on the wording of the [Act], that the Act *in the abstract*, or *in some cases*, will give rise to the use of US over imported goods."[63]

156. These statements by the EC are clearly at odds with the applicable legal standard embodied by Article 3.1(b). The Appellate Body has confirmed that Article 3.1(b) requires a complainant to establish that a subsidy is contingent, conditioned, and dependent for its existence on the use of domestic over imported goods. Demonstrating a "slight bias" in favor of domestic goods or that in some cases domestic goods will be used over imported goods does not make the exclusion of extraterritorial income "contingent" on the use of such domestic goods.

157. The fact that the EC is challenging the Act "as such" and "is not making any claim in respect of its application in a particular sector or to a particular product" does not diminish the EC's burden of establishing contingency within the meaning of Article 3.1(b). The EC must establish that the 50-per cent rule, as written, renders the

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[62] *EC Second 21.5 Submission*, para. 160.
[63] *Ibid.*, para. 175.

exclusion of extraterritorial income contingent on the use of domestic over imported goods. The fact that the 50-per cent rule is crafted in such a manner that it is every bit as permissible for foreign goods to be used as domestic goods confirms that the Act is not *de jure* contingent on the use of domestic over imported goods.

B. Canada Autos is Directly Applicable to this Dispute

158. The EC contends that *Canada Autos* is inapposite to this case because the measures at issue in that case related to a closed class of beneficiaries, not the "undetermined and unlimited series of instances and beneficiaries"[64] that are covered by the Act. Thus, while the EC recognizes that the Appellate Body considered how the local requirements operated at an individual-company level, the EC claims this is irrelevant because the scope of the measures in that case are different from the scope of the Act.

159. The EC's argument misses the most significant feature of the *Canada Autos* decision. That is, the Appellate Body concluded that it could not determine whether a value-based requirement was *de jure* contingent on the use of domestic over imported goods without understanding how the measure actually operated. Without this "vital information," a panel cannot know "enough about the measure to determine whether the [domestic value] requirements were contingent 'in law' upon the use of domestic over imported goods."[65] In this regard, the Appellate Body concluded that a measure requiring 60 per cent domestic value does not necessarily lead to a conclusion of *de jure* contingency.

160. Thus, the Appellate Body's decision in Canada Autos makes clear that it is not enough for the EC to merely demonstrate that the Act "in the abstract, or in some cases, will give rise to the use of US over imported goods."

C. The EC'S Annex does not Support a Claim under Article 3.1(b)

161. To the extent that the EC relies on the information provided in the EC's Annex to support its *de jure* claim, this information is insufficient.

162. The EC's "evidence" does not describe how the Act's 50-per cent rule actually operates with respect to US taxpayers that are eligible to exclude extraterritorial income. Second, the EC relies on data from European industries that include EC cost data and mere estimates of profit. No justification is provided for why this information would be representative of the costs and profits of a US taxpayer that is likely to make use of the Act's exclusion. Moreover, there is no basis for concluding that a given manufacturer necessarily would have to rely on domestic instead of imported goods.

163. Given the limited nature of the "evidence" provided, this Panel should reject the EC's attempt to diminish its burden of establishing *de jure* export contingency.

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[64] *EC Second 21.5 Submission*, para. 173.
[65] *Ibid.*

D. Rules of Origin Further Diminishes the Impact of the 50-per Cent Rule

164. The EC challenges the proposition described by the United States that applicable rules of origin diminish the practical effect of the 50 per cent rule on components incorporated into manufactured products. The United States explained that an input sourced from a US supplier may be deemed US-origin for purposes of the 50 per cent rule, despite the fact that the goods from which that component was manufactured may have been primarily, or even entirely, imported goods. The EC attacks this point as irrelevant, yet it simultaneously concedes that, as a result of rules of origin, companies may comply with the 50 per cent rule and still incorporate foreign value in excess of 50 per cent.[66]

165. The EC may not like the fact that the 50-per cent rule can be satisfied in this manner, but it is nonetheless the manner in which the rule is applied by the US Government. As a result, inputs that are nominally US in nature could in fact be essentially comprised entirely of foreign content. In this way, rules of origin and their relation to the 50-per cent rule further demonstrate that there is no basis to conclude that the Act is contingent upon use of domestic over imported goods.

X. THE ACT DOES NOT VIOLATE ARTICLE III:4 OF THE GATT

166. With respect to the EC's claim that the United States has violated Article III:4 of the GATT, the United States recalls its arguments under Article 3.1(b) of the SCM Agreement that the EC fails to understand how the 50-per cent rule operates and why it requires no substitution of US goods for imported goods. The same rationale applies to GATT Article III:4. No less favorable treatment is afforded to imported goods because the 50-per cent rule does not change the conditions of competition. Taxpayers are under no obligation to use domestic content, and the EC has not shown that any US manufacturers will do so.

167. In addition, the United States explained in its First Submission that the Act is a law of general application and, as such, complaining parties must show that there is a meaningful nexus between the measure and adverse effects on competitive conditions in order to make a *prima facie* case. In turn, this requires a showing that the measure has had more than a *de minimis* impact on the treatment of imported goods.[67]

168. The EC cites to a number of cases in response to this argument to try to convince the Panel that the Act on its face violates Article III:4. In the alternative, the EC states that, if it must submit evidence, it has proffered enough evidence to support its claim. However, the United States believes that a *prima facie* case for an Article III:4 violation in this case cannot be made based solely on the face of the Act, and that the EC has failed to submit probative factual evidence adequate to support its claims.

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[66] *EC Second 21.5 Submission*, para. 162.

[67] *Japan-Measures Affecting Consumer Photographic Film and Paper ("Japan Film")*, WT/DS44/R, Report of the Panel adopted 22 April 1998, DSR 1998:IV, 1179, paras. 10.381, 10.84.

A. The Act does not on its Face Violate Article III:4

169. The EC argues that all laws, regulations and requirements are subject to the same Article III:4 analysis whether or not the measure is one of general applicability or one affecting only a particular class or category of imports. As such, the EC need only show that, "based on the terms of the law", an advantage can be obtained using domestic products.[68]

170. However, the EC cannot refute the case law cited by the United States that shows that generally applicable measures engender a greater evidentiary burden than laws involving a specific class of imported products.[69] In fact, rather than respond to the cases cited by the United States, the EC relies on *EEC Parts and Components* for the proposition that generally applicable measures are subject to the same Article III:4 test as product- or class-specific measures.

171. The EC's reliance on this case, though, demonstrates its fundamental misunderstanding of the US argument. That case clearly involved a specific class of imported products – imported component parts subject to an anti-dumping measure. That law, just like in the vast majority of Article III:4 cases that have come before GATT and WTO panels (including *Canada Autos*), had a clear and direct affect on certain imported products. Alternatively, laws of general applicability have, at most, an indirect impact on imported products and therefore, as in *Japan Film*, a heightened burden is required to demonstrate an Article III:4 violation.

B. The EC Fails to Proffer Adequate Evidence to Support its Article III:4 Claim

172. In addition to its legal argument, the EC claims that it has proffered factual evidence to support its claim, despite its position that it can meet its burden without such evidence. However, this "evidence," which was submitted in its Annex to the EC's First Submission, merely reflects general conclusions about production processes in various sectors based on "some data relating to production in certain sectors" within the European Union.[70] Not only is there no evidence to support these conclusions, the data provided by the EC reflect only costs within the European Union, rather than costs within the United States or in other countries in which qualifying foreign trade property may be produced. Such data has little or no value in this case.

173. The absence of adequate factual support for the EC's Article III:4 claim should be viewed by this Panel with a high degree of scepticism and, without more, the EC' s claim should be rejected.

XI. THE UNITED STATES HAS COMPLIED WITH THE DSB'S RECOMMENDATIONS AND RULINGS

174. As this Panel is aware, the measures contested by the EC in the *FSC* case no longer exist. The US explained in its First Submission, however, that the Act does provide limited transition relief by providing one tax year for those FSCs in existence

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[68] *EC Second 21.5 Submission*, para. 237.
[69] *US First 21.5 Submission*, paras. 217-218.
[70] *EC First 21.5 Submission*, Annex, para. 4.

as of 30 September 2000 to continue in operation.[71] In addition, the Act does not alter the tax treatment of long-term, binding contracts between FSCs and unrelated parties entered into before 30 September 2000[72]72 These rules are narrow and apply only in highly particularized circumstances.

175. However, the EC contends that the United States has not complied with the DSB's recommendations and rulings because: (1) the Act contains transition rules that extend the FSC regime beyond 30 October 2000; and (2) the Act was not signed into law until after 1 November 2000. However, the United States has complied fully with the DSB's recommendations and rulings.

A. The Act's Transition Rules Constitute a Reasonable Method of Complying with the DSB'S Recommendations and Rulings

176. The EC alleges that the Act's transition rules allow US exporters to benefit from the FSC measures for "an indefinite period"[73] and that the *FSC* Panel already gave the United States a "transition" period until 1 October 2000 to change its laws. The EC cites to prior WTO cases for the proposition that this Panel may not consider business realities when it determines whether the United States has fulfilled its obligations.

177. None of these assertions, however, detract from arguments presented by the United States in this case. The United States has properly requested that the Panel find that the Act complies with the DSB's recommendations, and the Panel has the authority to make such a finding.

178. First, the Act does not provide US exporters with an "indefinite" transition period. Only in those cases where US exporters have engaged in long term contracts entered into under the FSC regime will the ability to use the FSC extend beyond 31 December 2001. The FSC tax regime will remain in effect *only for those contracts*.

179. Second, the EC recognizes that sound policy reasons underlie the promulgation of transition rules when repealing significant tax legislation. In this light, it would be unfair for the United States to provide no transition period as of the time the FSC tax regime was repealed. The EC claims that the WTO decision itself served notice on taxpayers that the FSC rules may be repealed, but taxpayers did not know until the legislation was passed exactly what new rules they would need to adjust to.

180. The cases cited by the EC do not limit this Panel's authority to uphold the Act's transition rules. These cases involved narrow legal provisions that impacted only a few private parties. The overall impact of repealing those provisions was relatively small.

181. That situation does not exist in this proceeding. The scope of the FSC regime was broad, and a quite large number of businesses were impacted by its repeal. Therefore, the cases cited by the EC should not control the Panel's actions in assessing whether the United States has properly implemented the DSB's recommendations.

182. Finally, it is worth recalling that the FSC provisions had been in place for a long time and the EC waited thirteen years before challenging it. During that time,

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[71] The Act § 5(c)(1)(A).
[72] The Act § 5(c)(1)(B).
[73] *EC Second 21.5 Submission*, para. 243.

US taxpayers came to rely on the FSC provisions in structuring their foreign transactions. Furthermore, the United States promulgated and maintained the FSC tax provisions in reliance on the 1981 Understanding adopted by the GATT Council. Such reliance was not unjustified.

B. The United States Complied with the Time Period Specified by the DSB

183. The EC also argues that the United States failed to comply with the DSB's recommendations in the *FSC* case because the Act was not signed until 15 November 2000. The EC's argument fails for two reasons.

184. First, the DSB did not recommend that the United States enact legislation by 1 October 2000. Instead, the DSB recommended that the United States withdraw the FSC subsidies with effect from 1 October 2000, which the DSB then extended to 1 November 2000. The Act's provisions apply retroactively and repeal the FSC provisions before 1 November 2000. The Act in fact provides that the "amendments made by this Act shall apply to transactions after 30 September 2000."[74] Thus, the United States complied with the DSB's recommendation by repealing the FSC with effect from 1 October 2000. None of the EC's arguments to the contrary support an alternative conclusion.

185. Second, the EC's arguments with respect to whether the United States complied with the DSB's recommendations and rulings within a reasonable period of time are moot. As reflected in Article 19.1 of the DSU, the WTO does not provide retroactive relief for alleged past wrongs.

186. In this case, the EC alleges that the United States failed to act by 1 November 2000. However, once the United States signed the Act into law on 15 November 2000, the allegation that the United States "failed to act" ceased to exist. In other words, by the time the EC made its panel request to commence this Article 21.5 proceeding, the violation – that is, the purported "failure to act" – it ostensibly was challenging no longer existed. Panels typically refrain from examining measures that cease to be in existence or in effect before a panel's terms of reference are set.[75] Therefore, the EC's claim that the United States has failed to properly comply with the DSB's time line should be rejected.

XII. CONCLUSION

187. In closing, the United States thanks the Panel for its patience in listening to a rather detailed discussion of the issues. The United States would like to end this statement where it began: focusing on the most important issues before the Panel.

188. To reiterate, the United States believes that the Panel must determine whether the partial exclusion of extraterritorial income under the Act constitutes a subsidy within the meaning of Article 1. The United States submits that it does not.

189. The Panel also must determine whether the fact that exporting is one way, but not the only way, of generating excluded extraterritorial income renders the exclu-

[74] The Act § 5(a).
[75] *See, e.g., Argentina Textiles*, paras. 6.13-15.

sion export contingent within the meaning of Article 3.1(a). The United States submits that it does not.

190. And, finally, the Panel must determine whether the fact that the Act's exclusion is not limited to the amount of foreign taxes paid precludes the Act from constituting a measure to avoid double taxation under footnote 59 of the SCM Agreement. The United States submits that this is not the case.

191. Whichever way the Panel rules, the United States urges the Panel to avoid the EC's "I know it when I see it" approach. Instead, the United States encourages the Panel in the strongest possible way to provide guidance as to what the relevant provisions mean and what they do and do not permit. Only in this way will the parties be able to do more than know the outcome when they see it. They will be able to understand and apply the principles on which that outcome is based. Thank you

ANNEX D-4

CLOSING STATEMENT OF THE UNITED STATES

(16 March 2001)

1. Mr. Chairman, members of the Panel, on behalf of the United States, I first would like to express our gratitude for your willingness to serve in this matter, and your patience and attention in listening to our arguments. It is clear from the questions you have posed over the last several days that you understand the issues in this case and the US positions with respect to them.

2. With respect to the European Communities' closing statement, we will address the points made and the new information attached to the statement in our written answers to the Panel's questions, to the extent that any of the points and new information are relevant. The only specific observation I would make at this time concerns paragraph 33 of the EC's closing statement, where the EC asserts that the United States has admitted that there can be cases where use of US articles will be needed. Of course, all the United States has said is that while it is possible to construct hypotheticals under which US articles would be needed, we are unaware of any actual situations where US articles would be needed.

3. Now, this proceeding involves legislation adopted by the United States in response to, and in order to comply with, findings by this Panel and the Appellate Body. This was the first occasion on which a WTO decision required the United States to change one of its statutes, and the repeal of the FSC and the adoption of the Act now under review were accomplished under the pressure of a relatively short deadline, during an election year, as nearly unprecedented free-standing tax legislation, and in the face of a consistent refusal by the EC to offer any input on what types of changes might be acceptable to it and, in its view, WTO-consistent. Despite the fact that the case was brought under circumstances considered dubious by many, the United States acted expeditiously and in good faith to comply.

4. This case is complex not only because the tax principles and provisions are complex, but also because the decisions in this dispute could have far-reaching implications. The measure found to be WTO-inconsistent in the original proceeding had been adopted, as had been its predecessor, to offset an underlying tax advantage that a difference in tax systems creates. The challenge for the United States has been to produce a replacement measure that both addresses that underlying economic issue while at the same time achieving WTO consistency. One of the challenges for this Panel, we respectfully submit, is to issue a ruling that fairly implements WTO principles, including the principle, reflected in the preamble to the WTO Agreement itself, that arrangements be "reciprocal and mutually advantageous." The United States submits that a decision fails to honour this principle if it produces an outcome that discriminates between tax systems even though the systems generate a similar economic result.

5. In developing its replacement measure, the United States was mindful not only of the customary rules of interpretation reflected in the *Vienna Convention* and their emphasis on the ordinary meaning of the relevant textual provisions, but also of the decisions of this Panel and the Appellate Body. Those decisions rigorously adhered to the textual prescriptions of the SCM Agreement, to the exclusion of prior

precedents on which the United States had relied and to which the United States, at least, attached considerable importance.

6. As a result, the United States's defense of the Act is, like the critiques of the Act's predecessor, highly textual. In this proceeding, it is the EC that advocates principles not found in the text of the applicable agreements and that advances arguments for which the relevant text provides no support. Having been in a similar position in connection with this same dispute, the United States understands the EC's problem, but is understandably unsympathetic.

7. The emphasis on the ordinary meaning of the text of the agreements – a constant feature of the Panel's original decision and the EC's original arguments – brings us first to Article 1 and the issue whether the Act constitutes a subsidy within the meaning of Article 1. That inquiry is based on a definition of "financial contribution" that is defined in three of its four prongs by affirmative governmental acts in providing money or goods and services. The fourth prong, at issue here, involves financial contributions that entail not collecting or foregoing revenue that is due and owing to the government, as in the case of a credit against taxes that are owed to the government.

8. By re-defining the concept of "gross income" in the US tax code, the United States Congress re-drew the outer boundary of its own taxing authority, and it expressly noted that that was what it was doing. It expressly modified the "prevailing domestic standard" under US law, and consciously changed the "normative benchmark" by which the Panel and Appellate body opined that provisions coming under subparagraph (ii) of Article 1.1(a)(1) would be measured. The result is a new measure that is not a "financial contribution" as that term is defined by the ordinary meaning of the language of subparagraph (ii). Although the EC is critical of that solution, it is one that is faithful to the text of the Agreement and to the findings of the Panel and the Appellate Body.

9. In addition, the Congress of the United States designed a replacement measure that is not "contingent" on exports as that term is used in Article 3.1(a). Following Appellate Body guidance on this very point in recent decisions emphasizing the definition of "contingent," the Congress created an exclusion that is not "contingent" on export performance. To the contrary, US taxpayers can take advantage of the new exclusion without ever exporting. Indeed, there is no US taxpayer who can take advantage of the exclusion *only* by exporting, because every such US taxpayer could also take advantage of the exclusion through foreign production and foreign sales. Indeed, there are even certain domestic transactions (domestic sales of products that are to be used outside of the United States) for which the exclusion is available. While exporters are plainly among those taxpayers who can utilize the exclusion, the exclusion does not meet the ordinary meaning of the test set out in the text of Article 3.1(a).

10. On this point, the EC asks the Panel to depart completely from the applicable text of the Agreement. Rather than consider whether the US exclusion is "contingent" on export performance – the test that is set out in Article 3.1(a) itself – the EC advocates a comparison test that appears nowhere in the text of Article 3.1(a). Article 3.1(a) does not call for or require a comparison; instead, the test is the one that Article 3.1(a) states – whether a subsidy is "contingent" on export performance, a test that the US exclusion does not meet.

11. The conclusion that the new US exclusion does not offend Article 3.1(a) is confirmed by recalling, as we have done in our preliminary answer to Panel question 21, that export subsidies are a type of specific subsidies. Article 2.3 expressly so provides. Thus, assuming for the moment that the exclusion is a subsidy within the meaning of Article 1, in analyzing whether it is export-contingent, one should consider how the analysis would be made if the question were: Is a subsidy specific because some sub-set of the users of the subsidy constitutes, for example, a specific group of industries while the remainder of the users are not a specific group? In that context, we submit, we would all be unlikely to find the subsidy specific on the basis that a subset of the beneficiaries of that subsidy constitute a specific group of industries. The answer must be the same if a subset of the beneficiaries consists of exporters.

12. The third main issue in this dispute involves the principle, articulated in footnote 59 of the SCM Agreement, that paragraph (e) of the Annex to Article 3.1(a) is "not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income." This issue, which was not addressed in the prior proceeding regarding the FSC, is clearly before this Panel. It is at issue because this was an explicit, stated objective of the Congress in adopting the new US measure.

13. The EC would have the Panel decree that this was not the purpose of the US Congress in adopting its new legislation, a proposition that would be arguable had the Congress been silent with respect to its intent, but an extraordinary proposition in the face of a clearly expressed Congressional purpose. The EC further contends that even if this were the purpose, that purpose was unnecessary because there are other means available to avoid double taxation, a proposition better suited for a policy debate than for an analysis of footnote 59. And the EC finally argues that a measure to avoid double taxation can be justified only through country-by-country determinations of whether there is an applicable foreign tax, a proposition that would be laughable were anyone to similarly suggest that territorial limits found in tax systems of EC member states should be permissible vis-à-vis certain foreign countries, but not others.

14. In fact, an exclusion is a widely recognized means of avoiding double taxation. OECD principles make clear that exclusions or exemptions need not provide dollar-for-dollar or pound-for-pound protection from double taxation, as European exemption systems demonstrate. The text of footnote 59, which does not limit measures to just offsets and does not use the term "permanent establishment", authorizes measures designed to avoid double taxation on "foreign-source income", a broader term on which the exclusion in the Act is based.

15. As a factual matter, it is clear that the income covered by the Act's exclusion is income that faces the legitimate possibility of taxation outside the United States. Foreign taxes will apply to the excluded income of foreign producers who take advantage of the new US exclusion, both in cases where there is a foreign permanent establishment and where there is foreign economic activity that does not meet the strict standard of a permanent establishment. Many countries do not limit their taxing authority to "permanent establishments", among them the United States, Canada, certain European countries, and a wide variety of developing nations. Income from electronic commerce transactions is just one recent example of income that may be subject to tax without regard to the "permanent establishment" standard. Nor does the

fact that a country has tax treaties with certain other countries nullify the final sentence of footnote 59, as again, European exemption systems show.

16. For all of these reasons, the new US exclusion is a legitimate, indeed conventional, measure "to avoid the double taxation of foreign-source income," as the text of footnote 59 allows.

17. With respect to all three of the core issues in this case, there is an underlying question of the general applicability of rulings that this dispute generates. It is, of course, true that European tax systems are not at issue here; they are not within the terms of reference of this Panel. It also is true that the existence of a corresponding subsidy in a European tax system is not a defense in a challenge to a United States measure. At the same time, though, it is equally true that any WTO principles articulated in this case are equally applicable to all WTO Members, European countries included. It is also true that European tax systems that incorporate territorial limits confer, without question, a tax benefit on exporters who realize both domestic and offshore income from export sales. And it is true that with the new exclusion, the United States has incorporated a measure that is similar to, albeit not identical to, features found in European tax systems.

18. It is not the intent of the United States to condemn European tax systems or to justify its own by pointing to similar practices in other countries. It *is* our intent, however, to suggest that this dispute has moved a considerable distance from its original posture, that the measure at issue and territorial limits found in many European systems are different mechanisms for achieving a fundamentally similar result, and that it is unlikely that the drafters of the SCM Agreement intended to invalidate all of those systems. The ordinary meaning of the text they drafted does not support that result.

19. In conclusion, the United States submits that this measure, like its predecessor, should be measured by the ordinary meaning of the text of the provisions that apply to it. Such an analysis, we believe, leads to the conclusion that in its central respects the United States measure is not inconsistent with the SCM Agreement.

20. The United States recognizes that it has voluntarily assumed the obligations of the WTO Agreement. At the same time, the United States understands, as this Panel undoubtedly also understands, that neither it nor the other proponents of the SCM Agreement contemplated that their obligations under the SCM Agreement would sharply circumscribe their ability to make their own tax policy decisions or to maintain rough tax parity with respect to the competitive advantages and disadvantages that different national tax systems confer. Thank you.

ANNEX E

Oral Statements of the Third Parties

ANNEX E-1

ORAL STATEMENT BY CANADA

(14 March 2001)

Mr. Chairman, Members of the Panel.

Thank you for the opportunity to provide Canada's views in this proceeding. We would take this opportunity to highlight briefly some of the key points made in our written submission.

As we stated in our submission, we agree with the EC that the *FSC Repeal and Extraterritorial Income Exclusion Act of 2000* does not bring the United States into compliance with the DSB recommendations and rulings in this dispute.

In support of this position, we would advance two principal arguments.

First, in our view, the FSC replacement scheme provides a "subsidy" to US-based enterprises within the meaning of Article 1.1 of the SCM Agreement.

Second, the subsidy provided under the FSC replacement scheme to US-based enterprises is contingent upon export performance, in violation of SCM Article 3.1(a).

Turning briefly to the first argument:

In our view, there is a "financial contribution" to US-based enterprises within the meaning of Article 1.1(a)(ii) of the SCM Agreement. The FSC replacement scheme continues to provide a financial contribution to US-based enterprises by excluding from taxation domestic income that they earn from export transactions.

As the Appellate Body stated earlier in this dispute, the "foregoing" of revenue "otherwise due" implies that less revenue has been raised by the government than would have been raised in a different situation, and that the government has given up an entitlement to raise revenue that it would otherwise have raised.

The basis for comparison must be the tax rules applied by the Member in question. In this case, the income earned by US-based enterprises on export transactions, which is part of the income excluded from taxation under the definition of "extraterritorial income", would otherwise be subject to tax in the absence of the FSC Replacement scheme. Moreover, as the EC has noted, the income earned from export transactions under the FSC replacement scheme corresponds arithmetically to the exempt foreign source income of the FSC scheme. The United States continues to provide subsidies to US-based enterprises earning this type of income.

The revenue or tax that would otherwise be due on "income earned from export transactions", which is part of the income excluded from taxation under the FSC replacement scheme, would be the tax applicable to such income under US law. Thus, in our view, the United States is providing a financial contribution to US-based enterprises earning this type of income by foregoing revenue that would otherwise be due within the meaning of Article 1.1(a)(ii) of the SCM Agreement. Moreover, as noted in our submission, since income earned from export transactions cannot by definition face double taxation, the exclusion from taxation provided for this income under the FSC replacement scheme can only reduce US tax otherwise payable.

In addition, the financial contribution clearly confers a "benefit" to US-based enterprises earning domestic income from export transactions.

Therefore, in our view, there is a "subsidy" within the meaning of SCM Article 1.1, since there is both a "financial contribution" and a "benefit." Both components of the definition have been met.

Turning to our second point:

Canada also submits that the "subsidy" provided to US-based enterprises is "contingent upon export performance." In order to benefit from the subsidy, the Act states that goods must not be sold "for ultimate use in the United States." As noted in our written submission, we agree with the EC that this is another way of saying, with respect to domestic goods, that the goods must be exported. As such, the subsidy is *de jure* export contingent.

The FSC replacement scheme, when applied to income earned from exports of domestic goods of US-based enterprises, results in the permanent reduction of US taxes otherwise payable. The export-contingent nature of the scheme leaves no doubt that the only way that income derived from the sale of a domestic good can qualify under the scheme is if the good is exported.

In conclusion, Canada respectfully requests that the Panel find that the United States has not complied with the recommendations and rulings of the DSB and that the United States continues to provide prohibited export subsidies under the FSC replacement scheme, inconsistently with Article 3.1(a) of the *SCM Agreement*.

Thank you.

ANNEX E-2

THIRD PARTY STATEMENT BY INDIA

(14 March 2001)

India is appreciative of this opportunity to present its views on this dispute.

The issue before this Panel is whether the FSC Repeal and Extraterritorial Exclusion Act of 2000 (hereinafter "FSC Replacement Act") is consistent with the recommendations and rulings of the DSB to withdraw the FSC measure found to be a prohibited export subsidy and thus inconsistent with the US obligations under Articles 3.1(a) and 3.2 of the Agreement on Subsidies and Countervailing Measures (SCM Agreement) and under Articles 10.1 and 8 of the Agreement on Agriculture.

We confine our presentation to the claims under the SCM Agreement, especially Article 3.1(a).

US failed to withdraw the original FSC subsidies "without delay"

India invites the Panel's attention to the transitional provisions of the FSC Replacement Act. Section 5(c)(1) (A) of this Act provides that for any FSC in existence on 30 September 2000 and at all times thereafter, the Act shall not be applicable to any transaction occurring:

- before 1 January 2002; or
- after 31 December 2001, pursuant to a binding contract

- with unrelated parties; and
- in effect on 30 September 2000.

It is submitted that the above provisions of the FSC Replacement Act would allow the US companies to continue to benefit from the WTO incompatible FSC scheme beyond the expiry of the reasonable period of time. Therefore, India requests the Panel to find that the US has failed to withdraw the FSC subsidies as required by Article 4.7 of the SCM Agreement and recommendations and rulings of the DSB, and has also failed to comply with its obligations under Article 21 of the DSU.

DSB Rulings and SCM Agreement

On 24 February 2000, the Appellate Body upheld the Panel's finding that various exemptions for certain types of income under the US Internal Revenue Code of 1986 (Code) earned by foreign sales corporations (i.e., FSC scheme), taken together, constituted a prohibited export subsidy under Article 3.1(a) of the SCM Agreement. The Appellate Body agreed with the Panel that having decided to tax foreign-source income, the US could not exclude certain types of this income from taxation without foregoing government revenue that would otherwise be due, and, therefore, without providing a financial contribution under Article 1.1(a)(1)(ii) of the SCM Agreement. Having also agreed with the Panel that the FSC measure provided a "benefit" to the recipients of the exemption, the Appellate Body agreed that the FSC measure represented a "subsidy" within the meaning of Article 1.1 of the SCM Agreement. Finally, the Appellate Body upheld the Panel's finding that the "subsidy"

was contingent upon export performance and, therefore, prohibited under Article 3.1(a) of the SCM Agreement.

The Appellate Body recommended that the DSB request the United States to bring the FSC measure into conformity with its WTO obligations.

The Appellate Body emphasized that its ruling was in no way a judgement on the consistency or the inconsistency of the relative merits of the tax system chosen by the US. The Appellate Body observed that:

> "[a] Member of the WTO may chose any kind of tax system it wishes - so long as, in so choosing, that Member applies that system in a way that is consistent with its WTO obligations. Whatever kind of tax system a Member chooses, that Member will not be in compliance with its WTO obligations if it provides, through its tax system, subsidies contingent upon export performance that are not permitted under the covered agreements." (para 179 of AB report)

These findings and conclusions of the Appellate Body were adopted by the DSB on 20 March 2000.

FSC Replacement Act

The US has enacted the FSC Replacement Act and amended its Internal Revenue Code relating to taxation of FSCs purporting to comply with the recommendations and rulings of the DSB. The Act excludes "extraterritorial income" from gross income on which tax liability is calculated. "Extraterritorial income" is defined as gross income attributable to "foreign trading gross receipts". Foreign trading gross receipts include gross receipts from sale, exchange, lease or rental of "qualifying foreign trade property", and related and subsidiary services.

Under Section 114 of the Code as amended by the Act, not all-extraterritorial income is eligible for exclusion from tax liability. Only the "qualifying foreign trade income" is eligible for such exclusion. Such income encompasses (1) income earned from export transactions by the US based companies; and (2) foreign source income earned by US company through a branch or subsidiary abroad. The income earned from the export transaction is excluded from tax.

Under Article 1.1(a)(1)(ii) of the SCM Agreement, a financial contribution by the Government exists where government revenue that is otherwise due is foregone or not collected. The term "otherwise due" implies a comparison between the revenues due under the contested measure and revenues that would be due in some other situation. As stated by the panel and Appellate Body in the examination of the original FSC measure, the basis of comparison is the tax rules applied by the US. (AB report, para 90).

The effect of the exclusion is to reduce tax liability of the beneficiary corporation. This represents a departure from the rules of taxation that would "otherwise" apply to such gross income. Accordingly, government revenue otherwise due is foregone or not collected within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement. A benefit is also conferred under Article 1.1(b) in the form of a reduction in tax liability.

It is submitted that the "subsidy" provided to US-based enterprises is clearly " contingent upon export performance", as in order to benefit from the "subsidy", goods must not be sold "for ultimate use in the United States." (Section 942(a)(2)(A)

of the FSC Replacement Act). India agrees with Canada and the EC that this is simply "another way of saying that they must be exported", and that these words are sufficient to make the subsidy de jure export contingent. As stated by the Appellate Body in Canada – Certain Measures Affecting the Automotive Industry (DS139-142):

> "a subsidy is ... properly held to be de jure export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be de jure export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfilment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure." (para 100 of the AB Report)

US argues that this extraterritorial income is excluded from the definition of "gross income" as a measure to avoid double taxation. In this connection it is submitted that the income earned from export transactions is income that would generally be taxable only in the US, since it arises from economic activities taking place in the US. The fact that the proceeds of sales are from foreign sources does not transform the export income into "foreign income" for tax purposes. Exporting goods in a foreign country does not create a sufficient nexus to trigger taxation in the importing country, even when one takes into account the "foreign economic processes " required under the FSC Replacement Act. It is submitted that such processes do not create a taxable presence abroad and, therefore, would not be considered as foreign business income subject to double taxation. Therefore, no double taxation needs to be relieved with respect to this component of "extraterritorial" income.

India therefore submits that by maintaining these provisions in the FSC Replacement Act, the US is continuing to provide prohibited export subsidies inconsistent with Article 3.1(a) of the SCM Agreement.

Conclusion

Therefore, India respectfully requests the Panel to find that the US has not complied with the recommendations and rulings of the DSB and that the US continues to provide prohibited export subsidies under the FSC Replacement Act inconsistent with Articles 3.1(a) of the SCM Agreement.

ANNEX E-3

ORAL STATEMENT BY JAPAN

(14 March 2001)

I. INTRODUCTION

1. Japan wishes to focus its comments on two specific legal issues: the violations by the United States of its obligations under Article 3.1(a) of the SCM Agreement and under Article III:4 of GATT 1994. By focusing on these two issues, however, it does not mean that Japan agrees with the United States on other issues raised by the EC before the panel.

2. Japan recognizes the principle confirmed by the Appellate Body in *Japan-Alcohol*[1] case that, as far as the rights and obligations under WTO Agreement are concerned, every sovereign Member has the authority to administer its own taxation system as it wishes, provided that its actions are consistent with the Member's obligation under the WTO Agreement. While respecting such sovereignty of Members, Japan would like to express its views to the extent that it considers relevant for the Panel's deliberation on certain issues concerning the proper interpretation of relevant provisions of the SCM Agreement and the GATT 1994, particularly as those provisions relate to the specific measure of the United States, the new tax law to replace the old FSC provisions (hereinafter referred to as "the FSC Replacement Scheme").

II. THE FSC REPLACEMENT SCHEME STILL CONFERS THE BENEFIT TO THE EXPORTS, AND STILL FALLS WITHIN ARTICLE 1 OF THE SCM AGREEMENT

3. In defence of the FSC Replacement Scheme, the United States asserts that the Scheme "modified the normative benchmark" that was in place under the previous FSC regime, in order to comply with the ruling of the Panel and the Appellate Body; the Replacement Scheme therefore does not constitute a subsidy within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement; the Replacement Scheme is a measure to avoid double taxation.

A. The Act Does Not Provide the Normative Benchmark as the United States Alleges

4. The United States extensively asserts in its first submission that the Act creates a new normative benchmark which replaces the old one, and this new benchmark excludes "Extraterritorial Income" from the "Gross income", thereby rendering "extraterritorial income" outside the territorial limit of the US taxing authority. Moreover, the United States asserts that the replacement of the benchmark for taxation is within the sovereign authority of Member states which is not affected by any provision of the WTO Agreement.

5. Japan nevertheless believes that the concept of "otherwise due" of Article 1 of SCM Agreement and the normative benchmark which the Appellate Body employed

[1] *Japan – Taxes on Alcohol Beverages* WT/DS8/AB/R, p.16, DSR 1996:I, 97, at 121.

for determining whether it is "otherwise due", must reflect the real nature of the exclusion and its relations with the underlying subsidy. In this case, the relevant normative category should be *all* foreign trade income, which includes export income. Since the United States has not excluded this entire category of income from taxation, but only a part, then it is *within* the category of foreign trade income to which the "otherwise due" criteria must be applied. Therefore, the question is whether tax is "otherwise due" in connection with foreign trade income under the US system.

6. Under the FSC Replacement Scheme, within the category of foreign trade income, the majority of foreign trade income is taxable. Thus, the taxation of most foreign trade income establishes that, from a normative standpoint, income tax on foreign trade income is "otherwise due" under the US tax system. It is only by virtue of the FSC Replacement Scheme that a small portion of that income (i.e., "qualifying foreign trade income") is excluded.

7. In this regard, Japan would like to draw the Panel's attention to the submission of Canada. As Canada correctly points out in footnote 19 of Canada's submission, "the foreign tax credit provisions of the US Internal Revenue Code have not been repealed by the FSC Replacement Act and still provide the basic approach used by the United States to relieve double taxation with respect to income subject to tax in other countries."[2]

8. Being a third party, Japan has not received a copy of rebuttal submission of the United States. So Japan has not learned of the US rebuttal on this point. But based on the materials and argument disclosed to Japan so far, the United States is yet to establish that the Act provides a new benchmark for the taxation of foreign income in the United States in place of the old one. Unless proven otherwise by the United States, Japan believes that the Act still confers a subsidy within the meaning of SCM Agreement Article 1.1(a)(1)(ii), and the "exclusion" from the Gross Income provided under the Act does not create a new benchmark as the United States alleges, but instead closely emulate the tax exemption that was available to FSCs under the previous scheme.

B. The US Defence Based on Footnote 59 Leaves Many Elements of the Replacement Scheme Unaccounted for

9. Now I would like to address the argument of the United States based on Footnote 59. As I mentioned at the outset of this statement, Japan fully respects the sovereign authority of Members to administer their respective system of taxation. In the following, I would therefore only like to point out the elements of the Replacement Scheme that are worthy of close scrutiny, and leave the final judgment to the Panel.

10. First, based on references to anecdotal legislative history connected to the passage of the FSC Replacement Scheme, the United States implies that the primary objective of the programme is to assist US companies in avoiding double taxation. If the intention of the programme were simply to avoid double taxation, the FSC Replacement Scheme would apply to 100 per cent of foreign trade income bar legitimate exceptions such as those for prevention of tax evasion. Instead, the programme allows companies to exclude only a small portion of foreign trade income from taxation. If the programme were genuinely designed to avoid double taxation, why then

[2] *Canada Third Party Submission to 21.5 Panel*, para. 33

would the programme only solve this problem for only a small portion of a company's exports, as opposed to all sales that might be subject to double taxation?

11. Second, if the Replacement Scheme is indeed a measure to avoid the double taxation, how could it be reconciled with the US stating in its submission that "the only requirement is that these persons be subject to US taxation"?[3] Judging from this US statement, the existence of double taxation does not seem to be a prerequisite to obtain benefits under the programme. In other words, a company may benefit from the FSC Replacement Scheme, whether or not the company is subject to double taxation. The phrase "measures to avoid" suggests a strong linkage between the measures and the elimination of double taxation. The United States has so far failed to fully account for such absence of clear linkage between its claim under Footnote 59 and what it claims in its own submission.

12. Finally, while Footnote 59 does sanction "measures to avoid the double taxation," this Footnote does not confer upon Members *carte blanche* to introduce any measure under the name of "a measure to avoid double taxation" As is the case with any exception permitted under the WTO Agreement, exceptions are permitted only to the extent necessary so as not to deviate from the generally binding principles applicable to all Members, which in this case includes, prohibition of export subsidies.

13. If the United States is to invoke Footnote 59 in justifying the Act as a measure to avoid double taxation, it must be demonstrated that the measures introduced under the Act contain clear linkage, both in letter and substance, to what is necessary for avoiding the double taxation. Thus the scrutiny for the invocation of exceptions must be conducted not only for the titles or categories of income used in the law in question, but also for the substance of those elements and the law – which is in this case a number of conditions attached to so-called "Extraterritorial Income" including the conditions attached to Qualifying Foreign Trade Property.

14. Such scrutiny leaves us puzzled as to why the Act attaches such conditions as:

> *"qualifying foreign income" would have had to be earned by an "eligible corporation," from the sale, lease, or rental of goods* - when such "eligible corporations" may be generating taxable income through activities other than the sale, lease, or rental of goods.
>
> *Or*
>
> *not more than 50 per cent of the fair market value of which is attributable to foreign content* - when the double taxation could occur irrespective of how much is attributable to domestic content.

15. In the eye of Japan, the Untied States has not met the burden of proof in demonstrating the clear linkage between the Act and what it claims under Footnote 59. Unless the United States meets this burden, the US effort to interpret footnote 59 to immunize measures that provide export subsidies, provided those measures also may possibly assist some companies in avoiding double taxation, should be rejected.

[3] *US First Submission to 21.5 Panel*, para 34

III. ADDING A SEPARATE CATEGORY OF ACTIVITIES THAT CAN ALSO BENEFIT FROM THE SUBSIDY DOES NOT ELIMINATE THE BENEFIT CONDITIONED ON EXPORTS.

16. Article 3.1(a) of the SCM Agreement explains that where export performance is solely or *one of several other* conditions, the subsidy will be prohibited. The fundamental point of Article 3.1(a) is whether export performance itself is one of the underlying conditions for receiving benefits. The addition of *another* category of activities eligible for subsidy benefits does not change the benefit for exports.

17. The United States tries to defend the FSC Replacement Scheme through such a device, by adding a new category to the old benefits for exports. This new category simply means that the FSC Replacement Scheme now provides subsidies to more than one category of activities: one directly related to export income, and another related to foreign-produced goods. Since eligibility for benefits under the FSC Replacement Scheme for foreign produced goods is a separate and independent condition from eligibility for direct export from the United States, two benefits are distinct. The benefit contingent on exporting goods is analytically unrelated to the subsidy related to foreign-produced goods. That the benefit is also available to the foreign-produced goods category does not in any way make the subsidy, as it is available to exporters, consistent with the SCM Agreement.

18. The panel should reject any argument that the addition of a foreign-produced category to the activities eligible for the FSC tax exemption somehow transforms the FSC Replacement Scheme from a prohibited subsidy into a generally available and permissible subsidy. If Members needed simply to add some new category of activity, no matter how inconsequential, to an export subsidy to remove the subsidy from the scope of Article 3.1(a), then any Member could easily circumvent the disciplines of Article 3.

19. The United States argues that Article 3.1(a) requires a finding that when there are several conditions that establish eligibility for an export subsidy, export performance must be a *required* condition. According to the United States, the phrase "several other conditions" in Article 3.1(a) means a "series of conditions precedent, all of which must be satisfied."[4] The implication is that if the conditions are alternative, and a company may obtain the benefit of the subsidy without satisfying the export performance condition, then the entire programme somehow escapes scrutiny as providing an export subsidy to companies.

20. This interpretation of Article 3.1(a) must be rejected. First, the US argument has no basis in the text. The United States reads into the text the critical requirement that "all" of the conditions must be met. But the text provides no such language or idea. Rather, the text of Article 3.1(a) speaks only of conditioning the benefit on exports, which may be one of several requirements.

21. Second, this interpretation ignores the context of Article 3.1(a) as creating a discipline against export subsidies. The mere fact that a company happens to export does not trigger the discipline. But when a government offers some benefit conditioned on the fact of exportation, then the discipline must apply. The mere existence of other conditions, and other categories of activities that will allow company to benefit from the subsidy by means other than exports, does not magically render the

[4] *US First Submission to Article 21.5 Panel*, para. 135.

programme WTO-consistent as a whole. The export condition remains an export condition. That others may also benefit does not change the export condition.

22. Third, the US argument would render Article 3.1(a) largely meaningless. Under the US interpretation, a programme could provide benefits to 99 companies meeting the export condition, and a single company meeting some other non-export condition. Yet the programme itself would be permissible, because not every recipient received benefits based on the export condition. This approach makes no sense as a means to discipline export subsidies, and cannot reflect the purpose of Article 3.1(a).

23. Finally, as both the EC and Canada correctly pointed out in their submissions[5], the Appellate Body for the *Canada-Autopact* case made clear that "a subsidy is held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure." Japan believes that the very language used in the conditions attached to the "foreign trade income" under the Act cannot escape the disciplines of this test.

24. In this dispute, the crux of the EC's challenge relates to the fact that the FSC Replacement Scheme still authorizes a category of activity – exports - to qualify for subsidy benefits. The fundamental purpose of this Article 21.5 proceeding is to examine whether the same commercial activities – exports - are still eligible for subsidy benefits under the FSC Replacement Scheme. If so, then the fundamental problem from the initial panel proceeding has not changed, and the Replacement Scheme still violates Article 3.1(a).

IV. THE FSC REPLACEMENT SCHEME'S 50 PER CENT RULE IS INCONSISTENT WITH ARTICLE III OF GATT 1994

25. The United States argues the FSC Replacement Scheme does not require the use of domestic product, and therefore must be consistent with Article III of GATT 1994. This argument, however, misses the essential point of Article III. A measure violates Article III whenever an imported product is accorded less favourable treatment than the domestic product. A measure can accord "less favourable" treatment whether or not there is a specific legal requirement to use domestic goods. Article III prohibits government measures that create legal incentives that disrupt the "effective equality of opportunities between imported products and domestic products.[6]

26. The scope of the FSC Replacement Scheme is wider than just domestic products, but the measure nevertheless covers domestic products. As long as such disparity in treatment between imported products and domestic products exists, the violation of Article III occurs. The FSC Replacement Scheme creates such a disparity. Under this tax programme, an eligible corporation may increase its use of domestic product to any level without affecting whether the income can be deemed "qualifying foreign income," and thus may generate tax benefits. In sharp contrast, an eligible corporation does not have such flexibility with regard to foreign content. Once the foreign content exceeds 50 per cent of the fair market value of the income, the income can no longer be deemed "qualifying foreign income," and the tax benefit is

[5] *EC First Submission to 21.5 Panel*, para. 84, *Canada Third Party Submission to 21.5 Panel*, para. 40.

[6] *Canada – Certain Measures Affecting the Automotive Industry*, WT/DS139/R, WT/DS142/R, Report of the Panel, as modified by the Appellate Body, adopted 19 June 2000, DSR 2000:VII, 3043, para. 10.78.

lost. This differential treatment, which skews the incentive to use domestic products over foreign products, violates the "effective equality of competitive opportunities" guaranteed by Article III.

27. Adding new ways to impute value does not change this fundamental problem. The United States may be correct in stating that the FSC Replacement Scheme does not impose any legal "limitation" requiring only products to be used in determining the value. Eligible corporations, when imputing the value, may use not only products but also services, labor, intellectual property rights, and other intangibles, or even elect to forfeit the qualification as "qualifying foreign income", if it so wishes. These additional features, however, do not change the fundamental fact that the FSC Replacement Scheme creates an incentive to use domestic goods, thereby giving domestic goods preferential status under the law. The disparity between imported products and domestic products does not disappear just because these alternative means of imputing the value is introduced. The FSC Replacement Scheme therefore violates Article III:4.

V. CONCLUSION

28. After a rather lengthy dispute settlement process, the largely unchanged US FSC scheme is before the panel once again. The already long process was made even longer by the US-EC Procedural Agreement of September 29th. Japan believes that the need to reach this temporary Agreement, which was applicable only to this specific case, highlights the urgent need for all Members of the WTO to engage in a process leading to permanent resolution of the outstanding issues. Otherwise, this dispute may continue indefinitely, requiring additional derogations from the normal DSU procedures for resolving disputes.

29. For all of the foregoing reasons, this Panel should determine that the United States has not complied with the recommendations of the original Panel and the Appellate Body.

ANNEX F
ANSWERS TO QUESTIONS AND COMMENTS ON THESE ANSWERS

ANNEX F-1

ANSWERS OF THE EUROPEAN COMMUNITIES TO THE QUESTIONS OF THE PANEL

(27 March 2001)

Q1 In section 3.2.5. of its first submission, the European Communities expresses the view that the FSC Replacement scheme gives rise to two distinguishable subsidies : the "basic FSC Replacement subsidy" and the "extended FSC Replacement subsidy".

- **Does this mean that the EC is requesting the Panel to make two separate rulings, one on each of the alleged subsidies?**
- **Does the EC consider that the application of a different portion of the FSC Replacement scheme may involve different types of subsidies under the SCM Agreement?**
- **Please identify the relevant portion of the FSC Repeal and Extra-territorial Income Exclusion Act ("the Act") framing these two "distinguishable" alleged subsidies.**
- **Does the EC believe that the status of a subsidy under the SCM Agreement is determined by the particular legal circumstances in which it is granted on a case-by-case basis?**

Reply

1. The EC does not consider that the Panel need necessarily make two separate rulings on each of the subsidies. It is not requesting two independent rulings in the way that it had asked for separate and independent rulings on the FSC subsidies resulting respectively from the tax exemptions and the special administrative pricing rules. But the EC does consider that the Panel's analysis and reasoning will have to consider the subsidies separately.

2. The first reason for this is that the two subsidies cover different situations. Furthermore, doing so allows a proper understanding of what the contingency laid down in the FSC Replacement Act means in respect of the different situations covered by the Act. Although the basic and the extended subsidy are both prohibited export subsidies, the reasons for this are different.

3. The basic FSC Replacement subsidy is prohibited because it is only applicable to profits arising from *export transactions*. The extended FSC Replacement subsidy is prohibited because it will often be necessary to use US articles (and therefore exports) in order to satisfy the *foreign content limitation*. Also, although the amount of both subsidies is the same, the conditions to be fulfilled to obtain it are different in each case (export of US goods in one case - export of US inputs and domestication in the second one).

4. Turning to the Panel's other precise questions:

- the subsidies arise from interconnected legal provisions.
- The EC is contesting a subsidy *scheme* (or *programme* to use the word employed in the *SCM Agreement*), rather than individual subsidy *payments*. It is therefore the conditions of the *law* that need to be consid-

ered, not the "legal circumstances in which it is granted on a *case-by-case* basis." However these conditions may differ from one category of cases to another (and do differ in the case of the FSC Replacement scheme between the basic FSC Replacement subsidy and the extended FSC Replacement scheme).

- As regards the legal condition under which subsidies are granted, the EC would add that the benchmark for the extended FSC Replacement subsidy would be the situation prevailing if the conditions (notably sale "not for use within the US" and the foreign content limitation) were not fulfilled. Generally applicable US tax rules would then require more tax to be paid.

5. With regard to the EC's Annex, the EC stresses that this was provided for the purposes of illustration. Although this relates to EC companies, the EC considers that, in view of the comparability and openness of the EC and US economies, the same cost structures can be presumed to also be illustrative of conditions in the US.

Q2 The European Communities claims that the FSC Replacement scheme is de facto export contingent and therefore contrary to Article 3.1(a) of the SCM Agreement.[1] Please explain how the legislation as such - which, by its terms, at least in the case of FSCs in existence on 30 September 2000, does not apply to transactions occurring before 1 January 2002 - can constitute a de facto violation of Article 3.1(a) of the SCM Agreement. Can the EC cite any GATT/WTO reports in which legislation as such was found to be a de facto violation of any obligations under the GATT/WTO Agreement?

Reply

6. The precise boundaries of *de facto* violations are not entirely defined. All the arguments of the EC can be considered to relate to *de jure* subsidies because, as the question puts it, the EC is attacking the law *as such.*

7. The EC would further note that the Appellate Body has considered that a *de jure* condition is one that arises from the words of the law or by *necessary implication* from those words.[2] That is the case here. The term *de facto* export contingent subsidy is probably best reserved for cases where the export contingency is not apparent at all from the text of the law or even a necessary implication but arises out of the exercise of some separate power – for example when a discretion to grant a subsidy is exercised in a way that means that the grant "is in fact tied to actual or anticipated exportation or export earnings" (see the terms of footnote 4 to the *SCM Agreement*).

8. The EC would also observe that the Appellate Body has held that the standard of contingency is the same, whether the subsidy arises *de facto* or *de jure*.[3]

.9. The EC would also refer the Panel to what it said on the requirements of proof regarding factual issues in cases such as this in its second written submission.[4]

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[1] EC first submission, para. 145.

[2] Appellate Body Report, *Canada – Certain Measures Affecting the Automotive Industry ("Canada – Automotive Industry")*, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, DSR 2000:VI, 2985, para. 99.

[3] Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft ("Canada – Aircraft")*, WT/DS70/AB/R, adopted 20 August 1999, DSR 1999.III, 1377, para. 167.

10. A complaint against a mandatory law that is not yet fully applied can in any event only be judged on the basis of the text and evident facts.

11. The EC has argued in the alternative that there is a *de facto* violation for the case that the Panel should take a different view of the distinction.

Q3. The European Communities states that it "… sees no reason to contest that the last sentence of footnote 59 may be an exception to Article 3.1(a)." [5] **Does this mean that the EC is of the view that measures satisfying the requirements for the last sentence of footnote 59 constitute "[m]easures referred to in Annex I as not constituting export subsidies" under footnote 5 of the SCM Agreement?**

Reply

12.. The EC was not stating that it considers that the last sentence of footnote 59 is an exception to Article 3.1(a). The precise requirements for a statement in Annex 1 to be considered as falling within the terms of footnote 5 have not yet been clarified by cases. The EC was merely stating that it does not consider it necessary for the Panel to address this question since the conditions of the last sentence of footnote 59 are in any event not fulfilled.

13. The EC would also emphasize that the last sentence of footnote 59 only applies to measures falling under the terms of item (e).

14. The EC considers that the last sentence of footnote 59 can be considered to be declaratory. The simple exemption of foreign source income is not in the view of the EC a subsidy at all, or at least not specific. This matter is discussed further in response to question 45 below.

Q4. Please provide further clarification of the point made in paragraph 161 of the EC second submission, if possible, with reference to actual cases addressing Article III:4 of the GATT.

Reply

15. The EC was making the point that an analysis of the origin of sub-components would have made the cases impossibly complicated.

16. The point, made in response to a paragraph of the US first submission (para. 203), is that, when a claim concerning a local content requirement is reviewed (under Article III:4 of the GATT as well as other WTO provisions), the *domestic* status of a given product depends on its origin as a "unitary" good. Whether this input, is in turn, made out of sub-components that were originally foreign is not relevant.

17. Likewise, when comparing the use of 'domestic' *over* 'imported' products in Article 3.1(b), one has to look at a product as a whole - if that is domestic, the previous (foreign) origin of some of its sub-components is irrelevant to assess whether there is preference for domestic products.

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[4] Second written submission of the EC, Section 4.1 (paras 41 to 58).

[5] EC second submission, para. 181.

18. Regard must be paid to the *current* origin of the products (domestic and foreign) being compared. There are no longer individual sub-components distinguishable from the domestic products that are being compared to the 'imported' ones.

19. The sub-components would further not be "like" or "directly competitive to" the foreign products to which the "qualifying foreign trade property" would be preferred.

20. There are, to the EC's knowledge, no cases under Article III:4 of the GATT where, in comparing domestic and imported products, panels looked beyond the domestic origin of products to check (and give relevance) to the former foreign origin of the sub-components of domestic products.

Q5. Please provide further clarification of the point made in paragraph 227 of the EC second submission.

Reply

21. The EC was simply pointing out that (contrary to what Canada appeared to believe) the income benefiting from the extended FSC Replacement subsidy need not be foreign-source. The example it gave was that of a US company distributing foreign-made goods. The reference to the FSC Replacement Act should be to Section 943(c), not Section 943(e)(4)(C).

Q6. The European Communities claims that the FSC Replacement scheme is a prohibited export subsidy contrary to Article 3.1(a) and item (e) of Annex 1 of the SCM Agreement. Are these alternative claims? In the EC's view, which claim must be addressed first by the Panel?

Reply

22. The claims are alternative.

23. The item (e) claim is also an Article 3.1(a) claim. It is Article 3.1(a) that brings the practices described in the Annex within the prohibition. The examples in the Annex are particular examples of prohibited subsidies.

24. It is a matter for the Panel whether it looks to the general terms of Article 3.1(a) or the Annex first. The EC has addressed the Article 3.1(a) claim first but does not consider that the Panel "must" do so.

Q13. Regarding the relationship between Article 3.1(a) of the SCM Agreement and item (e) of Annex I, would it be possible that a certain measure is not within the scope of the latter, but nonetheless within the scope of the former, and vice versa?

Reply

25. The EC believes it is possible that a measure could fall within the scope of Article 3.1(a) of the SCM Agreement but not item (e) of Annex I and also *vice versa*.

26. For example:

- Tax exemptions to export promotion or shipping companies (rather than the exporters themselves) may not fall under the general terms of Article 3.1(a) but would fall under item (e).
- A tax advantage that is not an exemption remission or deferral (e.g. a deduction) would not fall under item (e) but would fall under the general terms of Article 3.1(a) if contingent upon export performance.

Q14. The Panel is well aware that the WTO-conformity of income tax regimes of European countries is outside the scope of our terms of reference for this case. In paragraph 96 of the US first submission, the US introduces examples of a few European tax systems which "refrain from taxing foreign income in a qualified or conditional manner."[6] Among those systems, is there one which excludes foreign income from the scope of taxable income on the following conditions:

(i) the property for sale from which income arises must be held for ultimate use outside the country, (and not be sold for final consumption in that country); and

(ii) the same property must have foreign content of not more than a certain percentage of its fair market value.

Reply

27. The EC is confident that none of its Member States has such a tax system.

28. The US is apparently of the view that the term "foreign-source income" should be interpreted widely so as to signify export income. The EC would comment that if this had been intended, the last words of footnote 59 would have been "export income."

Q15. Is the term "foreign-source income," "foreign-source" or "source" used elsewhere in any provisions of other WTO Agreements than the SCM Agreement? What guidance, if any, may be drawn as to the meaning of these terms from the SCM Agreement or other WTO Agreements?

Reply

29. The term "foreign-source income" or "foreign-source" is only used in footnote 59. The word source is used elsewhere, notably in the trade defence agreements, including the SCM Agreement to refer to the origin of imports or of information.

30. As the EC has explained, the term "foreign-source income" is used as a taxation term of art in footnote 59.

31. At the hearing on the Panel also asked whether this expression was used in panel or Appellate Body reports.

32. The term foreign-source income was indeed used extensively by the US in the *DISC* and *Tax Legislation* cases to describe income arising outside the territory of the taxing country. For example, the US explained that:

[6] US first submission, para. 97.

> Prior to 1962 the United States did not tax the foreign source income of a foreign corporation organized outside the United States. Taxes on that income were deferred until the income was repatriated. When "sub-part F" was enacted in the Revenue Act of 1962, the United States began taxing currently to the United States shareholders of controlled foreign corporations the income from certain sales and services of these foreign subsidiaries.[7]

33. The US was using the term "foreign-source income" in the sense of "income from sources without the US" in Section 862 of the IRC. [8]

Q16. The European Communities claims that[9]:

> **"Even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) of the SCM Agreement because it gives exporters a choice that is not available to other operators…. This additional advantage would also be a subsidy,…. This unwarranted overcompensation is also a subsidy….**
>
> **(For the EC): Please provide a textual analysis of how the alleged additional advantage and overcompensation constitute subsidies under Article 1 of the SCM Agreement.**
>
> **(For the US): How does the US respond to this allegation?**

Reply

34. The argument that there is an additional subsidy is really just another way of stating what was already said (in the previous section 4.6.4, paragraphs 213 to 218 and 220) that a measure that gives rise to 'double' double taxation relief cannot be said to be "to avoid double taxation".

35. The EC is further arguing in paragraph 222 of its second written submission that the 'double' double taxation relief to which the FSC Replacement scheme can give rise (as explained in the section 4.6.4, paragraphs 213 to 218 and 220) is also a subsidy in that revenue is forgone that would be due under the generally applicable system of double taxation relief (the foreign tax credit system) which gives rise to a corresponding benefit.

36. It appears to the EC that Section 943(d) must, if it has any meaning, provide a possibility for such double double taxation relief.

Q17. The EC seems to argue that a Article 3.1(b) violation may exist if a certain measure gives an "incentive" to domestic production for export.[10] In the same vein, the EC argues that "Article 3.1(b) prohibits local-content contingency to *any* degree,… [and] there is no de minimis rule for prohibited subsidies in the SCM Agreement.".[11]

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7 *United States - Income tax legislation (DISC)* (BISD 23S/98), para.8.
8 Text in Exhibit EC-21.
9 EC second submission, paras. 221-222.
10 *See* EC first submission, para. 165.
11 EC second submission, para. 160.

(For the EC): How would this argument be supported by a textual analysis of Article 3.1(b) in accordance with Article 31 of the Vienna Convention? Can the European Communities cite any Appellate Body or panel reports in which the term "incentive" was explicitly used in the context of Article 3.1 of the SCM Agreement, or Article XVI:4 of the GATT Agreement?

(For the US): Would a textual analysis of Article 3.1(b) lead to a conclusion that the EC's above argument is without merit? If so, why and how? Would the US take the view that there is de minimis rule for prohibited subsidies in the SCM Agreement? If so, what is the qualitative or quantitative threshold for that rule? Is the Appellate Body Report in Canada - Certain Measures Affecting the Automotive Industry[12] relevant to this question? Please give reasons for your responses.

Reply

37. The two quotes are in a sense "in the same vein", even though they relate to separate points.

38. The first sentence concerns the main EC argument, that the foreign content rule is inconsistent with Article 3.1(b) because it gives rise to a requirement in *any* case, and is also related with a further question (no. 26).

39. The second sentence responded to the US argument about the origin of sub-components, and the response can be outlined as follows. The presence of sub-components in domestic articles is not relevant for the purposes of applying Article III:4 of GATT to a situation where more favourable treatment of foreign articles is alleged.

40. Furthermore, there is not a *de minimis* rule in the sense that there is not a minimum threshold of domestic sub-components for a US good to be caught by Article 3.1(b).

41. Article 3.1(b) applies to all *US goods* (and compares *all* of them to foreign products), no matter what they are made of. It is an unqualified prohibition.

42. By contrast, the first sentence quoted by the Panel (paragraph 165, EC's first written submission) does not address the meaning of the word "contingent", nor the meaning of the world "domestic", but rather the meaning of the clause "use of domestic over imported".

43. For the textual analysis of Article 3.1(b), the EC would refer to its Oral Statement. The EC has clarified the meaning of Article 3.1(b) in its entirety, whereas the US continues to provide a selective interpretation. In interpreting Article 3.1(b), the Panel is called to give meaning to all its words, including the clause "use of domestic over imported" products.

44. As to previous reports, we would point out that in *Canada – Automobiles* the Appellate Body, when comparing Article 3.1(b) and Article III:4 of GATT 1994, noted that the latter "*also* addresses measures that *favour* the use of domestic over imported good".[13]

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[12] WT/DS139/AB/R, WT/DS142/AB/R, DSR 2000:VI, 2985.

[13] *Canada – Automobiles*, Appellate Body Report, DSR 2000:VI, 2985, para. 140.

Q18. Relating to Article III:4 GATT, EC has cited[14], inter alia, the Panel Report on Italian Discrimination against Imported Agricultural Machinery.[15] We note that two other documents - GATT Doc. L/695 (1957) and GATT Doc. L/740 (1957) - address similar issues. Are these relevant to the question of whether Article III:4 of the GATT in the first place covers exemptions to the tax on the "firm"? Please comment on whether and how these reports are relevant to our case.

Reply

45. The EC referred to *Italian Discrimination Against Imported Agricultural Machinery* in paragraph 198 and in footnote 69 to paragraph 192 of its first written submission.

46. The Panel seems to raise a preliminary question as to whether the EC considers that the relevant question is not whether Article III:4 of the GATT "covers exemptions to the tax on the firm".

47. The EC wishes to clarify that it is not claiming that the tax exemption as such is a "requirement affecting internal sale" within the meaning of Article III:4 of GATT 1994.

48. As clearly results from the EC's first written submission,[16] the EC's claim under Article III:4 of GATT 1994 is focusing on the foreign content limitation, which affects the sale or use of products on the US market and discriminates against foreign products.

49. This has been correctly understood by the US in its first written submission,[17] and there is thus no difference between the parties in this respect.

50. More specifically, the EC submits that the foreign content limitation is a "requirement" not because "an enterprise is legally bound to carry [it] out", but because "an enterprise voluntarily accepts [it] in order to obtain an advantage from the government". [18]

51. The above quotes from *EEC - Parts and components* show that for the analysis under Article III:4 of the GATT the 'advantage' ultimately sought from the government when voluntarily accepting a certain "requirement" is not relevant. In particular it is not relevant whether it is an advantage to the "firm".

52. The situation was similar in the *Italian Discrimination Against Imported Agricultural Machinery* case.[19] In that case, Italian farmers (the "firms") received an advantage (the special purchase credit terms) on condition that they met a certain requirement (the purchase of domestic products - agricultural machinery).

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[14] EC first submission, para. 98.

[15] GATT Doc. L/833 (1958), adopted 23 October 1958, BISD 7S/60.

[16] See e.g. EC first submission, para. 188.

[17] US first submission, para. 211, where the US notes "[t]he EC claims that the 50 per cent rule of the Act provides less favourable treatment to imported products than to like domestic products in violation of Article III:4 of GATT."

[18] *EEC - Parts and components,* Panel Report, para. 5.21; see also EC first submission, paras. 191-195; EC second submission, paras. 240 ff.

[19] Panel Report, *Italian Discrimination Against Imported Agricultural Machinery*, adopted on 23 October 1958, BISD 7S/60.

53. The two documents referred to by the Panel appear to confirm that requirements like the foreign content limitation are covered by Article III:4 of GATT 1994. Doc. L/693 in particular related to a benefit to purchasers of agricultural machinery (the "firms"), which benefit had become conditional on the purchase of domestic machinery since the entry into force of decree no. 57,904. The UK government precisely challenged the discrimination resulting from inducing French farmers to buy domestic products in order for them to be eligible for the benefit.[20]

Questions of 13 March

Q23. The EC argues that, "for owners of US produced goods, export is a condition for obtaining the benefits under the scheme for those goods"[21] and that there is accordingly an export subsidy. Assume the existence of an exclusion from taxation for all foreign-source income based upon application of a pure territorial system. Would export not be a condition for owners of domestically-produced goods to obtain the exclusion in that case as well? Does this mean that the application of a pure territorial system would also involve an export subsidy? Please explain.

Reply

54. In a pure territorial system, business profits from domestic sales and exports are taxed in exactly the same way. Income tax is paid on all income *generated* in the country concerned. If a firm located in a country with a territorial system sells to unrelated customers on the domestic and export market, and obtains the same level of profit on both sales, they will be taxed the same.

55. If the same firm sells to a foreign subsidiary taking responsibility for the distribution (and therefore resale) of the goods on the domestic market, the parent will pay tax on the profit earned by it in selling to the foreign subsidiary in the transaction but not on the profit of the foreign subsidiary. The situation is the same where the firm to the foreign subsidiary for subsequent distribution on export markets; the parent will pay tax only on the profit earned by it in selling to the foreign subsidiary. Thus, in both cases, the profit earned by the foreign subsidiary in these transactions through its activities in the country where it is located is not subject to income tax on this profit in the country that has a pure territorial system. This is because countries with territorial systems tax only income earned from activities in their territory. The separation (attribution) of income is made on an objective basis – at arm's length (i.e. as if the transaction was concluded according to commercial and financial terms, which would apply between unrelated parties). Unlike the FSC Replacement Act, a pure territorial system does not exempt income generated by activities undertaken within the territory, be it export or any other activity. Therefore, there is no revenue forgone and no subsidy.

56. The US regularly states that the EC has accepted that territorial systems provide better treatment to export sales. The US has misunderstood the EC position. As explained above, a pure territorial system does not treat export sales more favourably. More favourable treatment of export sales through a foreign distribution com-

[20] *Guide to EC Law and Practice*, Analytical Index, Geneva, 1995, Vol. 1, p. 173.
[21] EC rebuttal submission, para. 102.

pared with domestic sales through a domestic distribution subsidiary may arise out of the fact that the foreign country has a lower tax rate (but not when the foreign tax rate is higher). However, when like is compared with like, there is, as explained above, no more favourable treatment of such export sales compared with domestic sales.

57. The US has also stated that the 1981 tax legislation cases have made "factual findings" that territorial systems provide better treatment to export sales. The EC does not agree that this is so and does not consider these cases, which dealt with a different legal provision in a different agreement and under very different dispute settlement arrangements, to be pertinent to the present dispute.

Q24. Would a measure that exempted foreign-source income from taxation (i.e., a pure territorial system) be a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59?

Reply

58. The EC considers that because the prevailing benchmark in territorial tax system is the taxation of income generated on the territory in question, the exemption of foreign source income does not involve revenue forgone and is not a subsidy under Article 1 of the *SCM Agreement*. It is also not contingent upon export performance or specifically related to exports. It is however undeniably a measure to avoid the double taxation of foreign-source income.

Q25. The EC argues that "the fact that the extension of the FSC replacement scheme to foreign produced goods is subject to a foreign content requirement creates in many cases a requirement for exports to be made from the US. This renders the extended FSC Replacement subsidy also export contingent and thus prohibited."[22] Is it the EC's view that the measure is contingent de jure on export performance? Or de facto? Is it export-contingent only in those cases where compliance requires the export of US goods, or does the fact that the export of US goods may sometimes be required render the "extended FSC replacement scheme" export-contingent in its totality?

Reply

59. As the EC stated in reply to question 2, it considers that its claim is of *de jure* export contingency but appreciates that some may consider it *de facto* contingency.

60. The Appellate Body has made clear that a *de jure* condition is one that arises from the words of the law or by *necessary implication* from those words.[23] That is the case here. It was clear from evident facts known to all at the time the law was adopted that respecting the foreign content limitation would require the use of US articles in many cases.

61. As also mentioned above, the EC considers that the term "*de facto* export contingency subsidy" is probably best reserved for cases where the export contin-

[22] EC first submission, para. 119.

[23] Appellate Body Report, *Canada – Certain Measures Affecting the Automotive Industry ("Canada – Automotive Industry")*, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, DSR 2000:VI, 2985, para. 99.

gency is not apparent at all from the text of the law or even a necessary implication but arises out of the exercise of some separate power – for example when a discretion to grant a subsidy is exercised in a way that means that the grant "is in fact tied to actual or anticipated exportation or export earnings" (see the terms of footnote 4 to the *SCM Agreement*.)

62. Thus, turning to the Panel's precise questions: it is the EC's view that the extended FSC Replacement scheme is contingent *de jure* on export performance; the fact that the export of US goods may sometimes be required renders the "extended FSC replacement scheme" export-contingent in its totality.

Q26. The EC states that the basic FSC subsidy is contingent upon the use of domestic over imported goods because domestic US articles will "often" be necessary to ensure that the foreign content limitation is not exceeded.[24] Is it the EC's view that the frequency with which this will be the case is relevant to whether the 50% foreign content rule is inconsistent with Article 3.1(b)? Would the rule be inconsistent with Article 3.1(b) if domestic US goods were "sometimes" necessary? Occasionally? Rarely?

Reply

63. The EC considers the "50% foreign content rule" to be inconsistent with Article 3.1(b) by the reason of the fact that it give rise to a requirement to use US article in *any* case.

64. The FSC Replacement scheme is a subsidy programme – that is it is a general measure that gives rise to prohibited subsidies, and mandates the bestowal of such subsidies if certain conditions are met. The EC is contesting it as a general measure that mandates, and does nothing to preclude, the grant of individual subsidies which are contingent upon the use of domestic over imported products. A subsidy programme that gives rise to such subsidies is also prohibited under Article 3.1(b).

Q27. Is the Panel correct in its assumption that the EC's GATT Article III:4 claim is limited to the application of the "foreign content limitation" in the context of the "basic FSC replacement subsidy"? If not, please explain how Article III.4 could be applicable to the "extended FSC replacement subsidy" in light of the fact that Article III:4 relates to less favourable treatment for imported products in relation to laws, regulations and requirements affecting the internal use of such a product.

Reply

66. Yes.

Q28. Is it possible to establish on the basis of the Act itself, and without reference to external facts relating to the manufacture of particular products, that the 50% foreign content rules require a beneficiary in some cases to use domestic over imported goods? If not, and taking into account the view of the Appel-

[24] EC first submission, para. 174.

late Body in Canada – Certain Measures Affecting the Automotive Industry[25] that contingency in law is demonstrated "on the basis of the words of the relevant legislation, regulation or other legal instrument", please explain how the Act could be contingent in law on the use of domestic over imported goods.

Reply

67. The Appellate Body went on to say, after the sentence quoted in the question, that "[a]s we have already explained, such conditionality can be derived by necessary implication from the words actually used in the measure" and referred in its footnote to para. 100 of the Report.

68. Paragraph 100 of the Appellate Body Report states:

> The simplest, and hence, perhaps, the uncommon, case is one in which the condition of exportation is set out expressly, in so many words, on the face of the law, regulation or other legal instrument. We believe, however, that a subsidy is also properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfilment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.

69. Thus, *de iure* export contingency can result "clearly, though implicitly, in the instrument comprising the measure." In the case before you, on the basis of the words of the law, that is on the basis of the words of the 50 per cent rule, it can be derived that one producer with a given cost structure will have to use US articles.

70. The implications of a law always require knowledge of certain facts (for example that companies want to make profits, that other countries impose taxes etc.). The EC considers that the fact that in the case of some products the value of articles used for production will account for more than half the final value of the product is such a known fact that a requirement to use US articles in such case arises by necessary implication from the terms of the FSC Replacement Act.

71. Identification of the producers who, in practice, need to use US articles is a question of fact, which need not be decided in reviewing a *de iure* claim. At any rate, the EC has provided indications on this matter relative to certain sectors.

Q29. The EC argues that, "if the Panel should not agree that the foreign content limitation applied to foreign producers [leads to the "extended" subsidy being a prohibited export subsidy], the EC argues in the alternative that Article 3.1(b) should be interpreted as also prohibiting the imposition of a foreign content limitation on foreign producers".[26] Article 3.1(b) prohibits subsidies contingent upon the use of domestic over imported goods. In the case of the application of the "foreign content limitation" to foreign producers, the alleged subsidy

[25] Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, DSR 2000:VI, 2985, para. 123.

[26] EC first submission, paras. 181-182.

could be viewed as contingent upon the use of imported over domestic goods. Please comment.

Reply

72. Article 3.1(b) is drafted on the assumption that a government is providing a subsidy to its own companies, which would usually be located within its territory. The words "domestic" and "imported" therefore refer to "national" and "foreign" products. In the unusual case of a subsidy granted to a foreign company, taking these words literally would give rise to absurd results that do not correspond to the evident intent of the parties.

73. An illustration of the fact that the terms of Article 3.1 must be interpreted from the point of view of the granting authority, rather than that of the recipient, is provided by the *Brazil – Aircraft* case. There the subsidies were granted to foreign airlines contingent upon the purchase of Brazilian aircraft. They were export contingent only from the point of view of the granting authority. From the point of view of the recipient they were rather import contingent.

74. Once it is accepted that the *SCM Agreement* applies to subsidies granted to foreign beneficiaries, a literal interpretation of the words "domestic" and "imported" in Article 3.1(b) gives rise to absurd results, manifestly contrary to the intent of the parties. As explained in the EC's second written submission, these words must therefore be interpreted, in the context of subsidies to foreigners, as meaning "national" and "foreign" (see also question 29). This is justified under the *Vienna Convention on the Law of Treaties* by the fact that treaties are to be interpreted in good faith. An absurd interpretation is not in good faith.

Q30. The EC states that the Act's foreign content limitation constitutes a "requirement" within the meaning of Article III:4 of GATT 1994.[27] Is the Panel correct in understanding that the EC does not assert that the foreign content limitation constitutes a "law" or "regulation" within the meaning of that provision?

Reply

75. It is a requirement contained in a law. The word "requirement" is sufficiently broad to encompass requirements that are contained in legislative measures, and this is the reason why the EC used it.[28] Of course, this does not mean that the EC is denying, or not asserting, that it is legislative in nature, that is *of general application* – just as the rest of the FSC Replacement Act, as made clear in the whole of the EC's argumentation.

Q31. The reference in Article III:4 of GATT 1994 to "laws" and to "regulations" appears to relate to the form of certain measures. By contrast, the term

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[27] EC first submission, Section 3.7.1.

[28] See e.g. the review of subsidies and other benefits as "requirements" in the *Guide to EC Law and Practice*, Analytical Index, Geneva, 1995, Vol. 1, p. 173, which covers i.a. the legislative requirements addressed in *Italian Discrimination against Imported Agricultural Machinery* and in GATT Doc. L/695 (see *supra*, Question 18).

"requirements" could be taken to have implications with respect to the nature of the measures. Please comment.

Reply

76. Indeed, the word "requirement" is focusing on the content of the measure under review.

77. The use of the word "requirement" confirms that Article III:4 also applies to measures that are not in the form of laws or regulations.[29]

78. The EC does not consider that the nature of the prohibition in Article III:4 depends on the form of the measure.

79. In any event, the standard laid down in Article III:4 of GATT 1994 is the same both for "laws" and "requirements".

80. There is some degree of overlap in the words "laws, regulations or requirements" in Article III:4, in the sense that laws and regulations will typically lay down "requirements".[30] The use of the broad term "requirement" aims presumably to avoid loopholes in Article III:4 coverage, thus to avoid that Members could escape its prohibition by selecting a particular form for their discriminatory measures.

Q32. What is the relationship, if any, between the scope of Article III:4 of the GATT and Article 3.1(b) of the SCM Agreement - is one necessarily broader than the other- could a measure fall within the scope of one of these provisions, but not within the scope of the other? Please substantiate your response with reference to past GATT/WTO dispute settlement reports and other materials.

Reply

81. Article 3.1(b) of the *SCM Agreement* has its roots in Article III:4 of GATT. The negotiating history of Article 3.1(b) indicates that the decision to prohibit subsidies covered therein was based on past experience under Article III:4 of GATT.

82. The *EEC – Animal Feed Proteins* case[31] was brought by the US under Article III:4 of GATT and concerned EEC legislation providing for a payment of subsidies to processors of oilseeds whenever they established by documentary evidence that they had transformed oilseeds of Community origin.

83. In the EC's view there is a difference in scope in the sense that of course, Article III:4 is broader than Article 3.1(b). For example, many measures in breach if Article III:4 (i.e. local content requirements) do not involve a subsidy. It is hard to see how a measure violating Article 3.1(b) of the *SCM Agreement* would not be caught by Article III:4 of GATT 1994.

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[29] For example, in *Canada - Autos* the panel found violation of Article III:4 of GATT 1994 with regard to the Canadian value added requirements contained in the Letters of Undertaking from private companies (see para. 10.130 of the Report, DSR 2000:VII, 3043).

[30] For example, para. 1 of the Annex to the TRIMs Agreement states: "TRIMs that are inconsistent with ... paragraph 4 of Article III of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, *and which require…*"

[31] Panel Report, adopted 25 January, 1990, 37S/86.

84. There is one paragraph of the Appellate Body Report in *Canada – Automobiles* that somehow sums this up. The Appellate Body considered Article III:4 as relevant "context" to interpret Article 3.1(b) of the *SCM Agreement* and took the following view:

> First, we note that Article III:4 of the GATT 1994 *also* addresses measures that *favour* the use of domestic over imported goods, albeit with different legal terms and with a different scope. Nevertheless, both Article III:4 of the GATT 1994 and Article 3.1(b) of the *SCM Agreement* apply to measures that require the use of domestic goods over imports.[32]

Q33. The EC states that "… the US review of its subpart F legislation is yet to be completed".[33] Please explain whether and how this statement is relevant to the current proceeding.

Reply

85. It simply refutes the US contention that the FSC Replacement Act represented the fruit of a review of US taxation of foreign income. It was simply a reformulation of the FSC scheme.

Questions of 16 March

Q34. Is the Panel to understand from Section 4.3.2 of the EC's rebuttal submission that the EC is not relying on the language "whether sole or as one of several other conditions" as a basis for its argument that the existence of "alternatives" to exportation as a means to gain entitlement to the alleged subsidy provided under the Act does not eliminate the alleged export contingency?

Reply

86. That is correct. The EC argument does not depend on these words. The presence of these words does however confirm the EC position.

Q35. Please comment on paragraphs 91, 108, 159 and 170-171 of the US Oral Statement.

Reply

Paragraph 91

87. In paragraph 91 the US argues that the EC arguments would make territorial tax systems export contingent subsidies.

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[32] Para. 140 of the Report, DSR 2000:VII, 3043 (emphasis added).
[33] EC rebuttal submission, para. 29.

88. This is incorrect. As already explained in the EC's answer to question 23 from the Panel,[34] under a territorial tax system, taxation depends on where income is earned. Income can be earned abroad even where goods are sold into the territory of the taxing country. (See also paragraph 40, second bullet of the second written submission of the EC).

89. Thus, the allegation by the US that export sales are taxed more favourably than domestic sales is incorrect. In addition, in a territorial system, the exemption of foreign-source income from tax does not require that ultimate use of a product (following resale or processing) to be outside the domestic market. A territorial system taxes income from economic activity – the final destination of the product is irrelevant.

90. Under the FSC Replacement scheme, taxation depends on whether goods are sold not "for ultimate use in the US". In the case of US goods, this necessarily means that they have to be exported.

91. Such export contingency is not a necessary feature of a worldwide tax system. Both territorial and worldwide systems are normally export neutral. Both are based on perfectly defendable and yet conflicting desires to achieve tax equity.

92. As the EC explained during the course of the original proceeding, the worldwide approach is sad to seek capital-export neutrality and the territorial approach capital-import neutrality.

93. According to the principle of capital-export neutrality, it is considered inequitable that taxpayers should pay less tax when establishing themselves abroad and a country should design its international tax rules so as to neither encourage nor discourage outflows of capital. According to the principle of capital-import neutrality, it is considered inequitable for companies establishing themselves abroad to be subject to a higher tax burden because of their links to the capital exporting country and a country should therefore adopt international tax rules that seek to avoid its multinational companies bearing a higher effective tax burden in foreign markets than the local domestic companies or the multinational companies of other countries.

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[34] EC's answer to Panel's question 23:

> In a pure territorial system, business profits from domestic sales and exports are taxed in exactly the same way. Income tax is paid on all income *generated* in the country concerned. If a firm sells to unrelated customers on the domestic and export market, and obtains the same level of profit on both sales, they will be taxed the same.
>
> If the firm sells through a foreign subsidiary on the domestic market, the parent will pay tax on the profit earned by it in selling to the related subsidiary in the transaction. Similarly, if the firm sells through a foreign subsidiary on the export market, the parent will pay tax on the profit earned by it in selling to the foreign subsidiary in the export transaction. In both case, the profit earned by the foreign subsidiary in these transactions through its activities in the country where it is located is not subject to tax on this profit in the country that applies the pure territorial system. This is because territorial systems tax only income earned from activities in its territory. The separation (attribution) of income is made on an objective basis – at arm's length (i.e. as if the transaction was concluded according to the commercial and financial terms, which would apply between unrelated parties). Unlike the FSC Replacement Act, a pure territorial system does not exempt income generated by activities undertaken within the territory, be it export or any other activity. Therefore, there is no revenue forgone and no subsidy."

94. Both systems have a rational basis and choosing one or the other cannot by itself, in the view of the EC, give rise to a subsidy. As the Panel observed in the original proceedings:[35]

> Thus, the United States is free to maintain a world wide tax system, a territorial tax system or any other type of system it sees fit. This is not the business of the WTO. What it is not free to do is to establish a regime of direct taxation, provide an exemption from direct taxes specifically related to exports, and then claim that it is entitled to provide such an export subsidy because it is necessary to eliminate a disadvantage to exporters created by the US tax system itself.[36] In our view, this is no different from imposing a corporate income tax of, say, 75 per cent, and then arguing that a special tax rate of 25 per cent for exporters is necessary because the generally applicable corporate tax rate in other Members is only 25 per cent.

Paragraph 108

95. In paragraph 108, the US claims, in answer to the EC claim under item (e), not to understand how a measure that makes no reference to exportation, does not require exportation, and applies to a broad range of non-export transactions can be said to be "specifically related to exports."

96. The EC has already explained that the FSC Replacement scheme does require exportation even though it does not use the word "exportation" or "exports".[37]

97. The word "specifically" does not mean "expressly". It means, "having a special, precise or clearly defined relationship or connection to exports." [38]

98. The basic FSC Replacement subsidy (relating to US goods) has such a relationship to exports because it is necessary to export in order to benefit from the scheme. The extended FSC Replacement subsidy (relating to foreign-produced goods) has such a relationship because in many cases it will be necessary for US goods to be exported as components or raw materials in order to respect the foreign content limitation.

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[35] Panel Report, DSR 2000:IV, 1675, paragraph 7.122.

[36] The Panel's footnote reads:

> As the Appellate Body has stated, "Members of the WTO are free to pursue their own domestic policy goals through internal taxation or regulation *so long as they do not do so in a way that violates Article III or any of the other commitments they have made in the WTO Agreement*" (emphasis added). *Japan – Taxes on Alcoholic Beverages*, WT/DS8/AB/R-WT/DS10/AB/R-WT/DS11/AB/R, Report of the Appellate Body adopted on 1 November 1996, p. 16, DSR 1996:I, 97, at 110.

[37] E.g. first written submission of the EC, paragraph 71. It is worth noting that the definition of "qualifying foreign trade property" in the FSC Replacement Act is in this respect identical to the definition of "*export* property" under the FSC, which read "The term "export property" means property …(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct *use, consumption, or disposition outside the United States*." (emphasis added) The US had therefore no difficulty in using the word "export" to designate property "for disposition outside the United States".

[38] First written submission of the EC, paragraph 153.

Paragraph 159

99. In paragraph 159 the US seeks to respond to the EC argument that the statements of the Appellate Body in Canada – *Automotive Products* (where the Appellate Body considered that a measure requiring 60 per cent domestic value does not necessarily lead to a conclusion of *de jure* contingency) were not pertinent in the present case, since the FSC Replacement Act is a legislative measure applying to an undetermined and unlimited series of instances whereas the *Canada – Automotive Products* case concerned *individual measures*, each one applying a specific local content requirement to individual companies.[39]

100. The US argues that the EC "misses the most significant feature" of the *Canada – Automotive Products* decision which is, according to the US, that "the Appellate Body concluded that it could not determine whether a value-based requirement was *de jure* contingent on the use of domestic over imported goods without understanding how the measure actually operated."

101. The US simply fails to respond to – indeed misses – the EC's point. That is that the FSC Replacement scheme is attacked a legislative measure *as such* not in its application to particular goods or companies. In such a case all that the EC has to show is that contingency on the use of domestic over imported goods can arise – or is not precluded.

Paragraphs 170 – 171

102. In paragraph 170 the US refers back to paragraphs 217-218 of its first written submission and to the panel and Appellate Body reports cited therein, allegedly supporting the US contention that "generally applicable measures" give rise to a higher evidentiary burden than measures concerning a "specific class of imported products".

103. In its second written submission the EC has refuted the US contention about two evidentiary standards under Article III:4 GATT of 1994, which has no basis in the text of that provision, and has shown that the standard required is the one most recently articulated by the Panel in *Canada – Autos*.[40] Previous panels have relied indifferently on panel reports dealing with product-specific and with general measures.[41] This is most logical since otherwise WTO Members could easily circumvent the prohibition in Article III:4 of GATT 1994 by turning a series of product-specific measures – allegedly easier to challenge - into one single measure of general application.

104. Whatever its content, the US categorization is therefore plainly irrelevant to review the EC's Article III:4 claim.

105. Nonetheless, in view of the Panel's request the EC wishes to recall the following. In paragraphs 217-218 of its first written submission (referred to in paragraph 170 of the US oral statement) the US had exemplified its newly created category of

[39] Second written submission of the EC, paragraph 171 to 173.

[40] Referred to in the first written submission of the EC, paras. 201-204; second written submission of the EC, para. 232.

[41] First written submission of the EC, para. 201; Oral Statement of the EC, para. 87. For example, in *Canada - Autos* the panel refered to *US - Section 337* (where a general measure was at issue) in para. 10.78 of its report, DSR 2000:VII, 3043.

requirements applicable to a "particular class of imported products" by referring to the *Canada – Autos* and *US – Gasoline* panel reports.[42] These reports were clearly concerned with product-specific measures (relating to cars and other motor vehicles in the former case, and to gasoline in the latter one). It follows that the phrase "particular class of imported products" means "product-specific measures", as those at issue in the two panel reports cited. The US then contrasted this category with that of "generally applicable measures".

106. In paragraph 171 of its Oral Statement the US appears to have changed the meaning of its self-created category of measures relating to "particular class of imported products", since it now employs that term to designate the measures reviewed in *EEC - Parts and Components*.

107. As explained by the EC,[43] the measures reviewed in *EEC - Parts and Components* did *not* relate to a "particular class of imported products", but applied horizontally to all possible components used in the production of all possible products subject to anti-dumping measures. Indeed, those measures were strikingly similar to the foreign content limitation laid down in the FSC Replacement Act, which applies to all possible products that can be exported from the US and used for the production of qualifying foreign trade property. [44]

108. As a last point, the EC notes that the US keeps referring to the panel report in *Japan - Film*[45] in support of its argumentation for a "heightened evidentiary burden". The EC would point out that in the very paragraph referred to by the US[46] the panel found that the measures challenged by the United States were *origin-neutral* and that the US had not shown that, notwithstanding their not being discriminatory on their face, these measures had a differentiated impact on imported products (i.e., it had not established a *de facto* case).

109. The situation before the panel in *Japan - Film* was therefore opposite to the present case. The EC has brought a *de iure* claim against a statutory requirement which is origin-based, since it specifically places a limit on *foreign* products only.

110. Therefore, referring to the "disparate impact" of these measures "in their application" on imported products is totally inapposite in this dispute. As noted by the panel in *Canada - Automotive Products*

> a measure which provides that an advantage can be obtained by using domestic products but not by using imported products has an impact on the conditions of competition between domestic and imported products and thus affects the "internal sale,… or use" of imported products, even if the measure allows for other means to obtain the advantage, such as the use of domestic services rather than products. Consequently, the CVA requirements, which confer an advantage

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[42] Similarly, in para. 218 the US refers to "like class of imported goods".

[43] Second written submission of the EC, paras. 240 ff.

[44] In any event, it is hard to see how a measure involving "imported component parts" could be termed as "involv[ing] a *specific* class of imported products", or indeed a "class of products" at all. There are products which can indifferently be sold and used in the state as they are or used as components in the production of other products. Thus, a category of that type would be undefined and open-ended.

[45] Panel Report, *Japan – Measures Affecting Consumer Photographic Film and Paper* ("*Japan - Film*"), WT/DS44/R, adopted 31 March 1998, DSR 1998:IV, 1179.

[46] Panel Report, *Japan – Film*, , DSR 1998:IV, 1179, para. 10.381.

> upon the use of domestic products and deny that advantage in case of the use of imported products, must be regarded as measures which "affect" the "internal sale,… or use" of imported products, notwithstanding the fact that the CVA requirements do not in law require the use of domestic products. [47]

111. The EC would further point out that the only "meaningful nexus" referred to in that paragraph of the *Japan – Film* panel report is between two of the measures challenged by the US and the *pre-existing* market structure. Examination of the market structure pre-existing the adoption of a measure is not relevant to review a *de iure* claim.

112. The Panel will have also noticed that the phrase "heightened evidentiary burden" is nowhere used in the *Japan – Film* panel report.

113. The EC would also note that the *Japan – Film* report also supports its conclusions by referring to the *US - Section 337* panel report - that is, a report reviewing a measure which can genuinely be defined "of general application" .

Q36. In regard to the "extended" FSC Replacement subsidy scheme, is there "revenue forgone" that is "otherwise due"? What is the US legal rule that would apply to the foreign beneficiary of the extended scheme in the absence of the "extended" scheme? What is the "some other situation" for foreign beneficiaries of the "extended" regime, in which their income would be subject to the US taxation? If, in the EC's view, it is different from the legal rule - normative benchmark - applicable to the "basic" subsidy scheme, please specify.

Reply

114. The "some other situation" or applicable benchmark in the case of the extended FSC Replacement subsidy is that which would prevail if the conditions for obtaining the benefit of the FSC Replacement scheme were not fulfilled. That is the situation that would prevail if the goods were "for ultimate use in the United States" or if the foreign content limitation were not respected.

115. In these cases, the income from the transactions would not be "excluded" from tax but would be taxable under the generally applicable rules.[48]

116. In the case of US taxpayers (i.e. where a transaction is carried out by a foreign branch of a US corporation or involves distribution activities carried out in the US relating to foreign produced goods), the income would be taxable under Section 11 of the IRC[49] in conjunction with Section 61 (see further the answer to question 37 below).

117. If a foreign corporation conducts the transaction, the income produced from the transaction would, if the FSC Replacement scheme did not apply, not normally be directly taxable in the US.

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[47] *Canada - Automotive Products,* Panel Report, DSR 2000:VII, 3043, para. 10.82.

[48] In this and the next question, the EC will refer to provisions of the US law. The US has provided some of the provisions in its Exhibit US-4. Others are supplied in Exihibit EC-21. If the Panel wishes to consult other provisions of the IRC, it may wish to know that they are available on the internet (e.g. at *www.fourmilab.ch/ustax/www/contents.htlm*).

[49] Extracts from the IRC that are not already before the Panel are contained in Exhibit EC-21.

118. Foreign corporations only pay tax in the US on income "from sources within the US" (i.e. US source income) under section 881 of the IRC and on income "effectively connected with a US trade or business" under section 882 of the IRC. In this connection it may be noted that the definition of what is US source and foreign source (i.e. from "sources without the United States") is contained in sections 862 of the IRC.

119. Thus the foreign-source income of a foreign corporation that is not effectively connected with a trade or business in the US is not directly taxable in the US.

120. If the foreign corporation is a subsidiary of a US corporation, the income would be taxable when remitted to the US as dividends (section 61(a)(7) makes dividends received part of gross income). The dividends received deduction in section 243 of the IRC does not apply to dividends received from non-taxpayers such as the foreign subsidiary. The parent corporation may even have to pay tax earlier on deemed dividends if the anti-deferral provisions of sub-part F of the IRC are applicable.

121. The corporation may however, under the generally applicable US rules, claim a foreign tax credit for the tax borne outside the US but this is limited to foreign source income (section 904 of the IRC).

122. If a foreign corporation that is not a subsidiary of a US corporation conducts the transaction, the income would not be taxable in the US either directly or indirectly. In this case the application of the FSC Replacement scheme would not give rise to a subsidy because no revenue would be forgone.

123. The EC accepts that the extended FSC Replacement subsidy will in many cases not give rise to revenue forgone, in fact that it might only rarely do so. That is because deferral of tax on the income of a foreign subsidiary may, when it is available under US rules, often be more advantageous than the FSC Replacement scheme and because foreign corporations that are not subsidiaries of US corporations will not be subject to tax in the US on their foreign source income and will not therefore have any interest in using the (extended) FSC Replacement scheme. However, the extended FSC Replacement scheme is elective and it is clear that companies will only invoke it where it gives rise to a reduction in taxation. That is why it is a subsidy no matter how rarely it may be used.

Q37. What is the US "norm" which can constitute a "normative benchmark" for the purpose of Article 1 of the SCM Agreement? Can the EC specifically identify any US tax rules in addition to the new Section 941(a)(1) of the IRC, which defines the term "qualifying foreign trade income"? In other words, what is the statutory basis for the EC's argument that the US is still maintaining its "worldwide" tax system?

Reply

124. One starting place for this analysis could be the US Constitution. The power to impose income taxes is derived from the Sixteenth Amendment to the Constitution.[50] It states in pertinent part that:

[50] The full text of amendment XVI is

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived... .

125. From the earliest days of the income tax, the Supreme Court has made it clear that this includes the power to tax the foreign source income of US citizens.[51]

126. Section 61 of the Internal Revenue Code[52] embodies the exercise by Congress of the broad power given to it by the Sixteenth Amendment. Section 61 states in pertinent part that

> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived... .

127. The Supreme Court has commented on the "sweeping scope" and "pervasive coverage" of the provision now codified in section 61, stating that "the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted."[53]

128. It should be noted that "taxable income" is defined in section 63 of the IRC as "gross income minus the deductions allowed by this chapter... ." And section 11 of the IRC specifies that corporations are subject to tax on their "taxable income." Thus US corporations are subject to tax on income "from whatever source derived... ."

129. This state of affairs is recognized by the various treatises on US taxation of foreign operations. For example, one treatise states that:[54]

> The United States generally taxes U.S. citizens, resident alien individuals, and domestic corporations on their worldwide incomes.

130. Another states that US domestic corporations:[55]

> are taxed by the United States on their worldwide incomes.

131. The maintenance of the world-wide taxation system by the US is also recently (in December 2000, that is, after the adoption of the FSC Replacement scheme) clearly recognized in a study prepared by the US Treasury on "the Deferral of Income Earned Through US Controlled Foreign Corporations"[56]. The fact that the US continues to have a tax system which is fundamentally based on current taxation of world-wide income of US taxpayers is in fact and according to the study the underlying reason for the need of anti-deferral measures (Subpart F of the IRC). This state of affairs is reflected throughout the study, of which the conclusions also suggest that as the US tax system continues to be based on the principle of current taxation of the world-wide income of US taxpayers and as corporations are treated as separate taxpayers and separate legal entities from their owners, there is a continuous need for anti-deferral regime in the US tax system. By way of example, in Chapter 8 of the

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> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census of enumeration.

[51] See *Cook v. Tait*, 265 US 47 (1924).

[52] Text in Exhibit US-4.

[53] *Commissioner v. Glenshaw Glass Co.*, 348 US 426 (1955).

[54] Kuntz and Peroni, *U.S. International Taxation*, vol. 1, at p. A1-19 (1992).

[55] Isenbergh, *International Taxation: U.S. Taxation of Foreign Persons and Foreign Income*, vol. 1, at p. 2:32 (2nd ed. 2000).

[56] *The Deferral of Income Earned Through US Controlled Foreign Corporations; A Policy Study*. Office of Tax Policy Department of the Treasury, December 2000, Chapter 8 (Restatement of Conclusions of this voluminous study is attached as Exhibit EC-22 – the EC would be happy to provide a complete copy if the Panel wishes).

study (Restatement of Conclusions) in relation to the background of the subpart F legislation it is stated:

> …subpart F was, more generally, one in a series of measures addressing tax avoidance problems caused by a structural tension in the tax system. This tension is caused by the incompatibility of *certain fundamental features of the U.S. tax system, principally the current taxation of worldwide income* and the treatment of corporations as taxpayers and legal person separate from their owners. *These incompatible features are still a fundamental part of the U.S. tax system*.[57]

132. A relatively short list of items specifically excluded from gross income is set forth in sections 101 through 139 of the Code. The FSC Replacement Act added section 114 to that list. In keeping with their view that, in enacting the Internal Revenue Code, Congress intended to exercise quite fully its power to tax income, the Courts have long held that provisions granting deductions or exclusions of items from gross income are "matters of legislative grace" and are therefore to be "strictly construed."[58]

133. The EC has explained that section 114(a), in conjunction with the other conditions set out in the FSC Replacement Act, creates a fairly narrow exception to the general rule of US taxation of worldwide income.

134. In some respects, section 114 is similar to section 911 of the IRC. Section 911(a) states, in seemingly expansive terms, that the foreign earned income of a US citizen residing abroad is, at the election of such individual, to be excluded from such individual's gross income. Section 911(c), however, limits the amount that may be excluded to a stated annual amount ($78,000 in 2001).

135. Just as the US section 911 does not create a normative benchmark of non-taxation of the foreign earned income of US citizens resident abroad (particularly in light of the limitation and the elective nature of the exclusion), so also the new section 114(a) does not do so. Indeed, in both cases the existence of a limited exclusion or exemption in fact *confirms the general rule* of taxation.

136. The term "qualifying foreign trade income" is a creation of the new legislation. It is not a concept used elsewhere in the Code. Thus the statutory provisions that would apply to "qualifying foreign trade income" in the absence of the FSC Replacement scheme is section 11 of the IRC specifies that corporations are subject to tax on their "taxable income."

137. Finally, the EC would refer the Panel to the many reasons that the EC gave in paragraphs 40 to 52 and 55 of its first written submission to show that the exclusion of income from under the FSC Replacement scheme was in reality an exception and not the general rule.[59] Most significant perhaps is the fact that under the FSC Re-

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[57] *The Deferral of Income Earned Through US Controlled Foreign Corporations; A Policy Study*. Office of Tax Policy Department of the Treasury, December 2000, Chapter 8 (Restatement of Conclusions of this voluminous study is attached as Exhibit EC-22 – the EC would be happy to provide a complete copy if the Panel wishes), page 96, emphasis added.

[58] See, e.g., *Interstate Transit Lines v. Commissioner*, 319 U.S. 590 (1943); *Jones v. Kyle*, 190 F.2d 353 (10th Cir. 1951), cert. denied, 342 US 886.

[59] An additional reason which the EC did not mention in its first written submission is the fact that the FSC Replacement scheme does not apply to property which is considered in short supply (and of which the Us does not want to encourage the export). See paragraph 15 of the closing statement of the EC to the meeting of the Panel.

placement Act (new section 941 of the IRC) provides that only a certain portion of US taxpayers income attributable to foreign trading gross receipts qualifies for the exclusion, i.e. the exclusion is only partial.

138. The EC submits that it is therefore clear that the FSC Replacement scheme does not represent the benchmark or the general rule but is an exception to it.

Q38. In paragraph 185 of the US Oral Statement, the US argues that "[a]s reflected in Article 19.1 of the DSU, the WTO does not provide retroactive relief for alleged past wrongs." Please comment, in particular, on the US reference to DSU 19.1 and its relevance to the instant case.

Reply

139. Panel reports inevitably relate to facts that lie in the past. In some cases violations may be continuing and in others they will have terminated.

140. There is no general principle in the WTO that panels cannot rule on violations that have terminated. Not only is there no provision in the WTO to this effect, panels regularly do rule on terminated violations. The EC will give two recent examples:

- in *Korea – Dairy* violations of the notification deadlines in the *Safeguards Agreement* were found despite the fact that the notifications had been made prior to the request for the establishment of the panel;[60]
- In *United States – Import Measures*[61] violations of a series of WTO provisions were found despite the fact that the measure (provisional suspension of liquidation on certain imports from the EC) had ceased to exist prior to the request for the establishment of the panel.

141. The US seeks to derive such a principle from the fact that the WTO does not provide for retroactive remedies which it considers is reflected in Article 19.1 of the *DSU*.

142. However, the EC is not requesting any "remedy" in this proceeding. It is asking for a disagreement to be adjudicated. The DSB adopted the Panel and Appellate Body reports declaring the FSC scheme to be inconsistent with the obligations of the US under the *WTO Agreement* on 20 March 2000. It required the US to withdraw the subsidy and bring itself into conformity with its obligations with effect from 1 October 2000 and ultimately required the US to adopt the necessary measures by 1 November 2000.

143. Although the US failed to adopt the necessary measures by 1 November 2000, it persists in arguing that it "complied with the time period specified by the DSB."[62] The EC disagrees and asks the Panel to rule on this disagreement.

144. If the US were correct in its contention, panels would in particular never be able to rule on disputes concerning exclusively the *timeliness* of any measure (rather

[60] Panel Report, *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products ("Korea – Dairy Safeguards")*, WT/DS98/R, adopted 12 January 2000, as modified by the Appellate Body Report, WT/DS98/AB/R, DSR 2000:I, 49, para. 8.1.

[61] Panel Report, *United States – Import Measures on Certain Products from the European Communities ("United States – Import Measures")*, WT/DS165/R, adopted 10 January 2001, WT/DS165/AB/R, DSR 2001:II, 413, para.7.1.

[62] First written submission of the US, Section V. H. 2 (esp. heading).

than its existence) since such disputes would relate to violations that have terminated. The timeliness of implementation is one of the matters that a panel is required to decide under Article 21.5 of the DSU.

145. The question of what, if any, recommendation a panel makes in such a case is a separate matter that only arises once it has decided the nature and extent of the violations. This is demonstrated by the fact that panels can make findings and then not find it necessary to make any recommendations, as the Appellate Body did, for example, in *United States – Import Measures*.[63]

146. Generally, panels established under Article 21.5 *DSU* are not called upon to make recommendations under Article 19.1, but simply to make findings and adjudicate the disagreement relating to implementation. As the Article 21.5 panel in *Canada – Aircraft* stated (when requested to make a suggestion under Article 19.1):[64]

> In our view, Article 19.1 envisions suggestions regarding what could be done to a measure to bring it into conformity or, in the case of Article 4.7 of the SCM Agreement, what could be done to "withdraw" a prohibited subsidy. It does not address the issue of surveillance of those steps. For that reason, we decline to make the suggestion requested by Canada.

147. The EC would remind the panel that Mr Suringa's statements reported by the BNA Daily tax report (see EC-Exhibit 14), and confirmed during the hearing, indicate that implementing regulations and guidance about three primary elections under the FSC Replacement Act are not issued yet. This statements put into question whether in fact the US has implement the DSB recommendations and rulings at all and leaves open the question of when the US will do so.

Q39 In the EC's view, would the Act be consistent with the SCM Agreement if the United States eliminated the requirements that the property be held for use "outside the United States" and the "foreign content limitation"?

Reply

148. Yes, there would no longer be a prohibited subsidy within the meaning of Article 3 of the *SCM Agreement*.

Questions for both parties

Q43. Can a measure of a Member provided in respect of the production of a good outside the territory of that Member be a subsidy within the meaning of Article 1 of the SCM Agreement? Please explain your answer, taking into account any relevant provisions of the SCM Agreement.

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[63] Appellate Body Report, *United States – Import Measures on Certain Products from the European Communities ("United States – Import Measures"),* WT/DS165/AB/R, adopted 10 January 2001, DSR 2001:I, 343, para. 129.

[64] Article 21.5 Panel Report, *Canada – Measures Affecting the Export of Civilian Aircraft ("Canada – Aircraft")*, WT/DS70/RW, adopted 4 August 2000, as upheld by the Appellate Body Report, WT/DS70/AB/RW, DSR 2000:IX, 4315, para. 6.4.

Reply

149. Article 1.1(a)(1) of the *SCM Agreement* provides that:

> For the purpose of this Agreement, a subsidy shall be deemed to exist if:
>
> there is a financial contribution by a government or any public body *within the territory of a Member*

150. The italicized words in Article 1.1(a)(1) above qualify the nature of "public body" that may also give a subsidy. It does not imply a territorial limitation on where a "financial contribution" may be given or received. If this had been meant a different word order would have been used.

151. The ordinary meaning of the text is confirmed by the negotiating history. The original Chairman's text of 18 July 1990[65] referred only to a "financial contribution" in defining a subsidy in the then Article 3.1(a). The next revision of the text[66] clarified the definition as "a financial contribution by a government or any public body within the territory of a signatory (hereinafter referred to as "government").

152. This definition, while clarifying and arguably expanding the definition of government, qualified the definition of subsidy by making it clear that a financial contribution by a public body *outside* the territory of the Member concerned did not constitute a subsidy.

153. In any event, a financial contribution from a government, at least when created through the forgoing of revenue collected by that government, will always arise in the territory of the granting Member, since that is where the government in question is situated.

154. There is, on the other hand, no limitation in the text of the other component of a subsidy in Article 1 of the *SCM Agreement*, as to where this benefit should be conferred.

155. Where a taxpayer that benefits from the FSC Replacement scheme is situated outside of the US, it may be considered that the benefit is conferred outside the US. But nothing in the text of Article 1.1(b) of the *SCM Agreement* suggests that only benefits conferred within the territory of the granting Member are relevant. On the contrary the fact that the words "within the territory of a Member" do not apply to benefit in Article 1.1(b) although they are a feature of "financial contribution" in Article 1.1(a), implies that there is no territorial limitation on where the benefit can be enjoyed.

156. This was also, as the EC observed in paragraph 65 of its first written submission, the view taken by all the parties, the panel and the Appellate Body in the *Brazil-Proex* case, which also involved a subsidy granted to foreigners (foreign airlines).

157. The EC is aware that the US treats so-called "transnational subsidies" as being in principle non-countervailable under section 351.527 of the US countervailing duty legislation.

158. The EC doubts whether this non-countervailability of "transnational subsidies" is required under Part V of the *SCM Agreement* on countervailing duties. It notes that Part V does not limit participation in countervailing duty investigations but extends this to all "interested Members," so that the non-subsiding country of export would also be able to participate. The EC takes no position on this question but

[65] Doc. MTN.GNG/NG10/W/38 of 18 July 1990.
[66] Doc. MTN.GNG/NG10/W/38/Rev of 4 September 1990.

would only point out that the difficulties that arise when applying a countervailing duty in such circumstances do not exist in the case of prohibited or actionable subsidies. This is because a countervailing duty can only be imposed on the country *exporting* the goods in question, which in the hypothesis under consideration is not responsible for the grant of the subsidy. A WTO dispute settlement proceeding concerning a prohibited or an actionable subsidy would however be brought against the country granting the subsidy (in this case, the US), not against the country in which the primary beneficiary of the subsidy is situated (in this case, the country of the foreign corporation).

159. Even if one were to construe Article 1 of the *SCM Agreement* as only relating to subsidies for the production of goods within the territory of the Member responsible for the measure, it would still be necessary to consider that the extended FSC Replacement subsidy was a prohibited export subsidy.

160. The FSC Replacement scheme is a direct subsidy to the production not "for ultimate use within the US" of qualifying foreign trade property. But the foreign content limitation also makes it an *indirect* subsidy to the production in the US of raw materials and components ("articles" in the words of the FSC Replacement Act) of all kinds that can be utilized in making qualifying foreign trade property while respecting the foreign content limitation.

161. In the case of the extended FSC Replacement subsidy, the *indirect* subsidy to the production in the US of articles of all kinds that can be utilized in making qualifying foreign trade property is contingent upon export. It is contingent upon export because in those cases where articles make up more than 50% of the fair market value of the foreign produced goods, it will be necessary for goods to be exported from the US in order for the foreign content limitation to be respected.

162. It may also be noted that, according to the US itself, the extended FSC Replacement subsidy is also available to US companies that distribute from the US qualifying foreign trade property manufactured outside the US.

Q44. Assume for the sake of argument that the answer to question 43 is no. What relevance, if any, would such a conclusion have in respect of the issues of export contingency which are before the Panel in this dispute?

Reply

163. As explained in the answer to the last question, the extended FSC Replacement subsidy would still be an indirect subsidy to US articles which is contingent upon them being exported.

164. It would also have no effect on the export contingency of the basic FSC Replacement subsidy.

165. As the EC has argued at length, the fact that an advantage can in some circumstances be obtained without exporting does not stop it being export contingent in those circumstances where export is a necessary condition for obtaining the subsidy.[67] An export contingent subsidy does not cease to be so if it is included in a wider measure whereby a similar advantage is granted in an unobjectionable manner.

[67] First written submission of the EC, paragraphs 62 to 66 and 123 to 127, second written submission of the EC, paragraphs 8 to 15 and the oral statement of the EC, paragraphs 35 to 38.

166. The extended FSC Replacement subsidy and the basic FSC Replacement subsidy are available in mutually exclusive circumstances – a good is either produced within the US or outside the US.

167. These arguments only become stronger if the tax advantage given to transactions involving foreign-produced goods is not considered to be a subsidy at all (and therefore not relevant for the purposes of the *SCM Agreement*). After all, the "advantage" of not paying tax can also be obtained by not producing any goods at all or by not making any profit on the sale of goods that are produced. This is clearly not a subsidy and is irrelevant for the purposes of the *SCM Agreement*.

Q45. Is export income foreign source income? Some may take the view that the "foreign-source income" referred to in footnote 59 should include export income since the footnote is accompanying item (e) that is dealing with a type of subsidy specifically related to export. Please comment.

Reply

168. The last sentence of footnote 59 is written in declaratory language:

> Paragraph (e) *is not intended to limit* a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

169. It makes clear, for the case that there should be any doubt, that such measures are not prohibited export subsidies. This can be understood from the historical context represented by the decision in the panel reports in the *Tax Legislation* cases, which suggested that such measures could in some cases be export subsidies for the purpose of Article XVI:4 of GATT 1947.

170. If the sentence were intended to *derogate* from item (e) it would have been drafted differently, for example:

> Measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member shall not be considered export subsidies.

171. Indeed, to have the effect argued by the US item (e) it should have been drafted to read:

> The exemption, remission, or deferral of tax specifically on export income shall not be considered an export subsidy if related in some way to measures to avoid the double taxation of [foreign-source] income earned by its enterprises or the enterprises of another Member.

172. And clearly the foreign-source reference would have to be omitted as well.

173. Export income is not, by definition, foreign-source income. Export income represents the difference between the price of a product sold to a customer in a foreign country and the cost of producing that product. Therefore, although the customer is foreign, the costs are incurred by domestic economic activity and the income is therefore generated domestically. This point has been made in paragraph 206 of the EC's second submission and by Canada in its third party submission (paragraph 34). Indeed, Canada aptly describes it as "domestic income from export transactions".

174. It is hard to conceive of a situation in which such income would be subject to taxation by another Member, because none of the economic activity has been carried out in a foreign country.

LIST OF EXHIBITS

EC-21	Extracts from US legal texts
EC-22	Extract from *The Deferral of Income Earned Through U.S. Controlled Foreign* Corporations*; A Policy Study*. Office of Tax Policy Department of the Treasury, December 2000. Chapter 8, Restatement of Conclusions.

ANNEX F-2

ANSWERS OF THE EUROPEAN COMMUNITIES TO THE QUESTIONS OF THE UNITED STATES

(27 March 2001)

Q1. What is the "prevailing standard" or "general rule" of taxation in a country which taxes some persons on a worldwide basis and some persons on an exemption basis, in some cases at their election (and subject in such cases to the discretion of the government)? Please explain the basis for your answer.

Reply

1. The EC finds it impossible to answer this question. It is not possible to extract a "general rule" or a prevailing standard" from one isolated feature of a tax system.

Q2. Is the tax exemption by a country of "foreign-source income" (for purposes of footnote 59) permissible under the SCM Agreement only if all "foreign-source income" is exempt from tax? Please explain the basis for your answer.

Reply

2. The last sentence of footnote 59 to the SCM Agreement does not require that all foreign-source income be exempted from tax.

3. However, as the EC has explained[1] , a tax system that a provides a more advantageous means of avoiding double taxation restricted to certain privileged taxpayers may be providing a subsidy and it may be that this subsidy is not covered by the terms of the last sentence of footnote 59 to the SCM Agreement.

Q3. Would the Act confer subsidies contingent upon export performance in the absence of §§ 942(a)(2)(A)(i) and 943(a)(1)(B) and (C)? Please explain the basis for your answer.

Reply

4. The EC refers the US to its answer to the same question from the Panel (number 39).

Q4. Are the EC member States prepared to relinquish all source-based taxation with respect to business profits in the absence of a "permanent establishment," as that term is defined in Article 5 of the OECD Model Income Tax Convention?

Reply

5. Nothing in the WTO Agreement prevents Members from taxing whatever they wish so long as they do not grant prohibited or specific and injurious subsidies.

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[1] First written submission of the EC, paragraph 221 and EC answer to Panel question number 16.

6. However, the definition of a permanent establishment in Article 5 of the OECD Model Tax Convention is the basis of the respective provisions taken into all modern bilateral or multilateral tax treaties concluded by EC Member States with other countries, that is to say, into the vast majority of all tax treaties entered into by the EC Member States. The EC Member States do observe these treaties and thus, do not seek to tax business profits of enterprises of their treaty partners unless these maintain permanent establishments in the EC Member States in question. The business profits in such cases are only taxed to the extent that they are attributable to such permanent establishments.

7. Accordingly, for example, where a US enterprise exports goods to a EC Member State, without maintaining a permanent establishment in this EC Member State the profits derived from the export activities of the US enterprise are not chargeable to tax in that EC Member State. Similarly, even if the US enterprise did maintain a permanent establishment in the EC Member State in question but no part of the profits derived from the exports to that EC Member State were attributable to that permanent establishment, the EC Member State would not tax the business profits derived from the export activities of the US enterprise.

Q5. Do most countries, under their own domestic statutes and regulations, condition source-based taxation of business profits upon the maintenance by a foreign enterprise of a "permanent establishment," as that term is defined in Article 5 of the OECD Model Income Tax Convention, within their territorial limits? Please explain the basis for your answer.

Reply

8. Not only is not possible for the EC to verify the concordance of the jurisdictional standards contained in all countries domestic statutes and regulations with the 'permanent establishment' standard, it is also not necessary for the resolution of the present dispute.

9. It is a well-known fact that Article 5 of the OECD Model Tax Convention and its commentary have had a significant 'harmonizing' effect on the definition and the interpretation of the concept of a permanent establishment both in the bilateral tax treaties and in the national legislation of a large number of countries. This is in particular the case in industrialized countries with relatively sophisticated tax systems but also in many developing countries, either because of the endorsement of Article 5 of the OECD Model as such or because it has served as the basis for the equivalent Article (Article 5) of the UN Model Tax Convention. It is therefore that under these national provisions the permanent establishment concept is commonly used for the purpose of determining the limits of the taxing rights of a source country over the business profits of an enterprise resident in another country.

10. More importantly, the vast majority of the approximately 2000 mainly bilateral tax treaties which exist world-wide rely, as far as the definition of a permanent establishment and thus the source country's right to tax the business profits of an enterprise resident in the other Contracting State is concerned, on the standard definition of the permanent establishment concept in Article 5 of the OECD Model Tax Convention. As these bilateral (or multilateral) treaties are agreements between inde-

pendent countries, they are subject to the rules of public international law, in particular to the Vienna Convention.[2] Their status as a matter of national law varies but as a main rule they prevail over any conflicting national rule. In cases where under a particular legal system the national legislators have, in principle, the freedom to override such treaties, they are careful not to do so and in the absence of clear intention to override a treaty the national courts tend to assume an intention to observe it.

11. Given the large number of existing bilateral tax treaties and the fact that they cover the vast majority of such bilateral relationships in which the greater part of international trade and investment take place, the significance of the national rules of countries in respect of the conditions under which a source country may tax the business profits of an enterprise resident in another country is very limited. This is because conflicting national rules, if any, would and could not be enforced wherever there is a treaty.

12. Additionally, many countries have incorporated into their national legislation rules defining the existence of a permanent establishment that is based on the definition in Article 5 of the OECD Model. Thus, for example many European Member States apply the same standards for the purpose of defining their taxing rights over the business profits of enterprises resident in countries with which they have not concluded bilateral tax treaties as they do in treaty situations.

Q6. Does the OECD Model Income Tax Convention contain a definition of the term "foreign-source income"? If so, please identify the provision containing such definition.

Reply

13. The OECD Model Income Tax Convention does not use the term "foreign-source income" as such. The OECD Model Convention expresses the same concept in different ways – as does the US IRC, which uses the expressions "sources within the US" and "sources without the US".

14. Thus, for example, Article 4 of the OECD Model Convention (Resident) states:

For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is- liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

[2] The Vienna Convention on the Law of Treaties of 22 May 1969.

ANNEX F-3

ANSWERS OF THE UNITED STATES TO QUESTIONS FROM THE PANEL

(27 March 2001)

Preliminary Comment

1. Before addressing the Panel's questions, the United States first would like to comment briefly on the exhibits attached to the EC's closing statement of 16 March 2001. If the Panel were to consider this information, it tends to support, rather than undermine, the US position.

2. With respect to EC-19, which consists of a copy of pages from the 14 November 2000 edition of the *Congressional Record* dealing with the floor debate in the US House of Representatives on the bill that became the FSC Replacement and Extraterritorial Income Exclusion Act of 2000 ("the Act"), the United States should clarify for the Panel the significance of floor statements in discerning legislative intent under US law. While in appropriate situations courts may consider floor statements, as a general proposition, floor statements are treated as decidedly inferior to committee reports. This proposition was best expressed by the US Supreme Court – the highest court in the US judicial hierarchy – in *Garcia v. United States*, 469 US 70, 76 (1984) (copy attached as Exhibit US-19), in which the Court stated:

> In surveying legislative history we have repeatedly stated that the authoritative source for finding the Legislature's intent lies in the Committee Reports on the bill, which "represent[t] the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation." We have eschewed reliance on the passing comments of one Member, and casual statements from the floor debates. In *O'Brien*, we stated that Committee Reports are "more authoritative " than comments from the floor, and we expressed a similar preference in *Zuber* ... . (Citations omitted; bracket in original).

3. A similar principle was articulated by Justice Jackson – of Nuremberg Trial fame – in *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 US 384, 395-96 (1951) (concurring) (copy attached as Exhibit US-20), in which he stated:

> Resort to legislative history is only justified where the face of the Act is inescapably ambiguous, and then I think we should not go beyond Committee reports, which presumably are well considered and carefully prepared... . [T]o select casual statements from floor debates, not always distinguished for candour or accuracy, as a basis for making up our minds what law Congress intended to enact is to substitute ourselves for the Congress in one of its important functions.

4. Moreover, even when US courts do consider floor statements, they discount statements made by opponents of the legislation. As the Supreme Court stated in *Bryan v. United States*, 524 US 184, 196 (1998) (copy attached as Exhibit US-21): "As we have stated, however, '[t]he fears and doubts of the opposition are no authoritative guide to the construction of legislation.' 'In their zeal to defeat a bill, they understandably tend to overstate its reach.'" (Citations omitted).

5. Thus, if a US court were to consider the floor statements contained in EC-19, the statements to which a court most likely would give weight would be those of Representative Archer, then-chairman of the House Committee on Ways and Means, and Representative Crane, chairman of the Subcommittee on Trade of the House Committee on Ways and Means, who were important proponents of the Act. The EC does not quote the statements of these gentlemen. Here is what Representative Archer had to say:

> Mr. Speaker, I rise simply to say that the gentleman from California says that it is a corporate subsidy if we do not double tax all of the earnings overseas. We are one of the very few developed countries in the world that double taxes earnings overseas. So if we eliminate partially, only partially, the double taxation of those earnings to be only partially competitive with our foreign competitors, he calls it a subsidy. I do not believe the American people would agree with that.[1]

This statement provides further evidence that Congress intended that the Act serve as a measure to avoid double taxation.

6. With respect to Representative Crane, he made the following statement: "H.R. 4986 moves the US closer to a territorial tax system, more like the one governing the international activities of so many European businesses.[2] This statement provides further evidence that, by means of the Act, Congress consciously intended to incorporate territorial features into the US system of taxation.

7. In a similar vein, the EC's assertions regarding the reluctance of the US Executive Branch officials to speculate on Congress' motives in passing the Act are equally misplaced. To be clear, this reluctance does not stem from the fact that those officials have no knowledge regarding the drafting of the Act, but rather from the fact that any such knowledge is irrelevant for purposes of identifying Congress' intent. Instead, what is relevant is the legislative record created by Congress itself.

8. The Supreme Court has held that *post hoc* observations made by individuals involved in the drafting of legislation carry little weight with respect to discerning statutory meaning. *Bread Political Action Committee v. FEC*, 455 US 577, 582 (1982) (copy attached as Exhibit US-22). According to the Court, these statements have no probative weight because they only "represent the personal views of [the drafter]" and "the statements [a]re made after passage of the Act." *Id* . This is true even if such *post hoc* observations are made by a member of Congress. *Quern v. Mandley*, 436 US 725, 736 (1978) (copy attached as Exhibit US-23).

9. Thus, any *post hoc* speculation of the sort sought by the EC as to what Congress intended would be nothing more than that: mere, and legally irrelevant, speculation.

QUESTIONS FOR THE UNITED STATES

Question 7. The United States argues that, with the Act, it changed the general rule of US taxing jurisdiction[3], and thus, in regard to " extraterritorial income",

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1 EC-19, page H11892.
2 *Ibid.*, page H11891.
3 US first submission, para. 72.

there is no general rule of taxation that would apply "but for" the definition of gross income[4] The new Section 941(a)(1) of the IRC provides in relevant part:

> **"The term 'qualifying foreign trade income' means, with respect to any transaction, the amount of gross income which, if excluded, will result in a *reduction of the taxable income* of the taxpayer from such transaction…."(emphasis added)**

How can the US argument be reconciled or harmonized with the underlined words quoted above?

10. The above statements do not conflict. The reduction of taxable income referred to in the statute is the intermediate step in a formula for computing the amount of excluded income. Use of that intermediate step does not indicate that excluded income would be otherwise subject to tax in the United States.

11. A basic principle of US tax law is that a taxpayer may deduct the expenses it incurs in producing taxable income. A corollary to that principle is that a taxpayer may not deduct the expenses it incurs in producing income that is excluded from the tax base. To permit otherwise would allow a taxpayer to underpay its taxes.

12. The exclusion for extraterritorial income is an exclusion from gross income, not a reduction in taxable income. Under the US tax system, gross income refers to the income of the taxpayer without taking into account any deductions. Because excluded extraterritorial income is excluded from the US tax base, however, the Act denies deductions attributable to such income. This presents a computational problem: how are disallowed deductions to be removed if the excluded amount is based on gross income, which does not account for any deductions? The problem is solved by first computing taxable income, then denying deductions allocable to excluded extraterritorial income, and then "grossing up" the resulting figure into a gross income exclusion by attributing to the taxable income amount any allocable deductions. The legislative history of the Act provides the following summary: "[I]n order to calculate the amount that is excluded from gross income, taxable income must be determined and then "grossed up" for allocable expenses in order to arrive at the appropriate gross income figure."[5] A comprehensive numerical example of this process is contained in the legislative history of the Act.[6]

13. Thus, the exclusion for extraterritorial income is an exclusion from gross income, and the step of converting the amount of the exclusion into a reduction in taxable income is only a mechanism for determining the amount of the gross income exclusion.

14. More generally, one practical effect of any exclusion is that it has the ultimate effect of reducing taxes from what they would have been without the exclusion. This same issue arises in connection with exemption systems. To recognize this fact is separate from the question whether exclusion is part of a country's general rule of taxation.

15. In this regard, in an oral follow-up question, the Panel asked whether Question 33 is relevant to Question 7. The United States does not believe that the Treasury

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4 US first submission, para. 77.
5 *Senate Report* (US-2), page 12.
6 *Ibid.*, pages 11-14.

subpart F study is relevant to the formula for calculating excluded extraterritorial income.

Question 8. The European Communities states that, in order for extraterritorial income to be excluded from taxation, "US articles must be used whenever the cost of other inputs (not articles or direct labour) (C) and profit (D) are less than 50% of the selling price (or more exactly the US-assessed fair market value) of the goods".[7] Is this a correct characterization of Act? If not, could the US provide what it considers to be the correct description?

16. This is not a correct characterization of the Act. US articles do not have to be used in this situation because US labour could be used to meet the 50 per cent limitation without increasing the amount of US articles. For example, assume that the EC's (C) and (D) account for 49 per cent of the fair market value, leaving 51 per cent to be accounted for by articles and labour. Under the Act, all but 1 per cent of that 51 per cent could be accounted for by foreign labour and articles, while the remaining 1 per cent could be accounted for by US labour.

17. More generally, however, the EC has narrowed inappropriately the scope of the relevant question. The more appropriate question is whether the Act contains an affirmative requirement to use US articles. There is no such requirement in the Act.

18. This inaccurate description of the Act reflects the EC's limited understanding of the Act's structure and design. In this regard, the EC's algebraic breakdown fails to reflect the Act's distinction between the foreign labour and US labour components.

Question 9. In the Annex to its first and second submissions, the European Communities identifies cases where the cost of "articles" used to produce finished goods exceeds 50% of the value of the finished product, a situation in which the "requirement to use US articles must arise in practice".[8] How does the US respond to this allegation? Are such situations precluded by virtue of the Act ?

19. It is clearly possible to construct a hypothetical showing that the 50 per cent rule might not be satisfied in some situations. The EC claims that its hypotheticals are based on actual data, but, not having access to the data, the United States is unable to respond to the accuracy of the data or the validity of the conclusion derived by the EC from the data. The United States would note that it has been informed by a reliable source that the EC's percentage figures for aircraft engines and avionics are too high. From that, the United States can only assume that the other figures cited by the EC also may be inaccurate.

20. In an oral follow-up question, the Panel asked whether, if a particular company can only satisfy the 50 per cent rule by using US articles, the taxpayer is automatically entitled to the exclusion? The answer to this question is "no", satisfaction of the 50 per cent rule through the use of US articles would not guarantee eligibility for the Act's exclusion with respect to income from the sale of the finished product. The taxpayer still would have to satisfy all of the other requirements of the Act, such as the foreign economic process requirements of section 942(b).

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[7] EC first submission, para. 112.
[8] EC first submission, para. 116.

Question 10. The European Communities submits[9] that "the term "export" in Article 3.1(a) of the SCM Agreement refers to the sale of:

- **Goods;**
- **Originating in the country providing the subsidy;**
- **Destined for the market of, that is for final consumption in, another country."**

Does the US agree with this definition of the term "export" for the purpose of the SCM Agreement?

21. The United States does not agree with this definition. The United States believes that the EC got the definition right the first time, when it followed the dictionary definition: "Send (esp. goods) to another country".[10] Thus, based on the ordinary meaning of "export", where a good is ultimately consumed is irrelevant to whether it is exported, and a product can be exported multiple times until it is finally consumed. The EC offers no support for its assertion that the ordinary meaning of "export" should be ignored.

Question 11. Where qualifying foreign trade property is manufactured, produced, grown or extracted within the United States, is there a possibility under the Act for a taxpayer to exclude any amount of gross income earned from the sale of a good - thus resulting in the reduction of its taxable income - if such a transaction does not involve the exportation of the said good from the United States into any other country?

22. Yes. A manufacturer of goods can earn excluded income by sales to domestic buyers, provided that the goods in question are used outside the United States. Use outside the United States could occur, for example, if the good in question is a fishing boat sold to a United States person for use outside the territorial waters of the United States. In that case, income from the sale of the boat could qualify notwithstanding that the boat was not "consumed" within a foreign jurisdiction. Use outside the United States also could occur in certain circumstances if the article is incorporated into a good that is sold for use outside the United States. Thus, for example, extraterritorial income could be earned if a US manufacturer sells an aircraft engine to a US aircraft manufacturer for incorporation into a finished aircraft to be used outside the United States. The foregoing examples follow from the language of the statute, but the precise scope of these rules will be the subject of proposed regulations to be issued in the future.

23. In an oral follow-up question, the Panel asked whether there is no way to benefit from the exclusion if the final destination of a good is the United States, and whether a good must cross the border before final use?

24. With respect to the first question, taxpayers may earn excluded extraterritorial income with respect to some transactions in which the "final destination" of the property is the United States. The legislative history provides as follows:

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[9] EC first submission, para. 91.
[10] EC submission, para 85.

> [P]roperty that is sold to an unrelated person as a component to be incorporated into a second product which is produced, manufactured, or assembled outside of the United States will not be considered to be used in the United States (even if the second product ultimately is used in the United States), provided that the fair market value of such seller's components at the time of delivery to the purchaser constitutes less than 20 per cent of the fair market value of the second product into which the components are incorporated (determined at the time of completion of the production, manufacture, or assembly of the second product).[11]

Thus, for example, a US manufacturer of car tires may earn excluded extraterritorial income from the sale of tires to an unrelated US car manufacturer with a plant in Canada, even if the tires are installed on cars for sale in the US domestic market.

25. In addition, the foreign use requirement only requires *predominant* foreign use. Thus, some domestic use is permitted. According to the legislative history,

> property is considered to be used predominantly outside the United States for any period if, during that period, the property is located outside of the United States more than 50 per cent of the time.[12]

26. With respect to the second question, the Act does not generally require any border crossing. For example, a taxpayer may earn excluded income with respect to foreign-produced property that is produced and consumed within the same foreign jurisdiction.

Question 12. Where qualifying foreign trade property is manufactured, produced, grown or extracted within the United States by a US corporation or an individual permanently established in the United States, and where that corporation or individual does not maintain any permanent establishment outside the United States, are there situations in which extraterritorial income earned from the sale of such property can be taxed by another country than the United States ?

27. The United States believes that there are such situations, and the Act was designed to account for them. The United States, for example, subjects foreign persons to tax that do not have a permanent establishment in the United States.

28. The United States unfortunately is not in a position to opine regarding all the tax laws of the world. The United States would cite, however, certain examples of countries with which the United States has no income tax treaty and which may impose source-based taxation under domestic law in the absence of a permanent establishment:

- Brazilian domestic law does not contain a proper definition of the term "permanent establishment." In fact, there are no rules providing for special tax treatment of permanent establishments in Brazil.[13]

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[11] *Senate Report* (US-2), page 19.

[12] *Ibid.*, page 20.

[13] International Bureau of Fiscal Documentation, *Taxation in Latin America*, Section C, Brazil 21-23 (LA, Suppl. No. 121, September 2000) (copy attached as Exhibit US-24).

- Chilean source income is taxable in Chile even if it is earned by a non-resident with no establishment or agency in Chile. Chilean law does not provide for the concept of a permanent establishment. Chilean-source income is taxable even on occasional transactions.[14]
- Malaysia taxes non-residents on income accruing in or derived from Malaysia. The concept of permanent establishment is not part of Malaysian internal revenue law.[15]
- Panamanian-source income is subject to tax in Panama even if it is earned by a non-resident with no establishment or agency in Panama. Such income paid to non-residents is subject to a withholding tax. Whether or not income is Panamanian-source income does not depend on the nationality, domicile, or residence of the recipient, nor on the location at which the contract is concluded. Panamanian law does not recognize the concept of "permanent establishment".[16]
- Taiwan imposes income tax on all income derived from sources within Taiwan, whether earned by residents or non-residents. Taiwanese law does not use the term "permanent establishment". If a foreign individual or foreign "profit-seeking enterprise" without a "fixed place of business" or a "business agent" earns income in Taiwan, the income is subject to a final withholding tax.[17]
- Saudi Arabia levies tax on all income from Saudi Arabian sources. This is the case even in cases where the foreign entity has no presence in Saudi Arabia, and thus the government has no power to compel the foreign entity to file a tax return. In such cases, the payor of the income is liable for the tax, which is thus essentially transformed into a withholding tax. There is no concept of "permanent establishment" in Saudi Arabian law.[18]

The United States emphasizes that these are only a few examples of countries that do not provide for the concept of a permanent establishment in their domestic tax law.

29. Thus, the concept of a "permanent establishment" is not a universally adopted standard, as the EC suggests. Territorial systems do not define the scope of the exemption based upon the amount of income attributable to a foreign permanent establishment. Territorial systems simply exclude income earned outside the territorial boundaries of the country in question.

30. There are additional, independent reasons to reject the EC's approach. First, the United States recalls that it has income tax conventions with only 63 countries, leaving US business to face the domestic tax laws of all other countries without the benefit of a permanent establishment article.

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[14] International Bureau of Fiscal Documentation, *Taxation in Latin America*, Section C, Chile 23, 26 (LA, Suppl. No. 117, September 1999) (copy attached as Exhibit US-25).

[15] International Bureau of Fiscal Documentation, *Taxation and Investment in Asia and the Pacific*, Malaysia 33-34, 38, 43 (AP, Suppl. No. 189, May 2000) (copy attached as Exhibit US-26).

[16] International Bureau of Fiscal Documentation, *Taxation in Latin America*, Section C, Panama 4, 13, 14-16 (LA, Suppl. No. 113, March 2000) (copy attached as Exhibit US-27).

[17] International Bureau of Fiscal Documentation, *Taxation and Investment in Asia and the Pacific*, Taiwan 17, 19 (AP, Suppl. No. 111, November 1993) (copy attached as Exhibit US-28).

[18] International Bureau of Fiscal Documentation, *Taxation and Investment in the Middle East*, Saudi Arabia 43-46 (ME, Suppl. No. 90, August 2000) (copy attached as Exhibit US-29).

31. Second, the EC's argument is internally inconsistent. If the concept of permanent establishment were an internationally accepted standard, as the EC alleges, then there would be no need for Article 7 of the OECD model, which is designed to override the domestic laws of the signatories to a tax treaty.

32. Third, the EC's argument is counter-textual. Even assuming that the concept of a permanent establishment were an internationally accepted standard, which it is not, footnote 59 nowhere refers to the term "permanent establishment", and nothing in footnote 59 states that a measure qualifies as a measure for the relief of double taxation only if it conditions relief upon the existence of a permanent establishment.

33. Fourth, validation of the EC's argument would be unwise, given the evolving standards for when double taxation may arise. Take the example of the recent developments in e-commerce. With respect to cross-border electronic transactions, the definition of permanent establishment is the subject of an ongoing debate. Different countries have taken different positions on what degree of activity constitutes a permanent establishment, giving rise to the spectre of double taxation despite the absence of a permanent establishment.

34. Accordingly, the approach suggested by the EC is unwise and unwarranted.

QUESTIONS FOR BOTH PARTIES

Question 13. Regarding the relationship between Article 3.1(a) of the SCM Agreement and item (e) of Annex I, would it be possible that a certain measure is not within the scope of the latter, but nonetheless within the scope of the former, and *vice versa*?

35. The United States explained its position on the relationship between paragraph (e) of Annex I and Article 3.1(a) at paragraphs 157-61 of its First Submission. There, the United States pointed out that paragraph (e) identifies a particular type of prohibited export subsidy - that is, a particular type of subsidy made contingent on export performance.

36. The United States made its comments in response to the EC argument that paragraph (e) broadens Article 3.1(a) and prohibits export subsidies that are not within the scope of 3.1(a). The United States recalled that, as a part of the Illustrative List of Export Subsidies, paragraph (e) provides an example of a prohibited export subsidy. The United States maintained, and remains of the view, that paragraph (e) helps to clarify and apply 3.1(a), but it does not prohibit something that 3.1(a) does not. The United States notes that the panel in the *Canada Autos* case appears to have taken a similar view.[19]

37. The key issue seems to be that the EC wants the Panel to find that the fact that a measure is available to exports is enough to violate the SCM Agreement. The United States submits that this cannot be the case. A tax exemption, remission, or deferral that is "specifically related to exports" requires a much closer connection to

[19] *Canada - Certain Measures Affecting the Automotive Industry*, WT/DS139/R, WT/DS142/R, Report of the Panel, as modified on other grounds by the Appellate Body, adopted 19 June 2000, DSR 2000:VII, 3043, para. 10.196 ("Indeed, the use of the words 'including' and 'illustrated' makes it clear that, while all practices identified in the Illustrative List are subsidies contingent upon export performance, there may be other practices not identified in the Illustrative List that are also subsidies contingent upon export performance."). This particular aspect of the panel report was not appealed.

exportation than mere availability. The Panel need not even explore the relationship between paragraph (e) and Article 3.1(a) if that is the EC's theory. Even if such an attenuated connection could equal "specifically related to exports", the United States believes the connection to exports must still amount to a contingency. If not, then no violation of Article 3.1(a) can be shown.

Question 14. The Panel is well aware that the WTO-conformity of income tax regimes of European countries is outside the scope of our terms of reference for this case. In paragraph 96 of the US first submission, the US introduces examples of a few European tax systems which "refrain from taxing foreign income in a qualified or conditional manner."[20] Among those systems, is there one which excludes foreign income from the scope of taxable income on the following conditions:

(i) the property for sale from which income arises must be held for ultimate use outside the country, (and not be sold for final consumption in that country); and

(ii) the same property must have foreign content of not more than a certain percentage of its fair market value.

38. With respect to condition (i), every country that declines to tax income that domestic corporations earn outside the territory as fully as the income they earn domestically provides those companies a tax incentive to export. This is because any domestic corporation that exports and that can attribute some portion of the export income to offshore activities can, by virtue of territorial features found in certain European tax systems, be taxed at lower rates in the foreign jurisdiction. Exporters throughout Europe are keenly aware of this benefit and plan their business activities accordingly.

39. The conditions for taking advantage of this tax incentive in these European countries are similar, but not identical, to those in the Act. If a domestic corporation manufactures products domestically, it can earn exempt income only by exporting (a condition that is similar, but not identical, to the Act's requirement of a foreign sale). As a practical matter, in European countries that use the exemption method, it is undoubtedly the case that the primary beneficiaries of the exemption are exporters.

40. With respect to (ii), which is a feature of the Act that rarely comes into play, the United States is not aware of a similar provision in a European country. The US provision is probably unique.

Question 15. Is the term "foreign-source income," "foreign-source" or "source" used elsewhere in any provisions of other WTO Agreements than the SCM Agreement? What guidance, if any, may be drawn as to the meaning of these terms from the SCM Agreement or other WTO Agreements?

41. We have found two places in the Covered Agreements in which some or all of the above words are used. In paragraph 1(a) of the Annex to the Agreement on Trade-Related Investment Measures, the word "source" is used in reference to domestic content requirements. Specifically, the reference is to "the purchase or use by an enterprise of products of domestic origin or from any domestic *source* ... ." (Em-

[20] US first submission, para. 97.

phasis added). The use of "source" in this context appears to refer not to a situation in which a Member conditions an investment opportunity based on a requirement that goods be manufactured within its borders, but rather that goods be purchased from a domestic business or person (regardless of where the goods are made).

42. This use of "source" is consistent with the US position regarding the fifth sentence of footnote 59. The United States has noted that one attribute of income that may render it "foreign-source income" is that the purchaser of the good is foreign or the source of payment is foreign. The use of the term "source" in the TRIMs Agreement parallels this understanding of "source" in footnote 59.

43. Another reference is found in Article XIV of the General Agreement on Trade in Services, which provides as follows:

> [N]othing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:
>
> ...
>
> (d) inconsistent with Article XVII [national treatment], provided that the difference in treatment is aimed at ensuring the equitable or effective [6] imposition or collection of direct taxes in respect of services or service suppliers of other Members.[21]

44. Footnote 6 to Article XIV(d) states in relevant part as follows:

> Measures that are aimed at ensuring the equitable or effective imposition or collection of direct taxes include measures taken by a Member under its taxation system which:
>
> (i) apply to non-resident service suppliers in recognition of the fact that the tax obligation of non-residents is determined with respect to taxable items *sourced* or located in the Member's territory ; or
>
> ...
>
> (iv) apply to consumers of services supplied in or from the territory of another Member in order to ensure the imposition or collection of taxes on such consumers derived from *sources* in the Member's territory; or
>
> ...
>
> (vi) determine, allocate or apportion *income*, profit, gain, loss, deduction or credit of resident persons or branches, or between related persons or branches of the same person, in order to safeguard the Member's tax base.

Tax terms or concepts in paragraph (d) of Article XIV and in this footnote are determined according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure. (Emphasis added.)

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[21] "Direct taxes" is defined in GATS Article XXVIII to "comprise all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation." This definition of "direct taxes" is slightly different from, but not inconsistent with, the definition of "direct taxes" found in footnote 58 of the SCM Agreement.

45. The purpose of paragraph (d) and its explanatory footnote is to make clear that, with respect to the taxation of service income, Members are entitled to depart from the normal rule of national treatment to ensure the "equitable or effective imposition of direct taxes". In other words, Members are permitted to take special measures to prevent evasion that might otherwise occur as a result of the foreign location of service suppliers or the foreign performance of services. A key point in footnote 6 for purposes of the present dispute is the fact that the final sentence provides that the tax terms used in the relevant text do not have universally agreed upon meanings. Thus, the final sentence indicates that the negotiators of GATS wanted to provide flexibility to capture the various instances in which income can be regarded as "sourced" within a Member.

46. An equally important point is that the drafters understood that taxes can be derived from sources in myriad ways. They recognized that WTO Members use different sourcing rules and have different jurisdictional boundaries. Thus, what one country might deem to be taxable income, another might view as outside the scope of its tax system. At a minimum, this language in the GATS indicates that the EC's "foreign economic processes test" is too narrow. For example, subpart (iv) makes clear that Members may tax income of foreign service providers by levying taxes on domestic customers where the services in question are "supplied in or from the territory of another Member". That such a service can be "sourced" within the country of the customer means that a "foreign economic processes test" is too rigid to capture the complexities of modern international business and taxation.

47. In other words, the drafters of the GATS, like the drafters of the SCM Agreement, wanted the term "source" to be given its ordinary meaning. "Source " may mean different things depending on the context in which it is used. They did not intend for it too have one unique meaning to be applied in all cases.[22] They also did not intend to incorporate an extrinsic definition of the term, including the "special meaning" of "foreign source income" the EC claims exists in the OECD Convention. The United States has previously noted that the OECD Convention contains no definition of foreign-source income and recognizes that income that is not attributable to any foreign economic processes – i.e., passive income derived from foreign "sources" – may be exempted from taxation.[23]

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[22] Because the fifth sentence of footnote 59 speaks of not imposing limits on the ability of a WTO Member to take measures to avoid double taxation, the United States believes that the term "foreign source income" in the context of footnote 59 should be interpreted broadly. A broad interpretation in this case would account for the real possibility that a foreign jurisdiction could tax excluded extraterritorial income. As noted before, the United States believes that extraterritorial income has many attributes that make it "foreign" and, as a result, it could be subject to foreign tax. If the Panel were to adopt the EC's cramped interpretation of foreign-source income here, the Panel 's ruling would have the effect of preventing Members from relieving double taxation in certain cases as a matter of WTO law.

[23] If the drafters of the SCM Agreement had intended to incorporate the OECD Convention in the fifth sentence of footnote 59, they would not have done so silently. By contrast, item (k) of Annex 1 contains a specific reference to extrinsic sources. Item (k) of Annex I refers to "an international undertaking on official export credits to which at least 12 original Members to this Agreement are parties as of 1 January 1979 (or a successor undertaking which has been adopted by those original Members)". The United States is aware of only one undertaking that meets this description, and it is the OECD Arrangement on Guidelines for Officially Supported Export Credits. Thus, the fact that the drafters of the SCM Agreement did not tie the fifth sentence of footnote 59 to extrinsic documents cannot be assumed to be "merely accidental or an inadvertent oversight on the part of either

48. Finally, the United States notes that Article XIV(e) and Article XXII:3 of GATS confirm the flexibility built into the fifth sentence of footnote 59. Article XIV(e) provides an exception from Article II (MFN) where "the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound." Article XXII:3 provides that a Member may not invoke Article XVII (national treatment) under the GATS dispute settlement provisions "with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation." These provisions create an exception to GATS non-discrimination rules only to the extent that the relief of double taxation is provided for or allowed by another agreement. Footnote 59 contains no such limitation. Whether and how to avoid double taxation are questions left to individual WTO Members.

49. In an oral follow-up question posed at the Panel meeting, the Panel asked whether the Appellate Body's references to "foreign-source income" in its report in the *FSC* case have any relevance to the instant proceeding?

50. While the Appellate Body did not define the term "foreign-source income" within the context of footnote 59, it did apply the term broadly and did not tie the concept to a particular Member's tax law. More generally, the Appellate Body reaffirmed that Members have the right not to tax a particular category of foreign-source income.[24] This reaffirmation supports the US position, which is that excluded extraterritorial income is a category of "foreign-source income" that the United States has chosen not to tax. By contrast, the EC appears to argue that a Member cannot refrain from taxing foreign-source income unless it decides to refrain from taxing *all* foreign-source income. Under the EC view, anything less than a full exclusion would give rise to an "exception" from a "general rule" of taxation. The Appellate Body's opinion demonstrates that the EC's argument is without merit.

51. Moreover, the EC's approach is incoherent at best. The EC seems to ask the Panel to rule that the term "foreign-source income" has whatever meaning assigned to it by US domestic law. This approach proves the US case, because excluded extraterritorial income would be foreign-source income under US sourcing rules, as set forth in section 862(a)(4) and 863(b) of the IRC. Nevertheless, the United States notes that the EC's approach is internally inconsistent because the EC simultaneously asserts that the income in question must be subject to tax under foreign law. Unless the EC is prepared to assert that the entire world employs the US domestic-law sourcing rules, then the EC must admit that these two approaches to determining source often will generate different results. The difference between US sourcing rules and foreign sourcing rules reflects the basic fact that no general international consensus exists on how best to source income from cross-border transactions, transactions

harassed negotiators or inattentive draftsmen." *United States - Restrictions on Imports of Cotton and Man-made Fibre Underwear*, WT/DS24/AB/R, Report of the Appellate Body adopted 25 February 1997, page 17, DSR 1997:I, 11, at 25.

In this regard, at the meeting with the Panel, the Panel asked whether the reference in the fourth sentence of footnote 59 to bilateral tax treaties and the OECD suggests that the drafters intended extrinsic documents to apply for purposes of the fifth sentence. In the view of the United States, the answer to this question is "no." Indeed, the absence of a similar reference in the fifth sentence suggests the opposite conclusion; *i.e.*, that the drafters did not intend to incorporate standards or definitions from extrinsic sources.

[24] *FSC (AB)*, DSR 2000:III, 1619, para. 99.

such as those that generate excluded extraterritorial income. Despite the absence of such a consensus, the EC is inviting the Panel to impose one rule – with no relevant theoretical justification – upon the tax authorities of all WTO Members.

Question 16. The European Communities claims that[25]:

> **"Even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) of the SCM Agreement because it gives exporters a *choice* that is not available to other operators…. This additional advantage would also be a subsidy,…. This unwarranted *overcompensation* is also a subsidy….**
> **(For the EC): Please provide a textual analysis of how the alleged *additional advantage* and *overcompensation* constitute subsidies under Article 1 of the SCM Agreement.**
> **(For the US): How does the US respond to this allegation?**

52. The United States explained in paragraphs 35-38 of its Second Submission why countries can and do rely on alternative methods of avoiding double taxation. This is a common and well-accepted practice. For example, in France, with the permission of the Ministry of Economy and Finance, a French company may elect to be taxed on its worldwide income and obtain relief from its worldwide losses. Thus, in the context of export subsidies, alternative methods of double taxation relief should be irrelevant, especially where no unique or special benefits are provided exclusively to exporters. This is the case with respect to the Act, which is not uniquely applied to exporters or export income.

Question 17. The EC seems to argue that a Article 3.1(b) violation may exist if a certain measure gives an "incentive" to domestic production for export.[26] In the same vein, the EC argues that "Article 3.1(b) prohibits local-content contingency to *any* degree,… [and] there is no *de minimis* rule for prohibited subsidies in the SCM Agreement.".[27]

> **(For the EC): How would this argument be supported by a textual analysis of Article 3.1(b) in accordance with Article 31 of the *Vienna Convention*? Can the European Communities cite any Appellate Body or panel reports in which the term "incentive" was explicitly used in the context of Article 3.1 of the SCM Agreement, or Article XVI:4 of the GATT Agreement?**
> **(For the US): Would a textual analysis of Article 3.1(b) lead to a conclusion that the EC's above argument is without merit? If so, why and how? Would the US take the view that there is *de minimis* rule for prohibited subsidies in the SCM Agreement? If so, what is the qualitative or quantitative threshold for that rule? Is the Appellate Body Report in *Canada - Certain Measures Affecting***

[25] EC second submission, paras. 221-222.
[26] *See* EC first submission, para. 165.
[27] EC second submission, para. 160.

***the Automotive Industry*[28] relevant to this question? Please give reasons for your responses.**

53. The EC's "textual" analysis of Article 3.1(b) is incomplete. The EC notes that the dictionary (which for some reason known only to the EC is useful here but not in connection with other parts of the SCM Agreement) defines "over" as "in preference to". However, instead of interpreting "in preference to", the EC decides to abandon the dictionary and simply equates "preference" with "incentive" or "boost." However, the same dictionary relied on by the EC – *The New Shorter Oxford English Dictionary* – defines "in preference to" as "rather than."

54. Thus, a textual analysis would lead to the conclusion that the EC's argument is without merit. The key words in Article 3.1(b) are "contingent" and "use." "Contingent upon the use of domestic goods" simply is not the same thing as "incentive to use domestic goods."

55. With respect to the second part of the question, the question omits part of the quoted phrase; i.e., the phrase "even a slight bias in favour of domestic goods." In the view of the United States, "a slight bias" is not a contingency. A measure – at least a measure challenged on a *de jure* basis – either is contingent or it is not. The United States is not arguing that a *de minimis* contingency is permissible under Article 3.1(b); rather, the United States is arguing that a "slight bias" or incentive does not amount to a contingency. For these reasons, the United States does not see how the *de minimis* concept relates to a determination of contingency.

56. As for *Canada Autos*, the United States considers the Appellate Body report extremely relevant. In that case, the Appellate Body said that value-based requirements cannot automatically be deemed as creating a contingency within the meaning of Article 3.1(b). Instead, there must be an analysis of how the requirements operate for individual manufacturers. In the view of the United States, the EC has failed to demonstrate that the 50-per cent rule actually requires any manufacturer, whether located in the United States or abroad, to use US articles.

57. In this regard, the EC is making the same argument regarding Article 3.1(b) as the one rejected in *Canada Autos*; namely, that the standard of Article 3.1(b) is satisfied if a measure "favors or gives preference to the use of domestic over imported goods."[29] Neither the panel nor the Appellate Body accepted this interpretation. Although the Appellate Body did not expressly reject this interpretation, it is clear from the report that the Appellate Body implicitly rejected it. The Appellate Body's analysis set forth in paragraphs 126-131 indicates that a "slight bias" is not enough to establish a contingency for purposes of Article 3.1(b). Instead, it is necessary to analyze how value-based requirements operate for individual manufacturers.

Question 18. Relating to Article III:4 GATT, EC has cited[30], *inter alia*, the Panel Report on *Italian Discrimination against Imported Agricultural Machinery.*[31] We note that two other documents - GATT Doc. L/695 (1957) and GATT Doc. L/740 (1957) - address similar issues. Are these relevant to the question of

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[28] WT/DS139/AB/R, WT/DS142/AB/R, DSR 2000:VI, 2985.

[29] This argument is reflected in para. 10.214 of the panel report (DSR 2000:VII, 3043) and para. 119 of the Appellate Body report (DSR 2000:VI, 2985) in *Canada Autos*.

[30] EC first submission, para. 98.

[31] GATT Doc. L/833 (1958), adopted 23 October 1958, BISD 7S/60.

whether Article III:4 of the GATT in the first place covers exemptions to the tax on the "firm"? Please comment on whether and how these reports are relevant to our case.

58. These cases appear distinguishable on their face from the present dispute. At the most basic level, these cases involved programmes that applied directly to products. The governments provided subsidized financing or grants that could only be used for the purchase of domestic products. Because like imported products were ineligible for similar financing, the programmes violated the national treatment provisions of GATT Article III:4. By contrast, the present case does not deal with a measure that directly affects products, but rather, income taxes. A closer analogy to the agricultural machinery financing cases would exist if a country imposed differing levels of excise tax on imported, as opposed to domestic, products; such a case would properly be brought under Article III:2, rather than Article III:4.

59. Indeed, there is support in the history of the GATT that Article III:4 was never intended to apply to income taxes. The Reports of the Havana Convention, at which Article 18 of the Havana Charter[32] (the immediate predecessor to GATT Article III, with essentially identical text) was drafted, specify that "neither income taxes nor import duties fall within the scope of Article 18 which is concerned solely with internal taxes on goods."[33] It is striking that in over 50 years of GATT and WTO jurisprudence, few cases have been brought that alleged that income tax measures violated Article III:4[34], and there have been no panel decisions on the issue. A WTO panel, expounding generally on the scope of Article III, noted in passing that, "subsidies granted in respect of direct taxes are generally not covered by Article III:2, but may infringe Article III:4 to the extent that they are linked to other conditions which favor the use, purchase, etc. of domestic products."[35] This statement is purely *dicta*, because none of the measures within the panel's terms of reference involved an income tax.

QUESTIONS FOR THE UNITED STATES

Question 19. The United States appears to contend that, when a company manufactures goods in the United States and sells them abroad, the income generated may be partly domestic-source and partly foreign-source. If so, is it not equally true that, when a company manufactures goods abroad and sells them in the United States, the income generated may also be partly domestic-source and

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[32] Final Act of the United Nations Conference on Trade and Employment, March 24, 1948.

[33] Interim Committee for the International Trade Organization, *Report of Committees and Principal Sub-Committees,* Report of Sub-Committee A of the Third Committee on Articles 16, 17, 18 and 19, E/CONF./2/C.3/59, para 44, page 63, Geneva, 1948.

[34] The *Analytical Index, Guide to GATT Law and Practice,* Vol. 1, Geneva, 1995 cites a 1952 complaint by Austria that Italy granted a remission of income tax to firms that used domestically-produced ship's plate, L/875; a 1971 Working Party on the United States Temporary Import Surcharge held an exchange of views on the Job Development Tax Credit, a credit against United States income taxes which was allowed only on domestically-manufactured equipment, L/3575; and a 1987 EEC complaint concerning the temporary extension of tax credits and depreciation for passenger aircraft assembled in certain US states, L/6153.

[35] *Indonesia – Certain Measures Affecting the Automobile Industry,* WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, Report of the Panel adopted 23 July 1998, DSR 1998:VI, 2201, para. 14.38.

partly foreign-source? If so, and given your assertion that the Act is a measure to avoid the double taxation of foreign-source income, please explain why the exclusion provided by the Act for "extraterritorial" income is limited to instances where property is sold or leased for use outside the United States.

60. Depending on the circumstances, a portion of the income would be US-source income and a portion would be foreign-source income. The extraterritorial income exclusion, however, is limited to the foreign-source income that arises when property is sold or leased for use outside the United States because the United States has determined not to cede primary taxing jurisdiction over US-source income. Thus, in the case of a foreign person that earns US-source income from sales in the US domestic market, the United States would retain primary taxing jurisdiction over such income, and relief from double taxation would be left to the foreign jurisdiction to provide. In this respect, the Act provides parallel treatment with the exemption method. Just as the United States generally cedes taxing rights over excluded extraterritorial income, so, too, would a foreign exemption system generally cede taxing rights over US-source income in the case of a foreign person earning US-source income from sales in the US domestic market.

61. More generally, however, nothing in footnote 59 requires that a measure for the relief of double taxation resolve the problem of double taxation completely or precisely. Footnote 59 provides that paragraph (e) "is not intended to limit" a Member from taking measures to avoid double taxation. Indeed, it is highly unlikely that any system for the relief of double taxation would result in the complete elimination of double taxation without creating instances of double non-taxation. Such precision is probably impossible, given the many differences in taxation systems from one country to another and the many different ways that international commerce can be structured. This persistent problem in melding different systems is one reason that the OECD has provided only general guidelines regarding the relief of double taxation. It is also the reason that the United States suggests that the panel should not attempt to impose a single interpretation of the term "foreign-source" income in footnote 59. To interpret footnote 59 in the way suggested by the EC would effectively dictate to countries the manner in which they must structure their domestic tax systems with respect to international activities. It is safe to say that the drafters of the footnote had exactly the opposite goal, which was to allow Members to continue to determine how best to avoid double taxation of income.

Question 20. Assume that the US legislation provided that: "Gross income does not include income generated from export activities". Would there be revenue foregone which is "otherwise due" such that there was a financial contribution within the meaning of Article 1? How, if at all, would you distinguish this situation from the exclusion of "extraterritorial income" from gross income under the Act?

62. The ordinary meaning of the terms of Article 1.1(a)(ii) suggests that in such a situation there would *not* be a financial contribution within the meaning of Article 1.1(a)(1). This is because the tax revenue on export activities would not be "otherwise due" under the law of the Member, which is the normative benchmark for an Article 1 analysis. Although this would arguably permit countries to exclude narrow categories of income from tax if they were willing to so modify their general rule of

taxing authority, it is the reading that the ordinary meaning of the terms most directly suggests.

63. If the Panel believes that it is necessary to depart from the ordinary meaning of Article 1 and to interpret it more broadly, the only defensible broader interpretation, we believe, would be that gross income (or a comparable concept in a country other than the United States) can be defined in any manner that a sovereign state chooses, *except* that if the general rule creates an exclusion that is expressly specific within the meaning of the meaning of Article 2, then that exclusion would constitute a financial contribution within the meaning of Article 1.1(a). Under this interpretation, an exclusion that was applicable only to a specific universe of firms, as defined by Article 2, would constitute a financial contribution, and thus a subsidy, within the meaning of Article 1.

64. The reason that a broader interpretation would not be defensible is that if the exclusion were not expressly specific, then panels would have to determine what generic exclusions, of which some specific group was a part, would cause the exclusion to be a financial contribution. This would be impractical because in any given case, the mix of users from a specific group and users from a non-specific group could range from one end of the spectrum to the other. Would, for example, territorial limits constitute a financial contribution if it were shown that 30 per cent of the beneficiaries of territorial limits were exporters? 70 per cent? 95 per cent? There would be no criteria by which rational line-drawing in such a situation could be done.

65. Hence our answer is: (a) the ordinary meaning of the text suggests that the answer to the Panel's question 20 is "no"; (b) if the ordinary meaning is considered unacceptable, a broader reading of the text could find that an exclusion incorporated into a general rule would constitute a financial contribution if the exception were expressly applicable to only a specific group; and (c) any broader rule would not be principled or workable.

66. If the Panel were to apply our alternative broader principle to this case, we do not believe that the Act's exclusion would be specific within the meaning of Article 2.3, because, for the reasons previously articulated, the exclusion is neither export contingent nor contingent upon the use of domestic over imported goods. Similarly, there has been no allegation made, or evidence submitted, that the exclusion is specific within the meaning of Articles 2.1 or 2.2, and we do not believe that any sort of credible case could be made that it is.

Question 21. Assume that the "qualified" exemptions from taxation of foreign-source income described in paragraph 96 of the United States' first submission are "subsidies" within the meaning of Article 1 of the SCM Agreement. Would such subsidies be specific within the meaning of Article 2?

67. The United States has two answers: one based on the US approach and one based on the EC approach.

68. The qualified exemptions created by territorial limits in European tax systems are, for purposes of specificity, similar to the new US legislation. In our opinion, neither the European exemptions nor the exclusion in the US Act is specific, for the reasons that follow.

69. For purposes of discussion let us assume, as the EC asserts will be the case, that most of the US taxpayers that will take advantage of the Act's exclusion are ex-

porters. Let us also assume for purposes of discussion, as the United States believes the case to be, that most of the European taxpayers that benefit from the qualified exemptions created by territorial limits are also exporters. This would mean, as a factual matter, that most of the universe of beneficiaries for both the exemptions and the exclusion would be exporters who would realize the advantage of the exemption or exclusion by exporting.

70. The issue of law would then be whether, under those assumed facts, the exemption and exclusion are specific within the meaning of Article 2. In each case, a significant subgroup of the universe of beneficiaries would be exporters who could realize the benefit by exporting. As a matter of law, then, would the entire exemption or the entire exclusion be specific because a significant subgroup of the beneficiaries of each consists of exporters?

71. The answer to this question becomes clearer when one recalls that exporters are one type of "specific" group. Part II of the SCM Agreement is reached only in the case of programmes that are "subsidies" under Article 1 and "specific" under Article 2. Article 1.2 expressly provides that if these two standards are not met, one does not reach Article 3. Exporters come within the Article 2 definition of "specific" because Article 2.3 expressly provides that subsidies that are contingent on export performance are "deemed to be specific." Thus, subsidies contingent on export performance are subsidies that are deemed to be subsidies that are "specific to an enterprise or industry or group of enterprises or industries" ("certain enterprises").

72. This construct, which the structure and the language of Articles 1 and 2 make clear, is helpful then in answering the Panel's question. If, as Article 2 specifies, export subsidies are one form of "specific" subsidy, then the question of law set forth above becomes easier to answer. Assume, for example, that the sub-group of the universe of beneficiaries was not exporters but rather was a group of industries, say, service industries, or natural resources industries. Assume also that the remainder of the universe of users was not a specific group of industries or enterprises. Would the subsidy be "specific" because one subgroup of the universe of beneficiaries, considered in isolation, was "specific"? The answer is, of course, no. To the contrary, the conventional way of making a specific subsidy non-specific is to expand the universe of users or beneficiaries. Once it is expanded beyond a specific group of "certain enterprises," it ceases to be specific.

73. For precisely the same reasons, a subsidy that is provided to a broad group of users is not specific because a subset of the users consists of exporters. Rather, the way to cure an export subsidy is to ensure that the benefit is provided to a larger group than just exporters; that is, to a non-specific group. (This was a question raised by the Panel in the original proceeding that the EC essentially refused to answer.)[36] It would be no more appropriate to find a subsidy specific by parsing the universe of users until one finds a subset of exporters than it would be to find a subsidy specific by parsing the universe of its users until one finds a subset of "certain enterprises." To do either would have the effect of draining all content from the Article 2 concept of specificity.

74. For these reasons, the qualified exemptions created by territorial taxing limits should not be considered specific, for the same reasons that the new US exclusion should not be considered specific.

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[36] *FSC (Panel)*, DSR 2000:IV, 1675, para. 4.1068, note 468.

75. On the other hand, if one were to accept the EC's standard for export contingency – which is that export transactions are taxed more favorably than comparable domestic transactions – then the United States believes that the subsidies described in the question would be specific, because these measures result in exports being taxed more favorably than comparable domestic transactions. Under Article 2.3 of the SCM Agreement, "[a]ny subsidy falling under the provisions of Article 3 [*e.g.*, any subsidy that is export contingent] shall be deemed to be specific."

Question 22. In the case of a FSC in existence on 30 September 2000, at what point in time would the unconditional legal right of a FSC-beneficiary to receive the tax reduction arise - before or after 30 September 2000?

76. In the case of a FSC in existence on 30 September 2000, section 5(c) of the Act confers the legal right to a tax exemption by allowing the exemption despite the repeal of the FSC provisions effective on that date. This right, however, is not unconditional because it is subject to the conditions described in the Act.

QUESTIONS FOR BOTH PARTIES

Question 32. What is the relationship, if any, between the scope of Article III:4 of the GATT and Article 3.1(b) of the SCM Agreement - is one necessarily broader than the other- could a measure fall within the scope of one of these provisions, but not within the scope of the other? Please substantiate your response with reference to past GATT/WTO dispute settlement reports and other materials.

77. Article III:4 is broader than Article 3.1(b), so that a measure could fall within Article III:4, but not Article 3.1(b). This follows from the ordinary meaning of the terms used in the two provisions. Article III:4 speaks of "treatment no less favorable" and of requirements "affecting" internal sale, while Article 3.1(b) speaks of subsidies "contingent upon the use of domestic over imported goods." Based on the Appellate Body's interpretation of "contingent", this would seem to be a more difficult standard to satisfy than the standard of Article III:4.

78. The panel in *Canada Autos* reached a similar conclusion, stating in paragraph 10.215 as follows:

> We recognize that Article 3.1(b) in some sense has its roots in Article III:4 of GATT and in certain interpretations of that provision, which relates to non-discrimination. We do not consider however that Article 3.1(b) *ipso facto* has the same scope as Article III:4. To the contrary, while Article III:4 of GATT speaks of "treatment no less favorable" and of requirements "affecting" internal sale, Article 3.1(b) speaks of subsidies "contingent upon the use of domestic over imported goods." We are unwilling to import into Article 3.1(b) legal principles derived from the interpretation of a text which differs so markedly from that of Article 3.1(b).

This particular aspect of the report was not appealed.

Question 33. The EC states that "… the US review of its subpart F legislation is yet to be completed".[37] Please explain whether and how this statement is relevant to the current proceeding.

79. The statement by the EC is incorrect. The subpart F study was published in December 2000. If the EC had actually read the study, moreover, the EC would have recognized its irrelevance. The study deals with US anti-deferral mechanisms, which have no particular relationship to any of the issues in this case.

QUESTIONS FOR THE UNITED STATES

Question 40. Please comment on paragraph 36 of the EC oral statement.

80. In paragraph 36, the EC made the following statement:

> The Appellate Body, in *Canada-aircraft*, stated that benefit does not exist in the abstract. In the same way, export contingency does not exist in the abstract; it must be analyzed with regard to the recipient, transaction and product concerned. The US approach would render the SCM disciplines completely ineffective.

81. To the extent that the EC is saying nothing more than that the existence of an export contingency under Article 3.1(a) of the SCM Agreement can be determined only on the basis of the measure or facts before a Panel, the United States cannot disagree with the proposition. However, the EC's claim that the Panel must focus on "the recipient, transaction and product" in a case it styles as a *de jure* one seems rather strange. Indeed, the quoted passage reflects a significant flaw that permeates the EC's case: its inability to base its arguments on the relevant text of WTO provisions and its resulting need to incorporate concepts and principles not found in that text to compensate for this fundamental deficiency.

82. For example, in paragraph 36, the EC cites a statement made by the Appellate Body regarding the term "benefit" and tries to apply it to "export contingency". This statement is reflective of a circular argument that flows from the schizophrenic approach taken by the EC in interpreting Article 3.1(a).

83. In paragraph 35 of its oral statement, the EC explained that:

> In the case of the FSC Replacement subsidy, the EC does not dispute the theoretical possibility for the benefit to become available without exporting. However, the fact that this possibility exists does not mean that all subsidies granted under the Act are not export-contingent.
>
> Thus, paragraph 35 suggests that the EC is attacking the Act because (allegedly) particular transactions qualifying for the Act's exclusion may be export contingent.

84. However, in paragraph 4 of the *Preliminary Answers of the European Communities to the Questions of the Panel* (16 March 2001) ("*EC Preliminary Answers*"), the EC says that this is not what it is doing. In paragraph 4, the EC stated as follows:

> The EC is contesting a subsidy *scheme* (or *programme*) to use the word employed in the *SCM Agreement*), rather than individual subsidy *payments*. It is therefore the conditions of the *law* that need to be con-

[37] EC rebuttal submission, para. 29.

sidered, not the "legal circumstances in which it is granted on a *case-by-case* basis." (Italics in original).

85. Fundamentally, the EC is trying to have it both ways. In one breath, it says its challenging the Act as a whole, but in the next breath tries to divide the Act into separate alleged subsidies. The EC needs to do this, of course, because the Act, when taken as a whole, simply cannot be regarded as export contingent, as that term has been interpreted by the Appellate Body, because a taxpayer can earn excluded income without ever exporting.

86. Moreover, as the United States previously has explained, the EC's analysis is analogous to an application of the "specificity" standard of Article 2 under which a government measure would be found specific because some subset of users within the universe of users constitutes a specific group. Such a result would be clearly erroneous.

87. Finally, the EC's assertion that "[t]he US approach would render the SCM disciplines completely ineffective" is circular and incorrect. It is circular because it assumes the answer to the question posed; *i.e.*, whether a "subsidy" that is not limited to exporters is export contingent because exporters are eligible. It is incorrect because one method of curing a prohibited export "subsidy" is to broaden eligibility so that the "subsidy" is no longer export contingent, as that term has been defined by the Appellate Body. Thus, SCM disciplines are not "ineffective" to the extent that they do not prohibit non-export contingent "subsidies."

Question 41. In paragraphs 110-114 of the US oral statement, the US argues that the EC's approach to interpreting footnote 59 "never attempts to analyze the ordinary meaning of the text". Why and how would the US analysis of "the ordinary meaning of the text" lead to a different conclusion?

88. The differing approaches taken by the EC and the United States to interpreting the fifth sentence of footnote 59 lead to different conclusions regarding the application of that provision to this dispute. The EC attempts to narrow the scope of the fifth sentence of footnote 59 in ways that its language simply does not allow. The EC tries to do so in a number of ways:

- First, the EC asks the Panel to adopt wholesale the provisions of the OECD Model Convention.
- Second, as a result of the EC's undue reliance on the OECD Convention, the EC maintains that a measure to avoid double taxation must require taxpayers to maintain a "permanent establishment" with respect to every country and every transaction that results in extraterritorial income.
- Third, the EC claims that foreign-source income is limited only to income that is directly attributable to foreign economic processes performed by the taxpayer.
- Fourth, the EC argues that a country may institute a measure to avoid double taxation only upon a showing that it is "necessary" to do so.
- Fifth, the EC suggests that a measure that allows an overall tax savings does not come within the fifth sentence of footnote 59 because it permits improper "overcompensation".

89. The United States disagrees with all of these points. This disagreement stems from the fact that the United States and the EC have taken very different approaches in interpreting the fifth sentence of footnote 59. Unlike the EC, which has turned to extrinsic sources for supplying meaning to the provision in question, the United States has focused on the ordinary meaning of the relevant text.[38] It is the United States rather than the EC that is employing the correct method of interpretation under public international law. This is not merely a theoretical distinction. It results in a starkly different meaning of the fifth sentence of footnote 59 as applied in this case.

90. The United States submits that the text of the fifth sentence of footnote 59 does not prescribe the *types* of measures that may be measures to avoid double taxation. It leaves it to individual WTO Members to determine the nature and methodology of measures to avoid double taxation. It also allows Members to take a prophylactic approach, rather than waiting for a double tax actually to be levied and providing relief only after the fact. This can be seen in the language of the fifth sentence of footnote 59, which says that paragraph (e) of Annex I does not "limit" the "ability" of Members" to take "measures" to "avoid" double taxation. Footnote 59's focus is on not limiting the ability of members to fashion double tax relief.

91. The flexibility accorded to Members is also reflected by the fact that the ordinary meaning of the fifth sentence of footnote 59 essentially says in one sentence what treatises and treaties are written to achieve. These topics are the subject of considerable debate among WTO Members.

92. As a result, the United States does not believe that there are internationally accepted "special meanings" that can be used to fill in any perceived "gaps " in footnote 59. It may be convenient for the EC to point to the OECD Convention to supply requirements and conditions that are not contained in the SCM Agreement, but such reasoning is simply not in accordance with a proper interpretation under the Vienna Convention and the DSU. In contrast to the EC, the United States has cited these agreements only as evidence in support of its textual arguments. It has not attempted to substitute them for the text of the SCM Agreement.

93. Thus, respectfully, the Panel cannot assume that the concept of "permanent establishment" is a part of footnote 59. As the United States has explained, many countries do not rely on "permanent establishments" and have more aggressive tax systems. Even if it were part of footnote 59, there is no one internationally accepted definition of a "permanent establishment". The term "permanent establishment" as used in the OECD Convention can mean a fixed and enduring place of business, but it also can mean an agent acting on behalf of a non-resident. Moreover, it has a different meaning in the U.N. Model Agreement.

94. Indeed, one of the main reasons these agreements impose some "permanent establishment" requirement is because many countries tax non-residents who do not have "permanent establishments". WTO members should be able to protect their taxpayers from double taxation even where those taxpayers do not have a "permanent establishment " in a foreign country.

95. Likewise, the Panel should not read "foreign source income" as meaning only income directly attributable to foreign economic processes. Such a test is incompatible with the ordinary meaning of those words, which would seem to apply to income that has a foreign origin or comes from or is attributable to a foreign source. The EC

[38] *See US First 21.5 Submission* , paras. 166-167.

not only is unable to explain why the words "foreign source income" have the unique meaning it advances, but the EC also cannot explain how foreign economic activities are to be valued or allocated. Furthermore, the wide application of double tax avoidance measures to passive income (dividends, interest, etc.), including in the EC, would not be proper under the EC's argument because there are no economic activities associated with such income.

96. The EC also is unable to explain why a WTO Member must demonstrate "necessity" to institute a measure to avoid double taxation. The SCM Agreement does not impose such a requirement. The drafters of the WTO agreements clearly knew how to impose a "necessity" requirement – they did so elsewhere – but did not in the fifth sentence of footnote 59. Moreover, the fact that a Member has one method to avoid double taxation does not mean that it cannot adopt another. That is a matter left to the Member to decide. Many countries, including France, offer taxpayers alternative methods.

97. Finally, the fifth sentence of footnote 59 does not require that Members provide double tax relief in manner that is precisely calibrated to offset – dollar-for dollar, pound-for-pound, or euro-for-euro – foreign taxes actually paid. The essence of the fifth sentence of footnote 59 is that it leaves Members unlimited in their ability to avoid double taxation. This means that such relief can be preventive in nature. That is why a number of countries rely on the exemption method for avoiding double taxation. Unlike the credit method, which provides relief based on the amount of foreign taxes paid, the exemption method looks to whether income could be taxed elsewhere. As the Commentary to the OECD Convention explains, "[f]undamentally, the difference between the methods is that the exemption methods look at income, while the credit methods look at tax".[39]

98. Accordingly, the Act is a measure to avoid double taxation for purposes of the fifth sentence of footnote 59 because the ordinary meaning of that provision allows the United States to exclude from taxation income that could be taxed by another country. The transactions that give rise to extraterritorial income must involve the sale, use, or disposition of products outside the United States. The purchasers of such products may be foreign, title to the products may be transferred abroad, and any contracts involved may be executed outside the United States and may be subject to foreign law. In addition, the Act requires that at least a minimum amount of economic activities must occur abroad. In so crafting the Act, the United States has adopted a flexible approach to providing relief for its taxpayers against the myriad ways in which they might face double taxation.

Question 42. Is the EC correct in its statement that the "foreign economic process" requirements in Section 942(b) of the Act may be satisfied even where the functions were in fact performed within the United States? Please explain.

99. The EC is incorrect. Section 942(b) expressly provides that the Act's exclusion applies with respect to a particular transaction "only if economic processes with respect to such transaction take place outside the United States".[40] The Act does not allow this requirement to be met by performing the enumerated functions within the

[39] US-7.

[40] Section 3 of the Act, amending IRC Section 942(b)(1).

United States, as the EC asserts. As one of the legislative reports accompanying the Act's enactment explains:

> [u]nder the bill, gross receipts from a transaction are foreign trading gross receipts only if certain economic processes take place outside the United States. The foreign economic processes requirement is satisfied if the taxpayer (or any person acting under a contract with the taxpayer) participates outside of the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to such transaction and incurs a specified amount of foreign direct costs attributable to the transaction. For this purpose, foreign direct costs include only those costs incurred in the following categories: (1) advertising and sales promotion; (2) the processing of customer orders and the arranging for delivery; (3) transportation outside of the United States in connection with delivery to the customer; (4) the determination and transmittal of a final invoice or statement of account or the receipt of payment; and (5) the assumption of credit risk.[41]

100. Merely because the taxpayer can arrange by contract for an agent to perform the activities on its behalf does *not* mean that the agent may perform the activities within the United States. That agent, for example, still must negotiate or solicit sales outside the United States on behalf of the taxpayer. Accordingly, the United States is at a loss as to why the EC would contend that this requirement can be satisfied exclusively through domestic (US) activities. The EC's assertion is contradicted by the language of the Act and the legislative report explaining it.

QUESTIONS FOR BOTH PARTIES

Question 43. Can a measure of a Member provided in respect of the production of a good outside the territory of that Member be a subsidy within the meaning of Article 1 of the SCM Agreement? Please explain your answer, taking into account any relevant provisions of the SCM Agreement.

101. Yes. Although the provisions of the SCM Agreement that address this issue in general terms are not entirely clear, certain paragraphs of Annex I clearly contemplate the provision of subsidies to recipients located outside the territory of the Member providing a subsidy. Thus, the United States does not disagree with the statement made by the EC in paragraph 65 of its First Submission.

102. At the outset, the United States notes that the reference in the question to "in respect of the production" may be somewhat inaccurate in light of the Appellate Body's recent decision in *United States - Lead Bar.*[42] Although the United States previously was of the view that subsidies are provided to productive operations, the Appellate Body rejected this approach, finding instead that subsidies are provided to natural or legal persons.[43]

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[41] *Senate Report* , pages 8-9, US-3.

[42] *United States - Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom*, WT/DS138/AB/R, Report of the Appellate Body adopted 7 June 2000, DSR 2000:V, 2595.

[43] *Ibid.*

103. With this as a background, there are several provisions of the SCM Agreement that arguably touch upon the question posed by the Panel. Article 1.1(a)(1) refers to "a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as 'government') ... ." The phrase "within the territory of a Member" arguably could modify either "financial contribution" or "any public body". However, the location of the parenthetical suggests that "within the territory of a Member" modifies "any public body", so that the public body providing a financial contribution must be within the territory of the Member allegedly providing a subsidy, but that the recipient of a financial contribution need not be within the territory of that Member. If the latter had been intended, the provision presumably would have read "a financial contribution *within the territory of a Member* by a government, etc."

104. Article 8.2(b) – which is no longer in effect – refers to "assistance to disadvantaged regions within the territory of a Member ... ." However, this provision does not shed any light on the Panel's question, because the reference to "territory of a Member" arguably simply limited the circumstances under which a subsidy could be considered non-actionable, as opposed to the question of whether a subsidy existed at all.

105. Article 28.1 refers to "[s]ubsidy programmes which have been established within the territory of any Member ... ." However, this reference does not preclude the possibility that the recipient of a subsidy could be outside the territory of a Member.

106. Paragraph 6 of Annex IV – which also is no longer in effect – provided that subsidies provided by "different authorities in the territory of a Member shall be aggregated." However, this provision, like Article 1.1(a)(1), arguably refers to the location of the entity providing the subsidy, as opposed to the location of the recipient.

107. Finally, insofar as the concept of "territory" is concerned, paragraph 2 of Annex IV, which deals with the calculation of an overall rate of subsidization, provided *inter alia* that "the value of the product shall be calculated as the total value of the recipient firm's sales ... ." Footnote 63 to this paragraph stated that "[t]he recipient firm is a firm in the territory of the subsidizing Member." One can interpret this footnote two different ways. One interpretation is that it simply restates what is assumed in the remainder of the SCM Agreement; *i.e.*, that the recipient of a subsidy must be located within the territory of the subsidizing Member. Another interpretation, however, is that the footnote is necessary because it is *not* assumed in the remainder of the Agreement that the recipient must be located within the territory of the subsidizing Member. This latter interpretation would appear to be more in accordance with the principle of effectiveness of treaty interpretation.

108. Another relevant term is "jurisdiction", which in Article 2.1 refers to enterprises, industries or groups thereof "within the jurisdiction of the granting authority ... ." In the case of an alleged subsidy taking the form of a tax measure, it would seem appropriate to interpret the term "jurisdiction" as referring to the taxing jurisdiction of the Member in question.

109. Finally, certain provisions of Annex I involve practices that frequently entail the provision of a subsidy to a recipient located outside the territory of the Member providing the subsidy. In the case of export credits covered by paragraph (k), credits frequently are provided in the form of "buyer credits" that are received by a foreign

person. Similarly, the types of subsidies covered by paragraph (j) often are provided to foreign persons.

110. Although US countervailing duty practice is not binding on the Panel, the United States notes that the practice of the US Department of Commerce is generally to treat what it calls "transnational subsidies" as non-actionable. In other words, a subsidy may exist when the government of one country provides a financial contribution to a recipient in another country, but Commerce does not countervail it. However, this policy is subject to certain exceptions.

Question 44. Assume for the sake of argument that the answer to question 43 is no. What relevance, if any, would such a conclusion have in respect of the issues of export contingency which are before the Panel in this dispute?

111. This conclusion would seem to be irrelevant for purposes of analyzing export contingency, and, indeed, could have unintended adverse consequences if it were considered relevant.

112. The fact that a particular financial contribution may be labelled as a "subsidy" when provided to certain recipients and as not a "subsidy" when provided to others would seem to have little relevance to the question of whether the measure is export contingent. Again, referring to the concept of specificity – of which export contingency is a part – helps to clarify things.

113. Assume a government loan programme that provides loans to thousands of firms in a wide variety of industries at a standard interest rate of, say, 10 per cent. For all loan recipients but one, the government financial contribution – in the form of a loan – does not provide a "subsidy" because there is no "benefit." More specifically, for all recipients but one, a 10 per cent interest rate does not result in a difference between what the recipient pays on the government loan and the amount it would pay on a comparable commercial loan within the meaning of Article 14(b) of the SCM Agreement.

114. However, for one firm – which is in worse financial straits than other participants in the programme – the interest rate of 10 per cent *does* result in a difference, so that a subsidy exists. In analyzing whether this subsidy is specific, would one ignore the fact that loans on the same terms were provided to thousands of other industries, even though these loans did not technically satisfy the definition of "subsidy" under the SCM Agreement? The answer clearly has to be "no."

115. Thus, an analysis of specificity or export contingency which focused solely on those government outlays (or foregone revenue) that satisfied the technical definition of "subsidy" would generate peculiar and unintended results. In all probability, measures that previously were regarded as non-specific would be suddenly transformed into specific subsidies.

116. Indeed, insofar as the taxation of foreign-source income is concerned, an approach which focused on only one category of transactions capable of earning foreign-source income, such as exports, to the exclusion of other categories could result in labeling the tax regimes of most Members as subsidies. This follows from the fact that if, of the categories of transactions capable of generating foreign-source income, one excludes all categories involving products produced abroad, all one may be left with is the category of export transactions. Under the logic assumed in the question, the non-taxation (in whole or in part) of foreign-source income earned in export

transactions automatically would be export-contingent, notwithstanding the fact that the tax rule applied to foreign-source income earned in export transactions is the same as the rule applied to foreign-source income earned in other types of transactions. The absurdity of this result demonstrates that this approach must be incorrect.

Question 45. Is export income foreign source income? Some may take the view that the "foreign-source income" referred to in footnote 59 should include export income since the footnote is accompanying item (e) that is dealing with a type of subsidy specifically related to export. Please comment.

117. Export income can and usually does involve some amount of foreign-source income. By their very nature, exports involve more than two countries in a business transaction. They can involve foreign purchasers, foreign use of the product, foreign sales and promotion activities, foreign distribution, foreign formation and execution of contracts, foreign passage of title, foreign origin of payment, and other foreign attributes. Some or all of these attributes can give rise to income being subjected to tax by a taxpayer's country of residence as well as another, or foreign, country.

118. Whether or not a country considers income taxable or not turns on domestic law. Countries around the world employ two sets of widely varying rules that may bear on this question: taxing jurisdiction rules and sourcing rules. With regard to jurisdiction, some countries tax businesses only if they have a fixed and enduring place of business that has active and even profitable operations, while others require some lesser presence and some require no fixed or established presence at all. With regard to sourcing, some countries would view a large portion of an export transaction as being "foreign", others a smaller part, and some relatively little. There is no internationally accepted rule establishing under what circumstances exporters may be taxed in the country to which their products are sent, and there is no rule governing which parts of income earned in an export transaction can be said to be "foreign".

119. Footnote 59's connection to paragraph (e) confirms that export income may be foreign-source income, at least in part. Paragraph (e) makes clear that "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes" is prohibited by Article 3.1(a). That the fifth sentence of footnote 59 provides that paragraph (e) does not limit the ability of Members to take measures to avoid double taxation of foreign-source income means that Members may do so even through an exemption, remission, or deferral that is "specifically related to exports". If export transactions do not produce "foreign source income" within the meaning of footnote 59, then it is hard to understand why the drafters inserted the fifth sentence into a footnote attached to paragraph (e).

QUESTIONS TO THE EC

120. The United States would like to comment on the following questions posed by the Panel to the EC.

Question 1. In section 3.2.5. of its first submission, the European Communities expresses the view that the FSC Replacement scheme gives rise to two distinguishable subsidies : the "basic FSC Replacement subsidy" and the "extended FSC Replacement subsidy".

- **Does this mean that the EC is requesting the Panel to make two separate rulings, one on each of the alleged subsidies?**
- **Does the EC consider that the application of a different portion of the FSC Replacement scheme may involve different types of subsidies under the SCM Agreement?**
- **Please identify the relevant portion of the *FSC Repeal and Extraterritorial Income Exclusion Act* ("the Act") framing these two "distinguishable" alleged subsidies.**
- **Does the EC believe that the status of a subsidy under the SCM Agreement is determined by the particular legal circumstances in which it is granted on a case-by-case basis?**

121. In the view of the United States, it would be inappropriate for the Panel to bifurcate the Act in the manner suggested by the EC. The EC would like the Panel to examine the Act as if it has one category for income derived from export transactions and another for income from all other types of transactions. As the United States has explained, the Act does not treat exports differently than other transactions that may give rise to extraterritorial income. There is a single exclusion that applies to different types of foreign transactions.

122. Instead of the artificial analysis the EC advances, the United States proposes that the Panel examine the measure as it is. The United States submits that the Panel should determine whether excluding (at least in part) extraterritorial income from a wide array of foreign sales, leases, and other transactions is a subsidy or an export subsidy (among other things). If the Panel were to adopt the EC's approach, it would in effect signal that the appropriate method for analyzing any tax exclusion or exemption of foreign income would be to first examine how it applies solely to exports, and then examine how it applies to other transactions. This approach would condemn many export-neutral tax measures simply because a sub-category of taxpayers subject to the measure happen to be exporters. This approach also would create an artificial distinction that is not supported by the text of the SCM Agreement and that does not exist with respect to the measure at issue.

123. Ironically, while the EC asks the Panel to divide what the Act does not, it takes the 50-per cent value rule and attempts to integrate it into all aspects of the Act. Whereas there is no part of the Act that treats qualifying transactions differently, there is a separate provision of the Act that imposes the 50-per cent rule. Because the Act institutes the rule through a stand-alone provision, the United States suggests that it is appropriate for the Panel to rule on the EC's claims concerning the rule separately. For example, if the Panel were to find that the Act confers subsidies or exports subsidies because of the 50-per cent rule, the Panel should say so. The Panel should not condemn all provisions of the Act merely because it finds one potentially severable part to be problematic.

124. Thus, in reviewing the Act, the Panel should distinguish among its provisions where those provisions are separate within the architecture and design of the measure. The United States does object to imposing distinctions that the EC claims exist, but that cannot be found in the Act.

Question 3. The European Communities states that it "… sees no reason to contest that the last sentence of footnote 59 may be an exception to Article

3.1(a)."[44] Does this mean that the EC is of the view that measures satisfying the requirements for the last sentence of footnote 59 constitute " [m]easures referred to in Annex I as not constituting export subsidies" under footnote 5 of the SCM Agreement?

125. The United States respectfully refers the Panel to paragraphs 170-76 of its First Submission where it explained why, by virtue of footnote 5, a measure to avoid double taxation under footnote 59 is not prohibited by Article 3.1(a) or any other provision of the SCM Agreement. Neither the EC nor any third party has disputed this point.[45]

126. In this regard, several of the follow-up questions posed by the Panel to the EC appear to relate to the following: if the Act should be found export contingent by virtue of Article 3.1(a), rather than paragraph (e), would footnote 59 apply? In the view of the United States, the answer clearly is "yes."

127. Footnote 5 of the SCM Agreement reads as follows: "Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement." "[M]easures to avoid the double taxation of foreign-source income" are "referred to in Annex I [specifically, in footnote 59] as not constituting export subsidies ... ." Therefore, such measures are subject to footnote 5, regardless of the particular paragraph in Annex I to which footnote 59 is attached.

128. Any other outcome would have the absurd and perverse result that double taxation avoidance measures that are "specifically related to exports", within the meaning of the narrower standard of paragraph (e), are permitted, but comparable measures that are *not* "specifically related to exports" but nonetheless are export contingent under Article 3.1(a) are prohibited.

Question 5. Please provide further clarification of the point made in paragraph 227 of the EC second submission.

129. It is unclear to the United States how, under the Act, "income earned by a US company by distributing foreign goods may in large part be earned in the US." It would seem to the United States that, if a company is distributing foreign goods, it is doing so outside the United States. If a company is earning income by distributing goods for use within the United States, that income may not be excluded.

130. The United States is at a loss to understand how income earned from wholly-foreign transactions would not give rise to income subject to tax in a foreign jurisdiction and thus be subject to double taxation. The United States notes that Canada has agreed with the United States on this point. As it stated in its submission, "the 'foreign income' component of 'extraterritorial income' is the type of income typically subject to a measure to avoid double taxation." Accordingly, it is entirely appropriate for the United States to provide relief from double taxation with respect to this income.

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[44] EC second submission, para. 181.

[45] The United States notes that in its first submission in *Brazil - Export Financing Programme for Aircraft - Second Recourse by Canada to Article 21.5 of the DSU*, WT/DS46 (2 March 2001) para. 54, note 42, Canada takes the position that footnote 59 is one of four provisions in Annex I that are subject to footnote 5. The United States adds that Canada, like the United States, routinely makes public its submission in WTO dispute settlement proceedings.

131. The United States also would note that the EC has focused throughout these proceedings on the case where the taxpayer's activities in the foreign jurisdiction do not amount to a permanent establishment. What the EC has ignored is that taxpayers can earn excluded extraterritorial income when the taxpayer's activities *do* amount to a permanent establishment. The Act would provide relief from double taxation in such a case, even under the EC's argument.

Question 6. The European Communities claims that the FSC Replacement scheme is a prohibited export subsidy contrary to Article 3.1(a) *and* item (e) of Annex 1 of the SCM Agreement. Are these alternative claims? In the EC's view, which claim must be addressed first by the Panel?

132. In the view of the United States, there is only a single obligation – not to provide export subsidies – and a single claim – that the United States has not abided by this obligation. The EC simply may be making alternative arguments to support what is really a single claim.

ANNEX F-4

ANSWERS OF THE UNITED STATES TO QUESTIONS FROM THE EC

(27 March 2001)

Q1. The US does not contest that the benefit to taxpayers available under the FSC scheme is arithmetically equivalent it [*sic*] that available under the Act. Is their [*sic*] any reason why transactions and taxpayers that would have benefited from the FSC scheme would not in future, obtain equivalent benefits under the Act?

Reply

The "benefit" of the FSC regime is **not** "arithmetically equivalent" to the computation of excluded extraterritorial income, because the numbers used to determine the quantitative component of the Act's exclusion are not identical to the numbers used in the FSC regime. Even if there were arithmetic equivalence, moreover, this issue is irrelevant. Neither the Panel nor the Appellate Body in *FSC* found objectionable the percentages contained in the FSC provisions. The EC's attempts to compare the provisions of the FSC and the Act therefore are neither accurate nor meaningful.

Under the Act, the category of income excluded from US gross income is defined based on both a quantitative component and a qualitative component. The percentages contained in section 941 supply the quantitative component. The qualitative component defines a broader category of income subject to the exclusion than would have been eligible for the FSC exemption under the prior FSC regime. Most significantly, the qualitative definition of the category of income the United States has chosen not to tax applies without regard to whether the income is earned from exports, and without regard to whether the income is earned by a US or foreign individual, a US or foreign corporation, or a partnership or other pass-through entity. Accordingly, it is misguided to attempt to compare the prior FSC regime to the Act based on similarities in the quantitative measures.

Q2. According to the Congressional Budget Office, the new scheme will involve an increase in tax expenditure compared to the FSC. Please provide details as to how this increased tax expenditure arises?

Reply

The Act defines a category of income that is excluded from gross income and thus is not subject to tax. Because, unlike the FSC regime, the Act applies to a defined category of income, without regard to whether the income arises from an export sale and without regard to the taxpayer earning the income, the estimated revenue loss for the Act is independent of and greater than the revenue loss for the former FSC regime. In this regard, the CBO would publish the same type of projected revenue loss if Congress were to reduce the general corporate income tax rate.

More generally, the EC consistently misuses the term "tax expenditure." This misuse appears to stem from the EC's misunderstanding of the term. The determination of whether a provision is a tax expenditure is made on the basis of a broad, theoretical concept of "income" that is larger in scope than is "income" as defined under US income tax law. The Appellate Body in *FSC* rejected the use of benchmarks based upon what income theoretically could be subject to tax, in favour of the benchmark established by the member's actual law. Accordingly, the EC's use of tax expenditure analysis is not particularly helpful to the resolution of this case.

Q3. What part of that estimated increased tax expenditure is attributed to transactions involving goods manufactured abroad? What are the other sources of the increase in tax expenditure?

Reply

See answer to questions 2 and 4.

Q4. Has the US government produced any other studies or estimates of the impact of the Act?

Reply

The United States is not aware of any other published studies or estimates of the impact of the Act.

Q5. Why does Section 942(a)(3) of the Act allow taxpayers the option to exclude any transaction from being Foreign Trade Income under the Act and therefore from the exclusion of extraterritorial income from tax?

Reply

The following reason is set forth in the legislative history of the Act: "A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a consequence of such an election, the taxpayer could utilize any related foreign tax credits in lieu of the exclusion as a means of avoiding double taxation." *Senate Report* (US-2), page 8; *see also House Report* (US-3), page 21.

Q6. Why does Section 943(a)(3) of the Act exclude five categories of property from being capable of giving rise to excluded income under the Act? Why does Section 943(a)(4) allow the President to exclude other property that he determines to be in short supply from being capable of giving rise to excluded income under the Act?

Reply

Neither the Act nor the legislative history of the Act, as set forth in the reports of the relevant congressional committees, articulates the legislative intent behind sections 943(a)(3) and (4).

Q7. Why does the new Section 943(d)(1) provide that: "For purposes of section 114(d), any withholding tax … shall not be treated as paid or accrued with respect to extraterritorial income which is excluded from gross income under section 114(a)."? Why does new Section 943(d)(2) make an exception for the case that qualifying foreign trade income is calculated under 941(a)(1)(A)?

Reply

Neither the Act nor the legislative history of the Act, as set forth in the reports of the relevant congressional committees, articulates the legislative intent behind section 943(d).

Q8. What guidance or regulations relating to the Act has the US government produced or is planning to produce?

The US Department of the Treasury ("Treasury") and the US Internal Revenue Service ("IRS") already have released Form 8873, for use in calculating the amount of the exclusion. Treasury and the IRS currently intend to release the following additional guidance: (i) a revenue procedure providing guidance with respect to elections under the Act, (ii) a notice containing guidance with respect to specific issues under the Act, and (iii) proposed regulations interpreting the Act.

Q9. When imposing countervailing duties on *pasta from Italy* (Case C-475-819 ; 14 June 1996), DOC found that the Italian government was granting a subsidy because it exempted firms in the South of Italy from local income tax for a period of 10 years, while firms in the North of Italy had to pay such taxes. If the Italian government were to contract its taxing authority, and exclude the relevant profits of firms in the South of Italy from its definition of gross income (thus modifying its prevailing domestic benchmark), does the US consider that no subsidy would exist ?

Reply

See answer to Question 11.

Q10. Under section 80HHC of the Income Tax Act of India, the Government of India allows exporters to deduct profits derived from the export of merchandise from taxable income. In a number of countervailing duty investigations e.g. *Certain Iron-Metal Castings From India: Preliminary Results of Countervailing Duty Administrative Review* (Case C-533-063, 64 FR 61592 12 November 1999), the DOC has countervailed this exemption from income tax on export profits as an export subsidy. If the Indian government were to contract its taxing authority, and exclude the relevant profits derived from exports from its definition of gross income (thus modifying its prevailing domestic benchmark), does the US consider that no subsidy would exist ?

Reply

See answer to Question 11.

Q11. More generally, how would the US react if a WTO Member were to exclude all profits from sales of goods for final consumption abroad from its jurisdiction to tax?

With respect to Question 9, the Italian measure in question constituted an exception to the prevailing domestic benchmark. Similarly, with respect to Question 10, the Indian measure provided a special deduction with respect to income that would be taxed under India's prevailing domestic benchmark. Questions 9-11 essentially ask the same question: how would the United States react if another Member altered its prevailing domestic benchmark.

With respect to these questions, the United States refers the EC to the US answer to Question 20 from the Panel.

Q12. In discussing export subsidies in Section 351.514 of its CVD regs, DOC states :

> **However, under the new standard contained in Section 351.514, if exportation or anticipated exportation was either the sole condition or one of several conditions for granting Pioneer status to a firm, we would consider any benefits provided under the program to the firm to be export subsidies unless the firm in question can clearly demonstrate that it had been approved to receive the benefits solely under non-export-related criteria. In such situations, we would not treat the subsidy to that firm as an export subsidy.**

Does the US consider that this practice is in conformity with the *SCM Agreement*?

Reply

Just as the EC has declined to address in detail how the tax regimes of its own member states would fare under the interpretations of the SCM Agreement that the EC has advanced in this case, the United States declines to speculate on the status of section 351.514 under the SCM Agreement. The United States simply notes that this regulation was promulgated prior to any of the Appellate Body reports elaborating on the meaning of the term "contingent" as used in Article 3.1(a) of the SCM Agreement.

The United States also would add that the quoted language refers to exportation being a "condition" for the granting of Pioneer status, and, in fact companies can be required to agree to export a certain percentage of their production in return for Pioneer status, as reflected in the portion of the DOC notice that the EC omitted.[1] This is quite different from the Act, under which a given taxpayer can earn excluded income through export transactions, but is not required to export in order to earn excluded income.

Q13. A firm based in Texas produces only farm tractors and sells them directly to two unrelated customers. One customer is in California, the other in

[1] To be technically correct, the EC has not quoted the regulation itself, but rather the preamble to the regulation which explains the regulation and addresses comments from the public submitted in the course of the rulemaking proceeding that led to the regulation.

France. The firm makes the same profit on each transaction. On which of these transactions can the firm claim the benefit of the FSC Replacement Act? Please explain why.

Reply

The firm can earn excluded extraterritorial income on sales to both the customer in California and the customer in France. As the United States explained in response to question #11 from the Panel, the Act permits a US manufacturer of goods to earn excluded income from sales to domestic buyers, provided that the goods in question are used outside the United States. As long as the farm tractors are used outside the United States, the firm can earn excluded extraterritorial income in the sale to the customer in California and the customer in France.

This can occur in a number of ways. For example, a customer in southern California may purchase farm tractors for use in farming operations across the border in Mexico. The hypothetical firm's sale of the farm tractors under such circumstances would generate excluded income under the Act, assuming that the Texas firm satisfied the other requirements of the Act.

Q14. The same firm then begins producing lawn tractors. In what circumstances can it use this product to obtain further benefits under the Act?

Reply

The Act provides significant flexibility to the Texas firm in its production decision. The firm could earn excluded extraterritorial income by (i) selling or leasing tractors produced in the United States (ii) selling or leasing tractors purchased from a related or unrelated US company with a foreign production facility, (iii) selling or leasing tractors produced under a consignment arrangement with a related or unrelated US company with a foreign production facility, (iv) selling or leasing tractors purchased from a related or unrelated foreign manufacturing corporation that has made a domestication election, (v) selling or leasing tractors produced under a consignment arrangement with a related or unrelated foreign manufacturing corporation that has made a domestication election, or (vi) establishing its own foreign production facility and selling or leasing tractors produced in that facility.

More generally, it is immaterial whether the firm in question makes farm tractors, lawn tractors, or a totally different line of production.

Q15. Can the US explain the economic, social, political or fiscal objectives/goals that the 50 per cent foreign content limitation aims to achieve?

Reply

Neither the Act nor the legislative history of the Act, as set forth in the reports of the relevant congressional committees, articulates the legislative intent behind the 50 per cent rule.

Q16. What effects does the US anticipate that the 50 per cent foreign content limitation will produce?

Reply

It is not clear what the EC means by "effects" in this question. Moreover, the provision in question is not properly referred to as "the 50 per cent foreign content limitation" because it imposes no general restriction on foreign content; "qualifying foreign trade property" could consist of a product composed entirely of foreign content. In the context of the issues raised by the EC regarding the 50 per cent rule, the United States does not anticipate that the rule will have the "effect" of requiring taxpayers to use domestic over foreign goods in order to earn extraterritorial income.

Q17. Does the US agree that where more than 50 per cent of the fair value of a product is attributable to articles and direct labour costs within the meaning of section 943(a)(1)(C) IRC then not all of that 50 per cent may be foreign?

Reply

See the US answer to Question 8 from the Panel.

Q18. Does this not mean that some of it must be US-origin?

Reply

To the extent that the "it" the EC is referring to is articles, the answer is "no." See the US answer to Question 8 from the Panel.

Q19. How does the FSC Replacement scheme apply to the sale of foreign-produced agricultural products. How is the foreign content limitation applied to growing crops, freshly harvested crops and graded and cleaned agricultural commodities?

Reply

The Act contains no special provisions in respect of agricultural products.

In this regard, the EC appears to take the position that statements made by the United States in the initial phase of this proceeding regarding the FSC definition of "export property" and the application of that definition to agricultural products somehow constitutes an admission by the United States in the instant proceeding that an agricultural product produced abroad could never satisfy the 50 per cent limit on certain foreign value, and, thus, could never be eligible for the Act's exclusion. *EC First 21.5 Submission*, paras. 220-221. Of course, in the statement quoted by the EC, the United States merely was expressing its opinion that, given the likely sourcing patterns of US producers of agricultural products, the FSC definition of "export property" was unlikely to have any practical effect.

To be clear, however, the United States has never made the admission ascribed to it by the EC, and the EC's assertion ignores the differences between the FSC definition of "export property" and the Act's 50 per cent rule. Under the FSC, one of the criteria for "export property" was that no more than 50 per cent of the property's fair market value could be attributable to imports. Under the Act, however, the criteria for "qualifying foreign trade property" is that no more than 50 per cent of the fair market value of a good may be attributable to the sum of foreign articles and

foreign direct labour. The United States believes that agricultural products produced abroad are capable of satisfying this rule, and, thus, are capable of earning excluded extraterritorial income.

Of course, as the complainant, the burden of proving that agricultural products could not satisfy the definition of qualifying foreign trade property is on the EC, and the EC has submitted no evidence whatsoever on this point. Although the United States does not bear the burden of disproving the EC's unsubstantiated assertions, the United States nonetheless would note that a available data demonstrates that agricultural products produced abroad would be capable of satisfying the 50 per cent rule.

For example, based on data from the US Department of Agriculture (USDA) for US production in 1999, the "total gross value of production"[2] for soybeans (in dollars per planted acre) was $178.00. The cost of items that arguably could be considered "articles" (seed, fertilizer, soil conditioners, manure, and chemicals) amounted to $52.98. The cost for hired labour and the opportunity cost of unpaid labour amounted to $20.90. Thus, the total cost of articles and labour was $73.88, a figure well below 50 per cent of $178. In fact, this figure is below the single biggest item of cost, which was the opportunity cost of land (rental rate), which amounted to $77.66.

Of course, these are US data, but they are no more nor less representative than the purported European data provided by the EC in the annexes to its submissions. And, of course, it bears repeating that it is the EC, not the United States, that bears the burden of proof.

Q20. The US argues that the exclusion of 'extraterritorial income' from tax is justified as a measure to avoid double taxation. This necessarily implies that such income could be taxed in foreign countries. Therefore, would the US agree that foreign countries, which either have no bilateral tax treaties with the US or terminate them, may require US exporters to pay tax the profits made by them from exporting to their territories.

Reply

As the United States explained in its prior submissions to the Panel, the Act requires that transactions giving rise to extraterritorial income must have a variety of foreign attributes that can result in a sufficient nexus to a foreign taxing regime so as to render US taxpayers potentially subject to foreign taxation.

Transactions giving rise to extraterritorial income involve goods that must be used, consumed, or disposed of outside the United States. Thus, the purchasers of these goods typically will be located outside the United States, they generally will authorize or make payment for the goods in another country, and in many instances title will pass in that country as well. In addition, certain required levels of foreign economic activities must be performed with respect to the sales and distribution functions associated with qualifying transactions. These foreign attributes can lead a foreign taxing regime to tax the profits earned on sales of goods sold by US exporters to foreign customers. The United States, in response to Question 12 from the Panel, has

[2] "Gross value of production" may not correspond precisely to "fair market value" as used in the Act, but it is the closest term used in the data.

provided several examples of foreign taxing regimes that may tax extraterritorial income earned in export sales.

Accordingly, the United States believes that a significant risk of double taxation exists with respect to excluded extraterritorial income, which is why the Act provides necessary relief with respect to this category of foreign-source income. The question of whether foreign tax jurisdictions *should* seek to impose tax upon excluded extraterritorial income is a question more appropriately addressed to foreign tax policy officials.

Q21. If a US producer sells a good directly to a customer in a third country, is the income derived from this transaction foreign sourced?

Reply

See the US answer to question 45 from the Panel.

Q22. How can the exemption of such income be a measure to avoid double taxation?

Reply

The extraterritorial income exclusion is a measure for the relief of double taxation precisely because excluded extraterritorial income may be subject to tax in a foreign jurisdiction. See the US answers to questions 12 and 45 from the Panel and 20 from the EC.

Q23. If the intention of the Act is to avoid double taxation, why is the foreign content limitation present?

Reply

That the 50-per cent rule may operate so as to narrow the class of transaction producing excluded extraterritorial income is irrelevant to whether the exclusion comes within footnote 59. As the United States explained in response to question 19 from the Panel, nothing in footnote 59 requires that a measure for the relief of double taxation must resolve the problem of double taxation completely or precisely. Stated differently, all income that may be subject to double taxation need not be covered by a particular double taxation avoidance measure for that measure to be "intended" to avoid double taxation or for that measure to come within the scope of the fifth sentence of footnote 59. This is most clearly evident in the use of tax credits, which apply only to certain foreign taxes and, even where they do apply, often provide less than full relief.

Therefore, the United States submits that the 50-per cent rule has no bearing on the interpretation and application of footnote 59.

Q24. According to the US, is it compatible with the *SCM Agreement* for a WTO Member to allow its favoured companies the right to opt for a more generous system of double taxation relief, that is not available to other taxpayers?

Reply

The United States does not know what the EC means when it refers to "favoured companies". The United States submits that the Act in no way applies to a limited or "favoured" group of taxpayers.

Similarly, while the United States is pleased to see the EC acknowledge once again the advantages of the exemption method, the United States does not believe it is accurate to say that the exemption method is always "a more generous system of double taxation relief." Depending on the circumstances of a particular taxpayer, there may be situations where the use of the credit method is more favorable from the perspective of the taxpayer.

To the extent that this question is another way of the EC again raising its point that the United States should not be allowed to provide different mechanisms for avoiding double taxation, the United States notes that it explained in paragraphs 35-38 of its Second Submission why countries can and do rely on alternative methods of avoiding double taxation. This is a common and well-accepted practice. For example, in France, with the permission of the Ministry of Economy and Finance, a French company may elect to be taxed on its worldwide income and obtain relief from its worldwide losses. Thus, in the context of export subsidies, alternative methods of double taxation relief should be irrelevant, especially where no unique or special benefits are provided exclusively to exporters.

In the view of the United States, the key point is that US foreign tax credits are not available for excluded income. Thus, there is no "more generous system of double taxation relief."

Q25. According to the US is it compatible with the *SCM Agreement* to allow favoured companies to double the amount of benefit that is available under the Member's system for the relief of double taxation for certain beneficiaries?

Reply

See answer to question 24.

Q26. Does the US legislation contain any such anti-avoidance rules that were designed to prevent unwarranted exclusion of "qualifying foreign trade income" in all those cases where no other country will tax that income and thus, where there is no double taxation? The US Subpart F rules are designed to prevent unwarranted tax deferral but is the US contemplating any measures to prevent possible abuse of the FSC Replacement Act?

Reply

The Act does contain certain measures to prevent tax avoidance. For example, under section 943(e)(1), a foreign corporation that elects to be treated as a US corporation under the Act must waive all treaty benefits. If the electing foreign corporation could claim US treaty benefits, then it could claim under a US treaty that it remained a resident of its original jurisdiction under the "tie-breaker" rule of the treaty, thus obtaining an exemption for all of its income that is covered by the treaty. This would defeat the very purpose of the domestication election, which is to place all foreign manufacturing activities on par with respect to the US tax system. Although the EC has voiced its strenuous objection to this rule, it is a rule designed to prevent tax avoidance and to prevent the double non-taxation of income.

ANNEX F-5

COMMENTS OF THE EUROPEAN COMMUNITIES ON THE ANSWERS OF THE UNITED STATES TO THE QUESTIONS PUT FOLLOWING THE MEETING OF THE PANEL

(3 April 2001)

1. The EC[1] believes that the Panel is aware of the EC position on most of the points made by the US in its answers to the questions of the EC and the Panel following the meeting of the Panel with the parties. It will confine its comments to the following brief observations on matters where the EC position may not be fully clear to the Panel or where the EC considers that a comment on its part may be of assistance to the Panel.

1. Pertinence of the Legislative History

2. The US prefaces its answers to the Panel's questions with some remarks on the elements of legislative history that the EC presented at the meeting of the Panel in its Closing Statement.[2]

3. The US argues that US courts do not attach much importance, when interpreting US laws, to floor statements in the US Congress, but consider more important Committee reports in discerning the will of Congress. It concludes by stating that:

> Thus, any *post hoc* speculation of the sort sought by the EC as to what Congress intended would be nothing more than that: mere, and legally irrelevant, speculation.[3]

4. The EC would simply recall that it was not invoking legislative history for the purposes of interpreting the FSC Replacement Act. The terms of that measure are quite clear. The EC was responding to the US' refusal to respond to a series of questions about the *purposes* pursued by the US (not only Congress) in adopting this measure. (The US has invoked an alleged purpose of the FSC Replacement Act in its defence when it claimed that the FSC Replacement Act was "influenced by ongoing congressional review" of the US tax system.[4])

5. The US claims not to know why the FSC Replacement Act contains a foreign content limitation, why it excludes from its benefit products in short supply and why an alleged double taxation measure only applies to goods with limited foreign content "not for ultimate use in the US."[5] The legislative history demonstrates that the US in fact knew the reasons why these provisions were carried over from the FSC regime or inserted in the FSC Replacement scheme.

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[1] In the interests of conciseness, the European Communities abbreviates both its own name and that of the United States to EC and US respectively. It would request however that the term "European Communities" be used in the Panel Report.

[2] Closing Statement of the EC to the meeting of the Panel, paragraphs 3 to 9 and exhibits EC-16 to 19.

[3] Answers of the US to the questions from the EC, preliminary comments.

[4] First written submission of the US, paragraphs 24 and 25.

[5] As noted in paragraphs 3 to 9 of the Closing Statement of the EC to the meeting of the Panel and confirmed in the US' answers to Questions 2, 3, 4, 6,7, 15 and 16 from the EC.

2. US Erroneous statements about the FSC Replacement Act

6. The US has made some erroneous factual allegations concerning its FSC Replacement Act. The EC is astounded that the US should do this at such a late stage in the proceedings.

7. In paragraph 51 of its Answers to the Questions from the Panel the US states that:

> … excluded extraterritorial income would be foreign-source income under US sourcing rules, as set forth in section 862(a)(4) and 863(b) of the IRC.

In the same vein the US claims in paragraph 60 that:

> The extraterritorial income exclusion, however, is limited to the foreign-source income that arises when property is sold or leased for use outside the United States because the United States has determined not to cede primary taxing jurisdiction over US-source income.

8. These statements are demonstrably wrong and contradict what the US stated during the meeting with the Panel.[6] The EC feels obliged to explain why foreign-source income and extraterritorial income are entirely unconnected concepts.

9. Extraterritorial income is a new creation of the FSC Replacement Act. The foreign-source income concept is well established in the US tax law as a means of addressing primary tax jurisdiction for purposes of the statutory provisions that have the effect of eliminating or at least alleviating double taxation. Thus, a foreign corporation is generally subject to US tax on its US-source income, but not its foreign-source income.[7] A US corporation, while subject to tax on its worldwide income, is generally eligible for foreign tax credit based on the portion of its income that is sourced outside of the US.[8]

10. Extraterritorial income could be entirely US-source, entirely foreign-source or a mixture of the two. If a product were manufactured in the US and then sold by the manufacturer to another party for use outside the US in a transaction in which title passed from the manufacturer to the buyer within the US, the income realized by the manufacturer would be entirely US-source. Conversely, if the product were manufactured and sold in Europe by a US corporation or an electing foreign corporation, the income realized by the manufacturer would be sourced entirely outside the US. As a middle case, if the product were manufactured in the US but sold in a transaction in which title passed to the buyer outside the US, the transaction would produce a combination of US-source and foreign-source income. All three scenarios could produce the same extraterritorial income, provided that the other requirements of the Act were satisfied.

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[6] In its oral answer to what became EC Question 21 to the US, the US replied (correctly) and repeated a number of times that the source of income is not relevant for determining extraterritorial income. In its written answers the US avoids responding to this question.

[7] IRC, sections 881 and 882 (Exhibit EC-21).

[8] IRC, section 904 (Exhibit EC-21).

3. Existence of a subsidy – qualifying foreign trade income defined as a reduction in taxable income

11. Question 7 from the Panel to the US asked the US to comment on the fact that the new section 941(a)(1) of the IRC defined qualifying foreign trade income as "the amount of gross income which, if excluded, will result in a reduction of taxable income of the tax payer from such transaction" by a defined amount.

12. This formulation is effectively converting a given reduction in taxable income into an equivalent reduction in gross income. The US explanation of why it does this is revealing. It states that:[9]

> Because excluded extraterritorial income is excluded from the US tax base, however, the Act denies deductions attributable to such income. This presents a computational problem: how are disallowed deductions to be removed if the excluded amount is based on gross income, which does not account for any deductions? The problem is solved by first computing taxable income, then denying deductions allocable to excluded extraterritorial income, and then "grossing up" the resulting figure into a gross income exclusion by attributing to the taxable income amount any allocable deductions.

13. In other words, the above formulation is necessary because extraterritorial income is excluded from gross income and therefore taxable income must be "grossed up" in order to allow expenses to be deducted correctly. It refers to the explanation in the legislative history:

> [I]n order to calculate the amount that is excluded from gross income, taxable income must be determined and then "grossed up" for allocable expenses in order to arrive at the appropriate gross income figure."[10]

14. The US explanation serves to demonstrate the fact that the US is excluding part of a category of income from tax. Expenses are normally associated with a type of income or arise out of the activities required to produce the income. The reason why the "computational problem" arises is that the US is excluding from tax only part of a "category" of income, properly so-called.

15. The FSC Replacement scheme "exclusion" is in fact a formula-derived fraction of a type or category of income. Looking at the example contained in the Committee Report referred to by the US, it appears that the best measure of the actual taxable income derived from the sale of qualifying foreign trade property is "foreign trade income." In fact, the IRC defines "foreign trade income" as "the taxable income of the taxpayer attributable to the foreign trading gross receipts of the taxpayer."[11] In the example, this is $100. Yet the exclusion in the example is $60. Thus, the IRC is not excluding or giving up jurisdiction over all of the income attributable to a defined economic activity.

16. Thus, the US answer to this question simply underlines that qualifying foreign trade income cannot be regarded as a true category of income.

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[9] US answers to the questions from the Panel, paragraph 12.
[10] The US refers to the Senate Report in Exhibit US-2, page 12.
[11] Section 941(b) of the IRC.

4. Could other countries tax extraterritorial income?

17. Question 12 of the Panel to the US asked whether

> Where qualifying foreign trade property is manufactured, produced, grown or extracted within the United States by a US corporation or an individual permanently established in the United States, and where that corporation or individual does not maintain any permanent establishment outside the United States, are there situations in which extraterritorial income earned from the sale of such property can be taxed by another country than the United States?

18. The US replies by referring to the laws of 6 countries, Brazil, Chile, Malaysia, Panama, Taiwan and Saudi Arabia, which it claims do not rely on the concept of "permanent establishment" as a basis for taxation of income. The US statements are inaccurate. Even based on the partial quotations from the documents of the *International Bureau of Fiscal Documentation*[12], it can be understood that many of the countries mentioned by the US do have rules that are based on or analogous to the "permanent establishment" notion as far as taxation of business profits of foreign enterprises is concerned. For example:

- Brazil: under Brazilian legislation foreign enterprises pay tax on income derived through branches or agencies. As to the former, according to point 4.04 of exhibit US-24 branches are commonly understood to be registered (that is, to be "permanent" offices, or in other words, "fixed places of business" through which a foreign corporation carries out business operations). Thus, a branch is within the permanent establishment concept as defined in Article 5 of the OECD Model Convention). As to agencies, the rules set out in the third paragraph of point 4.05 are clearly based on Article 5.5 of the OECD Model Convention. A "dependent agent" under the OECD Model Convention constitutes a "permanent establishment".

  Moreover, in point 4.06 (direct trading) it is said: "payments for imported goods to non-resident sellers are not subject to income tax since imported goods are not from Brazilian sources".

- Chile: in point 4.04 of Exhibit US-25 it is stated that "the tax administration has declared that a foreign enterprise acting in Chile through a person who is not a representative with authority to conclude contracts and who rather makes contacts and provides information on potential clients, *is not deemed to have a permanent establishment* in Chile" (emphasis added). This language closely resembles that of Article 5 of the OECD Model Convention. Still in the same point (4.04) it is stated that "The Chilean income of agencies, branches and other permanent establishments of foreign enterprises operating in Chile is established... " This language also strongly suggests that Chile indeed is recognizing the same or a very similar standards to the OECD Model Convention.

[12] Exhibits US-24 to US-29.

- Malaysia: in point 11.3 of Exhibit US-26 it is stated: "The OECD model definition of permanent establishment is generally used in Malaysian double taxation treaties".

19. More fundamentally, the EC would note that:

- The US does not identify any double taxation problem with these or any other country that the FSC Replacement scheme is designed to solve. It simply suggests that there may be a theoretical possibility of double taxation.
- It is clear from the US description of these tax regimes and the annexes that all of these six countries only tax the *domestic-source income* of foreign corporations.

20. Even if it is true that some countries may not rely on an easily identifiable concept of "permanent establishment" as a basis for taxation, it is clear that no country tries to tax foreign corporations on foreign-source income. Countries only seek to tax the *domestic source income* of foreign corporations.

21. The question is therefore really whether qualifying foreign trade income of US exporters would be considered domestic-source income by foreign countries.

22. The FSC Replacement Act excludes from US tax income that would never be considered domestic source income in any other country – that is does not arise from economic activity or processes conducted in another country. The FSC Replacement scheme foreign economic process requirements simply require a certain minimal amount of *foreign costs* – not any *foreign income* at all. Countries tax the *income* arising from activities – not the *costs*!

23. The US has not identified any country in the world which considers that taxes the income of foreign exporters simply because they sell goods to customers in its territory and have some minimal costs in its territory. So far as the EC is aware, all countries only tax the domestic source income of foreign corporations and this requires that the income *arises* in their territories, not simply that some costs are incurred in their territories.

24. The US is effectively inviting WTO Members to impose a novel kind of tax on imports – to require foreign exporters to pay tax in their territories on the profits they make from exporting to those territories!

25. Finally, the EC would repeat that it is not relying on the OECD Model Convention to fill a "gap" in footnote 59 as alleged by the US[13] but simply as evidence of international practice. The EC and the US in fact agree on that the OECD Model Convention is only relevant as evidence of international tax practice. Reference to the concept the "permanent establishment" as a basis for taxation of business income is relevant as:

- A description of how most countries with developed taxation systems agree to apportion taxation authority;
- A demonstration that for income to be considered to arise in a country, that is have its source in that country, and to be taxable when earned by foreigners, there must be physical presence by which the income can be earned;

[13] Answers of the US to the questions of the Panel, paragraph 92.

- A recognition of the fact that, *in practice,* countries cannot collect tax on foreign business income if there is no lasting physical presence on which the tax can be levied and against which enforcement procedures can be directed.

5. The use of alternative means for the avoidance of double taxation

26. In reply to Question 16 from the Panel, the US argues that other countries do provide alternative mechanisms for the avoidance of double taxation.

27. The EC is not in a position to comment on whether and to what extent the tax systems of other countries do provide alternative mechanisms for the avoidance of double taxation.

28. The EC would only comment that allowing certain companies a choice of mechanisms for the avoidance of double taxation gives rise to revenue forgone that would otherwise be due and thus a subsidy under Article 1 *SCM Agreement,* at least where this is allowed transaction by transaction, since it can be assumed that companies will use this possibility to reduce their tax burden in a way not available to other companies.

29. The subsidy element in the FSC Replacement scheme, even if it is accepted as a mechanism for the avoidance of double taxation, is even clearer due to an additional feature – that it is not confined to foreign-source income. US taxpayers may, under general US tax rules, only obtain double taxation relief on their foreign-source income.[14] The FSC Replacement scheme allows what is claimed to be double taxation relief on both foreign-source income and domestic-source income. That is an advantage that no other US taxpayers are allowed, gives rise to revenue forgone and is contingent upon export performance.

30. The availability of double taxation relief on domestic-source income under the FSC Replacement scheme is also not covered by the last sentence of footnote 59. First, such an advantage is not an "exemption, remission or deferral of tax". Second the last sentence of footnote 59 is specifically limited to measures for the avoidance of double taxation on *foreign-source income*.

31. As a final comment in this Section, the EC would like to formally refute, again[15], the US suggestion in its response to question 24 from the EC[16] where it states "the US is pleased to see the EC acknowledge once again the advantages of the exemption method... " To be clear, the EC recognizes that each system has its own advantages for taxpayers and tax authorities in different circumstances. It does not however acknowledge that either system in itself presents any advantage for exports.

6. The meaning of the term "foreign-source income"

32. The EC has already set out its views on the meaning of the term foreign-source income in footnote 59 but would like to make two comments on the US answer to Question 15 from the Panel.

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[14] Section 904(a) of the IRC (exhibit EC-21).

[15] See also answers of the EC to Questions 23 and 35 from the Panel (esp. paragraphs 56 and 94).

[16] Answers of the US to the questions from the EC, paragraph 39.

33. First, the US refers the Panel[17] to the use of this term in footnote 6 to Article XIV of GATS, which states in its final paragraph that

> Tax terms or concepts in paragraph (d) of Article XIV and in this footnote are determined according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure.

34. The US seeks to use this text to assert that:[18]

> A key point in footnote 6 for purposes of the present dispute is the fact that the final sentence provides that the tax terms used in the relevant text do not have universally agreed upon meanings. Thus, the final sentence indicates that the negotiators of GATS wanted to provide flexibility to capture the various instances in which income can be regarded as "sourced" within a Member.

35. The EC does not agree that this text reflects a desire to allow flexibility in the sense desired by the US – that foreign-source income can mean whatever suits at any time. It provides, on the contrary, *precise* meanings to taxation terms and concepts – those used in the tax system of the Member.

36. The EC does not consider that the fact that something is stated expressly in one of the WTO agreements means that the same must necessarily be considered to apply under another agreement. Particular caution is required in the case of footnote 6 to the GATS because of the different concerns that it was addressing, arising out of the special features of trade in services.

37. However, if the approach reflected in the last sentence of footnote 6 to Article XIV GATS were to apply to footnote 59 to the *SCM Agreement*, the FSC Replacement scheme would not come within its scope because the benefit it grants is not limited to foreign-source income, within the meaning that term is given under the US tax system.

38. The US seems to have misunderstood paragraph (iv) of footnote 6 to Article XIV GATS.[19] This appears to relate to measures to ensure the collection of taxes of income of *consumers* derived from sources in the Member's territory. It does not support the apparent US view that the "source" of income can be the place where the customer is located.[20]

39. Equally irrelevant is the US argument that "source" must be given a "broad" meaning in footnote 59 so as to cover the different ways in which passive income can arise. Footnote 59, being attached to item (e), relates to tax exemptions etc that are "specifically related to exports". It therefore applies to income derived from trade in goods, not to "passive income".

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[17] The US also refers the Panel to the use of the term "source" in the TRIMS agreement. Since this is not referring to income or taxation, the EC does not consider that it adds anything to the use of the term in the trade defence agreements referred to by the EC; They all simply demonstrate that "source" has a similar meaning to " origin".

[18] US answers to the questions from the Panel, paragraph 45.

[19] US answers to the questions from the Panel, paragraph 46.

[20] The US also quotes but does not comment on paragraphs (i) and (vi) of the footnote. Paragraph (i) also does not support the US theory, but on the contrary is simply referring to the place income arises, and therefore supports the EC view of "source." Paragraph (vi) does not refer to the notion of source at all.

40. Second, the US refers to the use of the term "foreign-source income" by the Appellate Body in the original proceedings. The US misrepresents the Appellate Body report.

41. The Appellate Body did not "apply the term broadly;" it was clearly referring to income arising abroad. Also, although it did not expressly refer to the meaning of the term in the tax system under consideration, it did not exclude this interpretation. Indeed, elsewhere in the Report the Appellate Body says that:

> We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question.[21]

7. The US Specificity Argument

42. In response to Questions 20 and 21 from the Panel and in particular the fact that according to the US interpretation of Article 1 of the *SCM Agreement* the exclusion of all export income from gross income and therefore tax would not constitute a subsidy, the US invents, as an alternative argument, a novel theory according to which an exclusion of certain income from "gross income" (or an equivalent notion) would become a subsidy within the meaning of Article 1 of the *SCM Agreement* if it is specific in the sense of Article 2 of the *SCM Agreement.*[22]

43. The EC considers this argument completely misguided because the *SCM Agreement* clearly provides that the question of specificity only arises once it has been established that a subsidy exists.

44. The argument also appears pointless since Article 2.3 of the *SCM Agreement* **deems** all subsidies falling under the provisions of Article 3 to be specific. It cannot therefore save the FSC Replacement scheme.

45. The US is effectively arguing that an exception be made from Article 3 the *SCM Agreement* for prohibited subsidies that are non-specific within the meaning of Article 2.1 and 2.2 of the *SCM Agreement*. There is no basis for this in the text of the Agreement; indeed the text says the opposite. In any event, the EC does not accept that the FSC Replacement subsidies are non-specific.

8. The EC's Demonstration of the effect of the 50 per cent rule (Question 8)

46. Question 8 from the Panel to the US asked the US:

> The European Communities states that, in order for extraterritorial income to be excluded from taxation, "US articles must be used whenever the cost of other inputs (not articles or direct labour) (C) and profit (D) are less than 50 per cent of the selling price (or more exactly the US-assessed fair market value) of the goods".[23] Is this a correct characterization of Act ? If not, could the US provide what it considers to be the correct description?

[21] Appellate Body report, DSR 2000:III, 1619, paragraph 90.
[22] US answers to the questions from the Panel, paragraph 63.
[23] The Panel referred the US to EC first submission, para. 112.

47. Apart from repeating its view that the EC can only prevail if it demonstrates that "the Act contains an affirmative requirement to use US articles,"[24] the US response is limited to alleging that the EC' statement is inaccurate because:[25]

> … the EC's algebraic breakdown fails to reflect the Act's distinction between the foreign labour and US labour components.

48. The reason for this is simply that the EC made the simplifying assumption that there would be no US direct labour costs in foreign production.

49. The US does not respond to the Panel's request to provide an alternative description of the effect of the Act. A more sophisticated description of the effect of the Act that entirely takes account of the US criticism is easy to formulate, as the EC stated at the meeting with the Panel. It is simply necessary to split the component representing direct labour costs into two parts, B1 representing US direct labour and B2 representing foreign direct labour. Paragraph 112 of the first written submission of the EC can then be rewritten as follows:

> Since A2 + B**2** may not exceed 50 per cent of SP, (i.e. A2 + B**2** must be = or < SP/2), then mathematically,
>
> A1+**B1**+C+D must constitute at least 50 per cent of SP (i.e. A1+**B1**+C+D must be = or > SP/2 which can be expressed as A1 = or > SP/2-C-D**-B1**). This means that A1 will be positive whenever SP/2 > C+D**+B1**
>
> In other words, US articles must be used whenever the cost of **US labour (B1) and** other inputs (not articles or direct labour) (C) and profit (D) are less than 50 per cent of the selling price (or more exactly the US-assessed fair market value) of the goods.[26]

50. With this correction, the EC' description of the effect of the Act meets the only criticism the US has made. It can then also be used to demonstrate in what circumstances the Act requires the use of US articles in the production of qualifying foreign trade property in the US.

9. Export Contingency

51. In its first written submission, the EC offered a relatively detailed discussion of the meaning of the terms "export" or "exportation" in the *SCM Agreement.*[27] The EC sought to go beyond the dictionary definition stating that the definition "send (esp. goods) to another country" was not of much help, that is, did not fully exhaust the question.

52. The Panel invited the US to comment on this issue in its Question 10 to the US. The US does not attempt to debate the issue but states that

> The United States believes that the EC got the definition right the first time, when it followed the dictionary definition: "Send (esp. goods) to another country".[28]

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[24] US answers to the questions from the Panel, paragraph 17.

[25] US answers to the questions from the Panel, paragraphs 16 and 18 (quotation from paragraph 18).

[26] Bold type indicates changes from the original description to take account of the US criticism.

[27] First written submission of the EC, paragraphs 85 to 92.

[28] US Answers to the questions from the Panel, paragraph 21.

53. The EC does not consider that this can be an exhaustive definition of the meaning of the terms "export" in the *SCM Agreement* or in the *WTO Agreement.* But it can at least agree that it may not be necessary for the Panel to examine all the nuances of the term for the purposes of the present case.

54. Since, in order to qualify for the FSC Replacement scheme, a transaction involving US-produced goods must not be " for ultimate use in the US," it follows that these goods must be sent across the border of the US in order for the transaction to qualify.

55. Conscious that this means naturally that the goods must therefore be sent to another country, the US claims in answer to the Panel's next question, Question 11, that export may not always be necessary since a fishing boat could be not for ultimate use in the US even though it never arrives in a foreign country.

56. It is noteworthy that the US is unable to definitively assert that such a transaction would benefit from the FSC Replacement scheme stating that:

> … the precise scope of these rules will be the subject of proposed regulations to be issued in the future.[29]

57. But even if the US were to adopt rules that allowed transactions involving fishing boats and the like to benefit from the FSC Replacement scheme and even if it were accepted that such transactions are not "exports", it would remain the case that goods which are destined to be used in the territory of a country (the vast majority of goods) need to be exported in the sense of being sent to another country in order to benefit from the FSC Replacement scheme. For those goods, the FSC Replacement scheme is, even on the basis of the US definition, contingent upon export performance.

58. The other arguments of the US in relation to these questions relate to goods that may return to the US after exportation in the sense of being sent to another country, such as aircraft and tyres installed on foreign produced cars.

59. The EC would point out that these examples need not concern the Panel if it adopts the simple definition of export advanced by the US. Being sent to another country is in any event a condition that must be fulfilled by such goods if the FSC Replacement scheme is to apply.

60. The EC would draw the Panel's attention to one final point that simplifies the debate on this issue. It is that the requirement of not "for ultimate use in the US" in the FSC contained in the definition of "qualifying foreign trade property" in the FSC Replacement Act is in all material respects identical to the definition of "export property" under the FSC scheme.[30]

61. Thus, the FSC Replacement scheme is just as export-contingent as was the FSC scheme.

10. The applicability of Article III:4 of GATT 1994 to local content requirements contained in tax measures

62. In its reply to Question 18 from the Panel the US takes the view that income tax measures do not fall within the scope of Article III:4 of GATT 1994.

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[29] US Answers to the questions from the Panel, paragraph 22.

[30] See comparative table in paragraph 160 of the EC's first written submission.

63. Article III:4 of GATT 1994 is concerned with laws, regulations of requirements affecting the internal sale, purchase, use of products. However, Article III:4 does not specify, and therefore does not limit, where the requirements (including legislative ones) must be written in order to be caught by its prohibition.

64. As indicated since its First Written Submission, the EC has not challenged under Article III:4 the tax benefit, but rather one of the conditions to obtain it (the foreign content limitation).

65. The passage of the Panel Report in *Indonesia - Cars* to which the US refers correctly analyzed the issue and is not an *obiter dictum*. Assessing the meaning and scope of Article III was necessary for the Panel in order to dispose of Indonesia's defence, which turned on Article III as a whole.

66. If the measure in which a local content requirement is written were to be relevant in deciding whether it is covered by Article III:4, it would be quite easy to circumvent the prohibition in that provision of providing advantages to domestic products.

67. As recalled by the EC at the hearing, subsidies embodying a local content condition have indeed been reviewed under Article III:4.[31] There has been no discussion on, nor limitation to, this possibility of review. The US even recognizes in its reply that there have been cases where claims against *income taxes* benefits were brought.

68. The US tries to belittle this practice by referring to the drafting history of GATT 1947. Even if the drafting history could be relevant in the presence of a clear and unqualified prohibition in the text of Article III:4[32], and even if the drafting history of GATT 1947 meant what the US contends, this would not entail that such history be relevant to interpret Article III:4 of GATT 1994. GATT 1994 was negotiated after some practice was developed – including the cases that the US itself now brings to the Panel's attention – in the sense of making claims against subsidies and income tax measures under Article III:4. The EC would add that the in *United States – Taxes on Automobiles*[33] the Panel reviewed i.a. a US measure (the "CAFE" requirement) which did not concern products, but which was a penalty imposed on persons (enterprises). That dispute, started on 20 May 1992, further shows that the scope of Article III:4 was not viewed as being limited to measures directly concerning products, inasmuch as these embodied "requirements" favouring the sale, purchase or use of domestic products.

69. In the light of the practice recalled by the Panel in its question, by the EC and by the US, it is clear that if the drafters of the Uruguay Round agreements were on notice that such interpretations were possible and if they had intended to limit the scope of Article III:4 they would have been able to do so – for example by annexing

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[31] *EEC – Animal Feed Proteins* (see EC's reply to Question 32 from the Panel).

[32] Article 32 of the *Vienna Convention on the Law of Treaties* provides that

> "Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to *confirm the meaning resulting from the application of article 31*, or to *determine* the meaning when the interpretation according to article 31:
> (a) *leaves the meaning ambiguous or obscure*; or
> (b) leads to a result which is manifestly absurd or unreasonable." (emphasis added)

[33] DS31/R, 11 October 1994.

an *Understanding* on that specific provision. The text of and footnote to Article XIV (d) of GATS, also recalled by the US, further show that the drafters did provide for specific rules to address direct taxation when they so wanted.

70. Thus, there is no reason why Article III:4's unqualified prohibition would not cover other measures directly concerning persons, like direct taxes subsidies, inasmuch as these embodied a "requirement" favouring the use of domestic products.

11. Applicability of FSC Replacement scheme to Agricultural production

71. The EC has argued that the FSC Replacement scheme is a prohibited export subsidy, regardless of its extension to foreign- produced goods. The EC also argued that the alleged alternative means of obtaining the subsidy, i.e. production abroad, is also export contingent. The EC has argued that the extension of the FSC Replacement scheme to foreign produced goods is subject to a 50 per cent rule which creates in many cases a requirement for exports to be made from the US.

72. As regards agriculture, specific characteristics inherent to agricultural production and in particular to commodities make the qualification of foreign-grown agricultural products for the FSC Replacement scheme fraught with additional obstacles. The US example in fact illustrates very well the EC's point.

73. In question 19, the EC asked how the FSC replacement scheme is applied to foreign-produced agricultural products. The US gives no specific indication (which is hardly surprising, as the US has provided no guidelines on how it will apply the 50 per cent rule). It provides an example, using US data, whose stated objective is to demonstrate that foreign-grown agricultural products could qualify as qualifying foreign trade income and benefit from the extended FSC Replacement subsidy.

74. Even taken at their face value[34], the US methodology and data highlight very clearly the obstacles to benefiting from the scheme by growing agricultural products abroad. A more complete look at the USDA set of data cited as regards US production of soybeans immediately reveals that, based on the exact application of the US methodology, the limitation of 50 per cent value attributable to "articles" and labour is reached and surpassed in several regions of the US both in 1998 and 1999. In 1999 for example, articles + labour > 50 per cent in the US regions of the Southern Seaboard (76.59 per cent) and Mississippi Portal[35] (59.9 per cent). In 1998, 50 per cent was surpassed in the Eastern Uplands (57.27 per cent) and Mississippi Portal (52.6 per cent).[36]

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[34] The EC will not enter into a discussion of the methodology used by the US, as it judges that an examination of the US example as it stands is sufficient at this stage to illustrate the EC's point.

[35] These are regions defined by USDA, each including several States.

[36] The US proceeds as follows in paragraph 29 of its reply to EC Question 19 (emphasis added):

> based on data from the US Department of Agriculture (USDA), for US production in 1999, the 'total gross value of production' for soybeans (in dollars for planted acre) was $178.00. The cost of items that arguably could be considered 'articles' (seed, fertilizer, soil conditioners, manure, and chemicals) amounted to $52.98. The cost for hired labour and the opportunity cost of unpaid labour amounted to $20.90. *Thus, the total cost of articles and labour was $73.88, a figure well below 50 per cent of $178*".

For "articles" (seed, fertilizer, soil conditioners, manure and chemicals) and "labour" the EC has taken the same factors as identified by the US, and the same gross value of production in $/planted acre.

Eastern Uplands:

75. What is also extremely revealing is that the same producers, for the same commodity, for the same US region could one year hypothetically "qualify" for the exemption and the following year find themselves well above the 50 per cent ceiling. In one region, the Southern Seaboard, articles and labour jumped from 43 per cent in 1998 to 76 per cent of value of production in 1999.

76. Similar patterns can be found in other commodities in the USDA set of data. As regards wheat, for instance, the US-wide data show that, between 1998 and 1999, the proportion of the identified factors passed from 45.56 per cent to 50.44 per cent. As regards specific areas, the proportion was always above 50 per cent in the Basin and Range region (54.97 per cent in 1998 and 53.43 per cent in 1999), in the Heartland region (57.7 per cent in 1998 and 56.5 per cent in 1999), and in the Southern Seaboard region (83.7 per cent in 1998 and 87.6 per cent in 1999). It was above 50 per cent in the Fruitful Rim region (50.08 per cent) in 1998, and in 1999 in the Northern Great Plains region (50.49 per cent).[37]

77. A situation in which the factors identified by the US are above 50 per cent is thus very common even in the very data set cited by the US. The actual proportion of

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1998: "articles" + labour = 100.43$; value of production = 175.36$; percentage of sum of articles and labour = 57.27

Southern Seaboard:

1998: "articles" + labour = 94.29$; value of production = 217.20$; percentage of sum of articles and labour = 43.4

1999: "articles" + labour = 92.65$; value of production = 120.96$; percentage of sum of articles and labour = 76.59

Mississippi Portal:

1998: "articles" + labour = 75.51$; value of production = 143.50$; percentage of sum of articles and labour = 52.6

1999: "articles" + labour = 72.40$; value of production = 120.75$; percentage of sum of articles and labour = 59.9

[37] *US-wide data*:

1998: "articles" + labour = 50.55$; value of production = 110.95$; percentage of sum of articles and labour = 45.56

1999: "articles" + labour = 48.04$; value of production = 95.23$; percentage of sum of articles and labour = 50.44

Basin and Range region:

1998: "articles" + labour = 87.19$; value of production = 158.6$; percentage of sum of articles and labour = 54.97

1999: "articles" + labour = 82.74$; value of production = 154.84$; percentage of sum of articles and labour = 53.43

Heartland region:

1998: "articles" + labour = 72.73$; value of production = 125.97$; percentage of sum of articles and labour = 57.7

1999: "articles" + labour = 68.28$; value of production = 120.69$; percentage of sum of articles and labour = 56.5

Southern Seaboard:

1998: "articles" + labour = 92.33$; value of production = 110.25$; percentage of sum of articles and labour = 83.7

1999: "articles" + labour = 89.30$; value of production = 101.91$; percentage of sum of articles and labour = 87.6

Fruitful Rim:1998: "articles" + labour = 84.87$; value of production = 169.44$; percentage of sum of articles and labour = 50.08

Northern Great Plains:

1999: "articles" + labour = 42.76$; value of production = 84.69$; percentage of sum of articles and labour = 50.49

the relevant factors may vary from region to region of the same country, and what's more, from year to year for the same region. The US set of data thus precisely illustrates another obstacle to the application of the scheme to foreign-grown agricultural products - the impossibility for producers to predict with any certainty whether they will be able to qualify for the exemption.

78. Price variation is of course at the heart of this situation. This is an inherent aspect of agricultural production. It is well known that the price volatility of agricultural commodities is very high, and bears little or no relation to cost variations.[38]

79. The practical consequence of this is that producers cannot be certain that they will meet their cost target to qualify for the FSC replacement, as the final price will not normally be known until after costs are incurred.

80. The US example proves the EC's point because prices and costs vary, not only by region within the same country but also in time. Even if in some areas and/or at some times a producer may be tempted to believe that its foreign-grown agricultural product could conceivably qualify, the certainty will escape him because of the inherent characteristics of agricultural production such as the relationship between agricultural prices and costs. Taxpayers will therefore be well advised to turn to US production if they wish to be able to rely on the benefits of the FSC Replacement scheme.

12. The foreign process requirements

81. Question 42 of the Panel to the US concerned the foreign economic process requirements in the FSC Replacement Act.[39]

82. The EC had not devoted much attention to the foreign economic process requirements so far in this proceeding merely noting that they bore no relationship with the amount of excluded income.[40] The US had also said little about the foreign economic process requirements and has not contested that they bear no relation to the amount of the excluded income.

83. The EC statement that may have given rise to the Panel's question was in its closing statement to the meeting of the Panel:[41]

> ... the foreign economic processes requirement in the FSC Replacement Act is based on a percentage cost test and that it can be met without undertaking any activities outside the US. In this context it is equally important to bear in mind that US taxpayers wishing to be eligible for the subsidy can outsource to independent third parties all the activities, if any, that are to be performed outside the US.

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[38] Going no further that the USDA data cited by the US, soybeans gross value of production in 1999 fell 37 per cent from 1997 and 21 per cent from 1998 levels. The above-cited increase in percentage of the US-identified relevant factors in the Southern Seaboard soybean production from 43.4 per cent in 1998 to 76 per cent was in fact accompanied by a decrease of costs of these factors.

[39] Question 42 reads:

> Is the EC correct in its statement that the "foreign economic process" requirements in Section 942(b) of the Act may be satisfied even where the functions were in fact performed within the United States? Please explain.

[40] First written submission of the EC, paragraph 59 and second written submission of the EC, paragraph 220.

[41] Paragraph 28.

84. In view of the US' answer to Panel Question 42, and in case the Panel may consider it relevant, the EC will now set out its views on the foreign economic process requirements of the FSC Replacement Act in some more detail.

85. The foreign economic process requirements, now found in section 942(b) of the IRC are not materially different from the corresponding FSC scheme requirements found in section 924(d) of the IRC and are more symbolic than substantive. The Conference Committee Report specifically mentions the foreign economic process rules as one of the areas in which the existing FSC rules are to apply until rules are issued under the new statute.[42]

86. The FSC regulations state that

> Any person, whether domestic or foreign, and whether related or unrelated to the FSC, may perform any activity required to satisfy this section, provided that the activity is performed pursuant to a contract for the performance of that activity on behalf of the FSC.[43]

And that:

> If no direct costs are incurred by the FSC in a particular category, that category shall not be taken into account for purposes of determining satisfaction of either the 50-per cent or the 85-per cent foreign direct cost test. If any amount of direct costs is incurred in a particular category, that category shall be taken into account for purposes of the foreign direct costs test.[44]

87. Thus, while costs cannot literally be zero, they can be small. If one satisfied the 85 per cent test with respect to any two categories set forth in section 942(b)(3) of the IRC, one would satisfy the requirement of section 942(b)(2)(B) even if the costs involved in each of those two categories were minimal.

88. For example, a US company could satisfy the foreign direct cost requirement with respect to advertising costs by placing an advertisement in a foreign trade journal. Incurring a cost of this nature would certainly not cause the income realized from a sale of the advertised product to be foreign-source income.

89. One of the treatises regarding FSCs states that:

> Some exporters satisfy the advertising costs requirement by taking out an annual advertisement in a foreign trade journal which includes all export products marketed by it. Although the foreign direct costs allocated to each export transaction will be minimal, this fact will not prevent the FSC from meeting the foreign direct costs test. If there are no domestic sales promotion expenses attributable to the export property…, then this activity will satisfy the advertising and sales promotion direct cost category for those products.[45]

90. The regulations make this test even easier to satisfy, because they provide that:

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[42] Technical Explanation of the Joint Committee on Taxation, 1 November 2000, page 22 (Exhibit EC-5A).

[43] Reg. § 1.924(d)-1(b)(1).

[44] Reg. § 1.924(d)-1(d)(1).

[45] BNA Tax Management Portfolio No. 934, *Foreign Sales Corporations*, at A-29 (1998).

> Costs relating to advertising in United States publications are not treated as direct costs even if the publication also has a foreign edition in English.[46]

91. The EC would also remind the Panel that, as under the FSC scheme, there is no requirement to incur any cost for "foreign economic processes" for taxpayers whose foreign trading gross receipts do not exceed US$ 5 million in any taxable year.[47]

92. For further illustration of how minimal the foreign economic process requirements are in practice, the Panel may wish to refer back to the explanations provided in the original proceedings, including Exhibit EC-31.

[46] Reg. § 1.924(e)-1(a)(1)(iii)(C).
[47] Section 942(c)(1) of the IRC.

ANNEX F-6

COMMENTS OF THE UNITED STATES ON THE EC'S ANSWERS TO QUESTIONS FROM THE PANEL

Q1. In section 3.2.5. of its first submission, the European Communities expresses the view that the FSC Replacement scheme gives rise to two distinguishable subsidies : the "basic FSC Replacement subsidy" and the "extended FSC Replacement subsidy".

- **Does this mean that the EC is requesting the Panel to make two separate rulings, one on each of the alleged subsidies?**
- **Does the EC consider that the application of a different portion of the FSC Replacement scheme may involve different types of subsidies under the SCM Agreement?**
- **Please identify the relevant portion of the *FSC Repeal and Extraterritorial Income Exclusion Act* ("the Act") framing these two "distinguishable" alleged subsidies.**
- **Does the EC believe that the status of a subsidy under the SCM Agreement is determined by the particular legal circumstances in which it is granted on a case-by-case basis?**

Reply

1. With respect to the EC's answer to this question, the United States refers the Panel to the US answer to this question,[1] and reiterates that there is a single exclusion that applies to different types of foreign transactions. To restate in an accurate manner the first sentence of paragraph 2 of the EC's answers, "there is a single exclusion that covers different situations."

2. In this regard, the lengths to which the EC will go in its attempt to bifurcate the Act is revealed in paragraph 3 of the EC's answers, where the EC asserts that "domestication" is a condition of what the EC refers to as the "extended FSC Replacement subsidy". Of course, the EC conveniently omits the fact that a foreign branch of a US corporation can earn the "extended subsidy" without any "domestication".

3. Also in paragraph 3, the EC slips in the assertion that "it will *often* be necessary to use US articles" under the "extended subsidy." (Emphasis added). Of course, the EC has provided no evidence whatsoever to support the assertion that the necessity to use US articles will arise "often." The EC has not provided evidence that such a necessity actually will arise even once.

4. Finally, in paragraph 4 of the EC's answers, second bullet, the EC reiterates the argument that the United States quoted in paragraph 84 of its own answers to the Panel's questions. The United States refers the Panel to paragraphs 80-87 of the US answers, which explain how the EC is trying to have it both ways in this dispute; *i.e.*,

[1] US Answers to Questions from the Panel, paras. 121-124; see also *Ibid.*, paras. 67-75 and 80-87.

in one breath, it says its challenging the Act as a whole, but in the next breath tries to divide the Act into separate alleged subsidies.

Q2. The European Communities claims that the FSC Replacement scheme is *de facto* export contingent and therefore contrary to Article 3.1(a) of the SCM Agreement.[2] Please explain how the legislation as such - which, by its terms, at least in the case of FSCs in existence on 30 September 2000, does not apply to transactions occurring before 1 January 2002 - can constitute a *de facto* violation of Article 3.1(a) of the SCM Agreement. Can the EC cite any GATT/WTO reports in which legislation as such was found to be a *de facto* violation of *any* obligations under the GATT/WTO Agreement?

Reply

5. With respect to paragraph 8 of the EC's answer to Question 2 and the EC's statement that the "standard of contingency is the same, whether the subsidy arises *de facto* or *de jure*", the United States reiterates that throughout this case the EC has ignored the meaning of the term "contingent" as interpreted by the Appellate Body. The relevant decisions of the Appellate Body are discussed in the *First US 21.5 Submission* at paragraphs 109-110, which for the convenience of the Panel, the United States reproduces here:

> 109. According to the Appellate Body, the "key word" in Article 3.1(a) is "contingent." The Appellate Body has explained that the term "contingent" has an ordinary meaning of "conditional" or "dependent for its existence on something else." Thus, an export subsidy within the meaning of Article 3.1(a) is a subsidy that requires recipients to export in order to obtain it. Or, in the words of the Appellate Body, "the subsidy is available only upon fulfilment of the condition of export performance."
>
> 110. It is not enough for a subsidy to be granted upon the mere expectation that the subsidy will lead to new or additional exports; the grant of the subsidy in and of itself must be conditioned on export performance. As the Appellate Body has said, "It does not suffice to demonstrate solely that a government granting a subsidy *anticipated* that exports would result. The prohibition in Article 3.1(a) applies to subsidies that are *contingent* upon export performance ... . A subsidy may well be granted in the knowledge, or with the anticipation that exports will result. Yet, that alone is not sufficient, because that alone is not proof that the granting of the subsidy is *tied to* the anticipation of exportation." (Footnotes omitted).

6. By contrast, the EC standard for export contingency in this case ignores applicable Appellate Body teachings. Because the Act, on its face, clearly allows a taxpayer to earn excluded income without exporting, it cannot be regarded as "conditional", "dependent" or "tied to" exportation. As discussed above in connection with the EC's response to Question 1, in an effort to avoid the Appellate Body's teachings, the EC improperly bifurcates the Act's exclusion into two separate exclusions.

[2] EC first submission, para. 145.

7. With respect to paragraph 11 of the EC's answer, if the EC actually is making an alternative claim of *de facto* export contingency, it has provided absolutely no evidence to support such a claim. Significantly, the EC does not even cite to any evidence that it has submitted which would support a claim of *de facto* export contingency.

Q3. The European Communities states that it "¼ sees no reason to contest that the last sentence of footnote 59 may be an exception to Article 3.1(a)."[3] Does this mean that the EC is of the view that measures satisfying the requirements for the last sentence of footnote 59 constitute "[m]easures referred to in Annex I as not constituting export subsidies" under footnote 5 of the SCM Agreement?

Reply

8. The EC assertion in its answer to Question 3 that footnote 59 is simply a hortatory reminder that double taxation avoidance measures are not subsidies is implausible. First, if this is what the drafters had intended, they would have made footnote 59 a footnote to Article 1, as they did in footnote 1 with respect to the exemption of indirect taxes.[4]

9. Second, the EC's answer to Question 3 is inconsistent with its prior position in this dispute. Previously, the EC took the position that the "last sentence of footnote 59 may well guide the interpretation of Item (e) in a manner that is narrower than an alternative interpretation that might prevail in its absence."[5] Translated, this constitutes an admission by the EC that the fifth sentence of footnote 59 qualifies the scope of paragraph (e). The United States will address footnote 59 further in its comments on the EC's answer to Question 45.

Q5. Please provide further clarification of the point made in paragraph 227 of the EC second submission

Reply

10. The EC does not adequately explain why it believes that extraterritorial income earned in a wholly foreign transaction is not foreign-source income. The EC merely refers to an example in which a US company distributes foreign-made goods. This example would result in extraterritorial income if the US company distributed foreign-made goods to foreign purchasers or for foreign use. In fact, this example would almost certainly involve distribution outside the United States. It is unclear why such activities would be "domestic source" or would involve exportation at all.

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3 EC second submission, para. 181.
4 See *FSC (AB)*, DSR 2000:III, 1619, para. 93.
5 *FSC (Panel)*, DSR 2000:IV, 1675, para. 4.949.

Q13. Regarding the relationship between Article 3.1(a) of the SCM Agreement and item (e) of Annex I, would it be possible that a certain measure is not within the scope of the latter, but nonetheless within the scope of the former, and *vice versa*?

Reply

11. In the view of the United States, the EC did not answer the Panel's question, which was aimed at whether the standard of "contingency" is narrower in paragraph (e) than in Article 3.1(a).

12. The United States also notes that the example provided by the EC in paragraph 26, first bullet, is incorrect. The United States does not know what the EC means by its reference to "export promotion", but in the case of "shipping companies", shipping companies provide a service. Thus, if a tax exemption constituted a subsidy to shipping companies, such a subsidy would not fall under the SCM Agreement at all.

Q14. The Panel is well aware that the WTO-conformity of income tax regimes of European countries is outside the scope of our terms of reference for this case. In paragraph 96 of the US first submission, the US introduces examples of a few European tax systems which "refrain from taxing foreign income in a qualified or conditional manner."[6] Among those systems, is there one which excludes foreign income from the scope of taxable income on the following conditions:

(i) the property for sale from which income arises must be held for ultimate use outside the country, (and not be sold for final consumption in that country); and

(ii) the same property must have foreign content of not more than a certain percentage of its fair market value.

Reply

13. The United States refers the Panel to the US answer to Question 14, and our comments on the EC's answer to Question 23. In the view of the United States, the fact that exports are taxed more favourably than domestic transactions under European tax regimes cannot be seriously contested.

14. With respect to paragraph 28 of the EC's answer to Question 14, the United States has not argued that "the term 'foreign-source income' should be interpreted widely so as to signify export income." The United States merely has argued that export transactions are one type of foreign transaction that typically generates foreign-source income. As an evidentiary matter, the EC has not established that the types of transactions capable of earning excluded income under the Act do not have a "foreign-source income" component, nor has the EC established that the Act somehow excludes domestic-source income.

[6] US first submission, para. 97.

Q15. Is the term "foreign-source income," "foreign-source" or "source" used elsewhere in any provisions of other WTO Agreements than the SCM Agreement? What guidance, if any, may be drawn as to the meaning of these terms from the SCM Agreement or other WTO Agreements?

Reply

15. The United States notes what the Panel probably has figured out on its own; namely, that with respect to the Panel's question regarding the use of the term "foreign-source income" in the *FSC* panel and Appellate Body reports, the EC did not answer the Panel's question, but instead engaged in a seemingly irrelevant discussion of the *Tax Legislation Cases*. The United States respectfully refers the Panel to the US answer to Question 15.

16. The European Communities claims that[7]: "Even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) of the SCM Agreement because it gives exporters a *choice* that is not available to other operators. This additional advantage would also be a subsidy,. This unwarranted *overcompensation* is also a subsidy.

(For the EC): Please provide a textual analysis of how the alleged *additional advantage* and *overcompensation* constitute subsidies under Article 1 of the SCM Agreement.

(For the US): How does the US respond to this allegation?

Reply

16. The United States is pleased to note that in its answer to this question, the EC appears to have abandoned its specious argument that the existence of a choice between the use of foreign tax credits and the exclusion somehow constitutes a subsidy. This argument is not credible given that: (1) the OECD Convention considers it acceptable to use credits, exemptions, or both methods of double taxation avoidance,[8] (2) the EC previously has acknowledged that most countries use a combination of methods to avoid double taxation,[9] and (3) EC member states, such as France, allow for such a choice.[10]

17. The United States also reiterates that the Act and its legislative history make clear that there is no "double double taxation relief", as the EC puts it. Foreign tax credits may not be used with respect to excluded extraterritorial income.[11] As the United States has explained previously, the Act does not provide a special advantage to a privileged class of taxpayers. Instead, it merely provides an alternative form of double taxation relief that is broadly available to taxpayers. The availability of an

[7] EC second submission, paras. 221-222.
[8] See First US 21.5 Submission, para. 181.
[9] See US Oral Statement, para. 141, citing to EC-2, page 2 (US-5).
[10] See US Answers to Questions from the Panel, para. 52.
[11] See the Act § 3, amending IRC § 114(c)-(d) (US-1); Senate Report, page 2 (US-2); House Report, page 10 (US-3); First US 21.5 Submission, para. 26; Second US 21.5 Submission, paras. 36-38; and US Oral Statement, paras. 148-151.

alternative in this context is no different than similar choices found in tax systems around the world. Either the Act's incorporation of the exemption method itself is problematic under WTO rules or it is not. To hold, as the EC suggests, that the Act can be a prohibited export subsidy because it provides an alternative mechanism of relief – even if that method is otherwise unobjectionable – simply cannot be correct.

Q17. The EC seems to argue that a Article 3.1(b) violation may exist if a certain measure gives an "incentive" to domestic production for export.[12] In the same vein, the EC argues that "Article 3.1(b) prohibits local-content contingency to *any* degree, [and] there is no *de minimis* rule for prohibited subsidies in the SCM Agreement.".[13]

> **(For the EC): How would this argument be supported by a textual analysis of Article 3.1(b) in accordance with Article 31 of the *Vienna Convention*? Can the European Communities cite any Appellate Body or panel reports in which the term "incentive" was explicitly used in the context of Article 3.1 of the SCM Agreement, or Article XVI:4 of the GATT Agreement?**
> **(For the US): Would a textual analysis of Article 3.1(b) lead to a conclusion that the EC's above argument is without merit? If so, why and how? Would the US take the view that there is *de minimis* rule for prohibited subsidies in the SCM Agreement? If so, what is the qualitative or quantitative threshold for that rule? Is the Appellate Body Report in *Canada - Certain Measures Affecting the Automotive Industry*[14] relevant to this question? Please give reasons for your responses.**

Reply

18. With respect to paragraph 43 of the EC's answer to this question, the United States believes that it is the EC that has provided a selective interpretation that fails to give meaning to all of the words used in Article 3.1(b). For reasons previously expressed, the EC has ignored the meaning of "contingent." Similarly, the EC's interpretation of the phrase "domestic over imported goods" is not based on the ordinary meaning of the words used, and the conclusion the EC draws from the phrase already has been rejected by the Appellate Body.[15]

19. With respect to paragraph 44 of the EC's answer, the EC quotes the Appellate Body statement that Article III:4 "also addresses measures that favour the use of domestic over imported goods."[16] From this, the EC appears to draw the conclusion that the Appellate Body has found that the standard for Article 3.1(b) is one of "favouring" domestic products.

20. This is a classic *non sequitur*. A measure that is "contingent" upon the use of domestic over imported goods, within the meaning of Article 3.1(b), would "favour"

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[12] See EC first submission, para. 165.
[13] EC second submission, para. 160.
[14] WT/DS130/AB/R, WT/DS142/AB/R, DSR 2000:VI, 2985.
[15] See US Answers to Questions from the Panel, paras. 53-57.
[16] As a technical point, the United States observes that the EC failed to note that it added emphasis to the quotation that is not in the original.

domestic goods, but that does not mean that the standard under Article 3.1(b) is transformed from "contingent" into "favour." Moreover, the next sentence in *Canada Autos* that immediately follows the sentence quoted by the EC states: "Nevertheless, both Article III:4 of the GATT 1994 and Article 3.1(b) of the *SCM Agreement* apply to measures that *require* the use of domestic goods over imports."[17] The 50 per cent rule does not "require" the use of domestic goods over imports.

Q23. The EC argues that, "for owners of US produced goods, export is a condition for obtaining the benefits under the scheme for those goods"[18] and that there is accordingly an export subsidy. Assume the existence of an exclusion from taxation for all foreign-source income based upon application of a pure territorial system. Would export not be a condition for owners of domestically-produced goods to obtain the exclusion in that case as well? Does this mean that the application of a pure territorial system would also involve an export subsidy? Please explain.

Reply

21. The EC contends that export transactions under a territorial system are taxed the same way as non-export transactions.[19] This contention is incorrect.

22. For a taxpayer to earn excluded income under a territorial system, the taxpayer must export the goods to a foreign jurisdiction. It is irrelevant what happens to the goods after they are exported. Certain goods may be imported back into the home jurisdiction in a "round-trip" sale for consumption in the domestic market.[20] Other goods may be sold through the taxpayer's foreign branch or subsidiary for consumption in a foreign market. Regardless of their ultimate destination, however, the goods *first must be exported* to the taxpayer's foreign branch or subsidiary in order for the taxpayer to earn exempt income.

23. When the goods are exported – which again they must be to qualify for the exemption – they are taxed more favourably than comparable domestic sales, as the EC admits: "More favourable treatment of export sales through a foreign distribution [*sic*] compared with domestic sales through a domestic distribution subsidiary may arise out of the fact that the foreign country has a lower tax rate (but not when the foreign tax rate is higher)."[21] Accordingly, the EC's defence of its member states' use of the territorial exemption method conflicts with its own attack on the Act's exclusion of extraterritorial income.

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[17] Canada - Certain Measures Affecting the Automotive Industry, WT/DS139/AB/R, WT/DS142/AB/R, Report of the Appellate Body adopted 19 June 2000, DSR 2000:VI, 2985, para. 140 (underscoring added).

[18] EC rebuttal submission, para. 102.

[19] EC Answers to Panel Questions, para. 54. The United States also respectfully notes that the Panel's question is based on a false premise; i.e., in the real world, there are no "pure" territorial systems. Indeed, as the United States previously has demonstrated, the territorial exemptions applied by various EC member states are all subject to various qualifications and conditions. First US 21.5 Submission, para. 96.

[20] Second EC 21.5 Submission, para. 112.

[21] *Ibid.*, para. 56. When the foreign tax rate is higher, taxpayers presumably will choose not to route sales through the foreign distribution subsidiary.

24. The EC's attempt to treat the export-related activities of foreign subsidiaries as *non-export* activity is not new. The panel in the *Tax Legislation Cases* saw through the same artificial distinction the EC is now attempting to draw. As one leading scholar has explained regarding those cases:

> Given that the three European defendants had chosen not to assert the bilevel pricing defence [under GATT Article XVI], the only real issue in the three counterclaims was whether the failure to tax foreign earnings was an export subsidy in the first place. The key to the panel's finding on this point was its decision to treat the two parts of the tax-haven transaction – the exporter's initial export to its foreign alter ego and the alter ego's resale to the ultimate buyer – as a single export transaction ... . The implication was that what went on outside the country – the resale – was also part of the same 'process'. By not taxing the income from second sale, therefore, governments were granting a tax exemption to the exporting process.[22]

25. The EC most significantly errs in asserting that sourcing determinations for tax purposes must be based strictly upon arm's-length transfer prices. This assertion is invalid, and, in the present case, dangerous. Although broadly consistent with economic activities, sourcing determinations apply numerous rules of administrative convenience. For example, many jurisdictions simply rely upon the residence of the payor to determine the source of income, regardless of where the income was economically generated.

26. Nevertheless, the EC invites the Panel: (1) to define the term "foreign-source income" using the domestic laws of the alleged subsidizing party, and (2) to rule that "foreign-source income" for purposes of those very laws must be determined on the

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[22] Robert E. Hudec, Reforming GATT Adjudication Procedures: The Lessons of the DISC Case, 78 Minn. L. Rev. 1443, 1482 (1988) (copy attached as Exhibit US-30). Professor Hudec added: "Everyone in the tax business knew that a territorial tax system could be used to make the taxation of export operations significantly lower than the taxation of identical domestic operations. *Ibid.*

In paragraph 57 of the EC's answer to this question, the EC disputes the fact that the panel in the Tax Legislation Cases "made 'factual findings' that territorial systems provide better treatment to export sales." However, if the panel did not make such findings, then the post-1976 behaviour in the GATT Council of the EC and the member states involved becomes inexplicable, and it is difficult to fathom why they insisted on the adoption of the 1981 Understanding. In order to be clear on this point, here is what the panel in the Tax Legislation Cases found:

> The Panel found that however much the practices may have been an incidental consequence of Belgian taxation principles rather than specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market ... .
>
> In circumstances where different tax treatment in different countries resulted in a smaller total tax bill in aggregate being paid on exports than on sales in the home market, the Panel concluded that there was a partial exemption from direct taxes ... .

Income Tax Practices Maintained by Belgium, L/4424, BISD 23S/127, paras. 35, 37. The panel made similar findings in *Income Tax Practices Maintained by France*, L/4423, BISD 23S/114, paras. 48, 50, and in *Income Tax Practices Maintained by the Netherlands*, L/4425, BISD 23S/137, paras. 35, 37.

The EC's observation in paragraph 57 that the Tax Legislation Cases involved different legal obligations and different dispute settlement arrangements is irrelevant to the nature of what the panel found as a matter of fact. The GATT Council adopted those factual findings, and the only alteration the Council made was to adopt the 1981 Understanding, which changed the legal conclusions that flowed from the panel's factual findings.

basis of arm's-length transfer prices. Such a finding might suit the EC's present convenience, but it would contravene the intent expressed in footnote 59, which was to avoid placing any "limit" on the ability of Members to take measures to avoid double taxation of foreign-source income, rather than forcing them to adopt strict arm's length transfer pricing into their source rules.

Q24. Would a measure that exempted foreign-source income from taxation (i.e., a pure territorial system) be a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59?

Reply

27. The United States submits that territorial tax systems should be viewed in the same way as the Act in the context of footnote 59.[23] They should pass muster or fail for the same reasons.

28. The EC, however, attempts to distinguish the systems of its member states from the Act in a way that simply has no basis in reality. The EC states that the "prevailing benchmark" in a territorial tax system is to tax income generated within the territory of the taxing authority. However, this benchmark only exists because the EC says it exists. The EC's response is simply inconsistent with the way EC "territorial" systems actually operate. The EC explained to the *FSC* Panel that its member states generally apply taxes on business income on a worldwide basis, but then provide an exemption for foreign-source income.[24] The United States previously has explained how five European tax systems make an exception for foreign-source income in relation to their otherwise applicable tax rules.[25]

29. As discussed above in the US comments on the EC's answer to Question 23, so-called territorial systems tax income from export transactions more favourably than comparable domestic transactions because exporters can exempt part of their income from tax. Where exporters in a country providing a territorial exemption run their transactions through a lower-tax jurisdiction, they net an overall tax savings. According to the EC's argument in this dispute, this constitutes a subsidy contingent upon export performance.

30. The Panel's question raises the further interesting question, which the EC has consistently refused to answer:[26] whether a country that taxes some persons on an exemption basis and other persons on a worldwide basis (at their election) confers subsidies within the meaning of Article 1.1.[27] Under the EC's argument, it would appear that the answer to this question is "yes."

31. The United States also notes the EC's assertion that the territorial exemption "is however undeniably a measure to avoid the double taxation of foreign-source income." Given that countries that rely on the exemption method typically do not require that the exempted income actually be taxed, the United States considers this

[23] Again, the United States notes that there are no such things as "pure" territorial tax systems.
[24] Annex EC-2 (U-5), para. 2; see also First US 21.5 Submission, para. 41.
[25] First US 21.5 Submission, paras. 42 and 96.
[26] EC Answers to Questions from the United States, para. 1.
[27] As the United States has noted previously, France is an example of such a country. US Answers to Questions from the Panel, para. 52.

assertion irreconcilable with the position that the EC has taken with respect to the Act.

Q25. The EC argues that "the fact that the extension of the FSC replacement scheme to foreign produced goods is subject to a foreign content requirement creates in many cases a requirement for exports to be made from the US. This renders the extended FSC Replacement subsidy also export contingent and thus prohibited."[28] Is it the EC's view that the measure is contingent *de jure* on export performance? Or *de facto*? Is it export-contingent only in those cases where compliance requires the export of US goods, or does the fact that the export of US goods may sometimes be required render the "extended FSC replacement scheme" export-contingent in its totality?

32. The United States disputes the EC's assertion in paragraph 60 of the answer to this question that "[i]t was clear from evident facts known to all at the time the law was adopted that respecting the foreign content limitation would require the use of US articles in many cases." The EC cites nothing to support this assertion, and the United States does not believe that there is anything in the record of this case that would substantiate the assertion. The EC does not even identify what the "evident facts" were or the identity of the "all concerned" to which it refers. The EC essentially is asking the Panel to take "judicial notice" of a key fact which, under established WTO jurisprudence, the EC has the burden of proving, and for which it has failed to satisfy that burden.

33. The United States also disputes the EC's assertion in paragraph 62 of its answer to this question that "the fact that export of US goods may sometimes be required renders the 'extended FSC replacement scheme' export-contingent in its totality". The United States does not agree that it is ever a necessity for a taxpayer to use US, as opposed to imported, articles in order to qualify for the Act's exclusion. The United States also does not believe that, because some taxpayers choose to use US goods to satisfy the 50 per cent rule, this renders the Act export contingent. There are a host of reasons underlying private decisions to use domestic goods – or to export – in order to satisfy certain requirements, but these decisions do not create an export contingency *per se*. If that were the case, then every broadly applicable production subsidy would be export contingent if one manufacturer decided that it "needed" to export in order to obtain the subsidy.

Q26. The EC states that the basic FSC subsidy is contingent upon the use of domestic over imported goods because domestic US articles will "often" be necessary to ensure that the foreign content limitation is not exceeded.[29] Is it the EC's view that the frequency with which this will be the case is relevant to whether the 50% foreign content rule is inconsistent with Article 3.1(b)? Would the rule be inconsistent with Article 3.1(b) if domestic US goods were "sometimes" necessary? Occasionally? Rarely?

[28] EC first submission, para. 119.
[29] EC first submission, para. 174.

Reply

34. With respect to paragraph 63 of the EC's answer to this question, the United States is not sure what to make of the EC's assertion that the Act is inconsistent with Article 3.1(b) "by the reason [*sic*] of the fact that it give [*sic*] rise to a requirement to use US article [*sic*] in *any* case." (Emphasis in original). The United States assumes that this statement is merely the product of hasty drafting, and that the EC argument remains that the Act would violate Article 3.1(b) if in a single, actual case the use of US articles was required. If this remains the EC argument, the EC has not presented any evidence that this is the case, but simply has offered hypotheticals allegedly based on "actual" data to which only the EC has had access.

35. On the other hand, if the EC statement reflects a shift in the EC argument to the effect that the Act requires the use of US articles in all cases, the EC has not presented any evidence to support this assertion either.

Q28. Is it possible to establish on the basis of the *Act* itself, and without reference to external facts relating to the manufacture of particular products, that the 50 per cent foreign content rules require a beneficiary in some cases to use domestic over imported goods? If not, and taking into account the view of the Appellate Body in *Canada – Certain Measures Affecting the Automotive Industry*[30] that contingency in law is demonstrated "on the basis of the *words* of the relevant legislation, regulation or other legal instrument", please explain how the Act could be contingent *in law* on the use of domestic over imported goods.

Reply

36. The EC's answer to this question ignores the key portion of the Appellate Body report in *Canada Autos*, which runs from paragraphs 126-131 of the report. There, the Appellate Body found that the mere existence of a content requirement is not enough to violate Article 3.1(b). Instead, given the "multiplicity of *possibilities*", one must examine how such requires "operate for individual manufacturers." The United States does not believe that the EC has met its burden of proof with respect to the standard articulated in *Canada Autos*.

Q32. What is the relationship, if any, between the scope of Article III:4 of the GATT and Article 3.1(b) of the SCM Agreement - is one necessarily broader than the other- could a measure fall within the scope of one of these provisions, but not within the scope of the other? Please substantiate your response with reference to past GATT/WTO dispute settlement reports and other materials.

Reply

37. The United States is pleased to note that the EC agrees with the United States that the scope of Article III:4 is broader than that of Article 3.1(b).

38. In addition, with respect to paragraph 84 of the EC's answer to this question, the United States also is pleased to see the EC finally refer to a relevant portion of the

[30] Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, DSR 2000:VI, 2985, para. 123.

Appellate Body report in *Canada Autos*, which states that the standard of contingency under Article 3.1(b) is that a measure must "*require* the use of domestic goods over imported goods." (Emphasis added). Of course, the EC has failed to demonstrate that the Act *requires* the use of domestic over imported goods, but instead, relying on an incorrect legal standard, has alleged that the Act violates Article 3.1(b) because it allegedly "favours" or "gives preference to" domestic over imported goods.

Q33. The EC states that "the US review of its subpart F legislation is yet to be completed".[31] Please explain whether and how this statement is relevant to the current proceeding.

Reply

39. The EC asserts that the Treasury Department study of subpart F refutes the US statement that the Act represented, in part, the results of a review by the US Senate of the international provisions of the US Internal Revenue Code.[32]

40. The EC assertion proves nothing of the sort, and in making the assertion, the EC appears to be projecting on to the United States the relative powers of European Union institutions. However, in the United States, the Congress and the Executive are separate and co-equal branches of government (along with the Judiciary), and the fact that the bureaucracy may have been studying subpart F does not negate the fact that the US Senate was conducting its own, independent review of the international provisions of the Internal Revenue Code. The Senate stated that the Act was, in part, a product of its review, [33] and the EC's assertion to the contrary is presumptuous, as well as unsubstantiated.

Q34. Is the Panel to understand from Section 4.3.2 of the EC's rebuttal submission that the EC is not relying on the language "whether sole or as one of several other conditions" as a basis for its argument that the existence of "alternatives" to exportation as a means to gain entitlement to the alleged subsidy provided under the Act does not eliminate the alleged export contingency?

Reply

41. The EC's answer that its "argument does not depend on these words" is reflective of the fact that the EC has ignored these words. In the view of the United States, however, these words cannot be ignored, and the US explanation of what these words mean and their significance to this case is set forth in the *First US 21.5 Submission*, paras. 133-136. For the reasons set forth in prior US submissions, the United States believes that these words confirm the US – not the EC's – position, and the EC never has rebutted the US arguments regarding the meaning of these words.

42. Furthermore, the United States understands the EC's answer to mean that its Article 3.1(a) claim is *not* based on the notion that the Act is export contingent for

[31] EC rebuttal submission, para. 29.

[32] This statement was made in the First US 21.5 Submission, para. 24, citing to Senate Report, page 5 (US 2).

[33] Senate Report, page 5 (US-2).

one category of transactions but not others. The EC's answer indicates that its argument is premised on the theory that the Act is export contingent in its entirety. That is, there is one export contingency in the Act that applies equally in all circumstances. As a practical matter, this means that the EC is *not* arguing that the Act violates Article 3.1(a) because it requires exporting *or* some other type of activity. Rather, the EC is arguing that the Act requires exporting in all cases. As the United States has demonstrated, however, the Act does not require exporting at all, let alone in all cases. The EC has failed to prove otherwise.

Q35. Please comment on paragraphs 91, 108, 159 and 170-171 of the US Oral Statement.

Paragraph 91

Reply

43. The United States respectfully refers the Panel to the US comments on the EC's answer to Question 23.

44. The United States would add to those comments that it does not see how the EC's discussion regarding what it terms "capital-export" and "capital-import" neutrality is relevant to the present dispute. Nevertheless, with respect to the EC's statement in paragraph 93 regarding capital-import neutrality – in which the EC said that such neutrality pertains to not influencing whether a taxpayer establishes operations at home or abroad – the United States notes that the Act applies equally to foreign transactions irrespective of whether goods are produced in the United States or abroad.

45. In its answer, the EC continues to maintain that the tax systems of its member states are not export contingent under Article 3.1(a) because export income is not treated better than domestic income. The United States again notes, as it did in its comments regarding question 23, that domestic manufacturers can benefit from a territorial exemption only by exporting. The EC's attempts to distinguish between export sales made by domestic manufacturers to their subsidiaries on the one hand, and income earned by these subsidiaries in selling exported products on the other, ignores the reality of such transactions and the reasoning of the Panel and the Appellate Body in *FSC*. There, the Panel and the Appellate Body found that the US partial exemption of income earned by foreign sales subsidiaries – and the tax-free repatriation of dividends from such income – constituted prohibited export subsidies. The fact that foreign subsidiary income was involved was irrelevant.

Paragraph 108

46. With respect to the EC's answer regarding paragraph 108, in footnote 37 the EC states that the definition of "qualifying foreign trade property" in the Act is "identical" to the definition of "export property" in the former FSC provisions. In doing so, the EC conveniently ignores the fact that the FSC definition required that covered products must be made, produced, or extracted in the United States. In contrast, the most significant aspect of the definition of "qualifying foreign trade property" is that the term means, *inter alia*, "property ... manufactured, produced, grown, or extracted

within *or outside the United States*." The Act § 3, amending IRC § 943(a)(1)(A) (US-1) (emphasis added).

47. In paragraph 97, the EC asserts that "specifically", as used in paragraph (e) of Annex I, means "having a special, precise or clearly defined relationship or connection to exports." Assuming *arguendo* that the EC's interpretation is correct, the United States is at a loss to understand how an exclusion applicable to income earned from goods that can be manufactured and sold outside of the United States, and without incorporating any US articles, can have a "special, precise or clearly defined relationship or connection to exports.".

48. With regard to the EC's statement in paragraph 98 that the "extended subsidy" is export contingent "because in many cases it will be necessary for US goods to be exported as components and raw materials in order to respect the foreign content limitation", the United States notes that: (1) the EC has failed to prove that US goods will be used over imported goods in any instance, let alone "in many cases", and (2) the fact that private actors may *choose* to use US goods does not amount to the type of condition that renders the so-called "extended subsidy" export contingent under Article 3.1(a).

Paragraph 159

Reply

49. In paragraph 101 of its answers, the EC appears to have introduced yet another standard for Article 3.1(b) that deviates from the actual language of that provision. The EC now argues that Article 3.1(b) is violated if a contingency on the use of domestic over imported goods "is not precluded." Because the United States is not even sure what the EC means by this phrase, our comments necessarily are limited to the observation that this new standard is not supported by the text of Article 3.1(b) itself or applicable panel and Appellate Body jurisprudence regarding the meaning of the term "contingent".

Q36. In regard to the "extended" FSC Replacement subsidy scheme, is there "revenue forgone" that is "otherwise due"? What is the US legal rule that would apply to the foreign beneficiary of the extended scheme in the absence of the "extended" scheme? What is the "some other situation" for foreign beneficiaries of the "extended" regime, in which their income would be subject to the US taxation? If, in the EC's view, it is different from the legal rule - normative benchmark - applicable to the "basic" subsidy scheme, , please specify.

Reply

50. The United States is pleased to note that the EC now agrees that the normative benchmark in the United States is determined by the definition of "gross income" contained in section 61 of the IRC.[34] This answer, however, disproves the EC's own position because the Act, in section 114, excludes a category of income from the section 61 definition of gross income. The EC, therefore, seems to be arguing either

[34] EC Answers to Questions from the Panel, paras. 116, 126, 127.

(1) that section 114, despite its plain language, somehow is ineffective in amending section 61, or (2) that any amendment to section 61 automatically confers a subsidy.

51. Section 61 can be understood only in light of the other provisions of the IRC that define its terms and application. Section 114 is an integral part of section 61. The EC would disconnect section 114 from section 61. It in effect is asking the Panel to assume that the United States normative benchmark is to tax all income earned by parties that may be subject to US tax. However, in the US system, "gross income" is a term with a special meaning. It does not apply to all income. It applies only as defined by the IRC.

52. In any event, despite the EC's rhetoric, the EC's answer to the Panel's question shows how much this case differs from the *FSC* case. In that case, the Panel found that the FSC provisions conferred exceptions to three specific, otherwise applicable tax measures: subpart F (sections 951(e) and 954(d)), the tax on effectively connected earnings (section 921(a)), and the limitation on the dividends received deduction for foreign corporations (section 245(c)).[35] The EC points to no such exceptions in this case. Rather, the EC declares that the income would be taxable under section 61 if the Act had not amended section 61. However, Article 1.1 is not so broad as to sanction such circular reasoning.

Q37. What is the US "norm" which can constitute a "normative benchmark" for the purpose of Article 1 of the SCM Agreement? Can the EC specifically identify any US tax rules in addition to the new Section 941(a)(1) of the IRC which defines the term "qualifying foreign trade income"? In other words, what is the statutory basis for the EC's argument that the US is still maintaining its "worldwide" tax system?

Reply

53. The EC's answer to this question contains an assortment of misleading and irrelevant citations and quotations.

54. First, the EC cites certain historical documents to suggest that US Constitution requires the United States to maintain a "worldwide" tax system. This suggestion is false. The Sixteenth Amendment to the US Constitution gives the US Congress the *power* to levy an income tax "without apportionment among the several States, and without regard to any census or enumeration."[36] The Sixteenth Amendment does not *require* Congress to levy an income tax at all, much less an income tax on extraterritorial or foreign-source income. The same can be said about the EC's citation of *Cook v. Tait*, 265 US 47 (1924), and *Commissioner v. Glenshaw Glass Co.*, 348 US 426 (1955). Neither case states that the United States is bound to tax extraterritorial or foreign-source income.

55. Second, the EC cites two treatises for the false proposition that the United States still taxes its citizens and residents on a worldwide basis despite the extraterritorial income exclusion. However, both treatises pre-date the Act, and therefore fail

[35] *FSC (Panel)*, DSR 2000:IV, 1675, para. 7.100.

[36] The Sixteenth Amendment was adopted to override the rule, in Article III of the US Constitution, that "[n]o Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." US Const., art. III, § 9.

to reflect the Act's change to the normative benchmark for taxation in the United States.[37]

56. The EC next quotes the Treasury Department's Subpart F Study for the same, false proposition that the United States still adheres to a "worldwide" tax system. The EC, however, omits the statement, contained in the Study, that "[t]he United States also has elements of a territorial regime. For example, section 911 modifies US worldwide taxation by allowing US individuals working overseas to exclude from their US income certain amounts of foreign earned income and housing costs. Similarly, section 114 excludes from gross income extraterritorial income of a taxpayer."[38] The EC's selective citation of the Study undermines both its argument and its credibility.

57. Fourth, the EC cites two cases, *Interstate Transit Lines v. Commissioner*, 319 US 590 (1943), and *Jones v. Kyle*, 190 F.2d 353 (10th Cir. 1951), for the proposition that "provisions granting deductions or exclusions of items from gross income are 'matters of legislative grace' and are therefore to be 'strictly construed.'" Regardless of whether the Act is construed strictly or expansively, excluded extraterritorial income is no longer part of the US tax base. Moreover, the cited cases do not support the proposition advanced by the EC. *Interstate Transit Lines* only discussed deductions, not exemptions or exclusions, and *Jones v. Kyle* merely reiterated the rule in *Cook v. Tait* that the United States may tax foreign-source income if it so decides. The United States has decided not to tax foreign-source income that is excluded extraterritorial income.

58. Thus, the only true statement in paragraph 132 of the EC's answers is the statement that section 114 is one of several, specific exclusions from the section 61 definition of gross income. However, the EC still refuses to acknowledge the legal effect of this stubborn fact.

59. Fifth and finally, the EC cites the section 911 earned-income exclusion as support for its self-created "general rule" that the United States continues to tax on a purely worldwide basis. To the contrary, as noted above in connection with the Subpart F Study, section 911 represents another aspect of territoriality adopted by the United States. Thus, the EC's citation of section 911 disproves the EC's "general rule".

60. More generally, it is unclear to the United States how the foregoing use of misleading and irrelevant citations and quotations will assist the Panel in resolving this case.

Q39. In the EC's view, would the Act be consistent with the SCM Agreement if the United States eliminated the requirements that the property be held for use "outside the United States" and the "foreign content limitation"?

[37] The EC's citation to the Isenbergh treatise, "International Taxation: US Taxation of Foreign Persons and Foreign Income, vol. 1, at p. 2:32 (2nd ed. 2000)," appears to date from after the effective date of the Act. In fact, the quotation comes from a November 1997 insert to the treatise.

[38] Subpart F Study, at p. xi, n.18.

Reply

61. The United States is pleased to finally learn the specific provisions of the Act to which the EC actually objects – sections 942(a)(2)(A)(i) and 943(a)(1)(B) and (C). The EC's answer confirms that the EC's lengthy critique of other provisions of the Act is irrelevant.

62. Given the significance the EC attaches to these provisions, the United States believes that it is essential for the Panel to explain the relative importance of each of these provisions in its decision. For example, if the Panel were to find the "foreign content limitation" to be problematic, the Panel should clarify whether the requirement that property be held for use "outside the United States" is problematic only because of the existence of the "foreign content limitation" or is inherently problematic on its own. The United States has explained that it believes that neither is improper under WTO rules.

63. Furthermore, the United States submits that the EC's answer to question 39 highlights the superficial approach it has taken in this case. The EC, for example, does not address the fact that there are at least two types of income under the Act that would appear to satisfy even the EC's erroneous interpretation of the fifth sentence of footnote 59. First, with respect to wholly foreign transactions – that is, transactions taking place entirely outside the United States[39] – *none* of the income arising from such transactions can be said to be US or domestic income. *All* of the income earned in such transactions occurs outside the United States and can thus be subject to tax in another jurisdiction.

64. Moreover, with respect to transactions originating in the United States, new IRC section 941(a)(1)(A), as added by the Act, provides that 30 per cent of "foreign sales and leasing income" is excluded from taxation. According to new section 941(c), "foreign sale and leasing income" is the amount of the taxpayer's foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes [under the Act's "foreign economic processes requirements"]. Under the Act, these are activities that must be performed outside the United States and, as a result, comport fully with the EC's unduly narrow "foreign economic activities" definition of "foreign source income".

65. One of the legislative reports accompanying the Act gives the following example of "foreign sales and leasing income": "For example, a distribution company's profit from the sale of qualifying foreign trade property that is associated with sales activities, such as solicitation or negotiation of the sale, advertising, processing customer orders and arranging for delivery, transportation outside of the United States, and other enumerated activities, would constitute foreign sale and leasing income."[40] That report goes on to say that, where related parties are involved,

> foreign sale and leasing income may not exceed the amount of foreign sale and leasing income that would have resulted if the taxpayer had acquired the leased property in a hypothetical arm's-length purchase and then engaged in the actual sale or lease of such property. For example, if a manufacturer leases qualifying foreign trade property that it manufactured, the foreign sale and leasing income derived from that

[39] This includes circumstances in which no US goods are included the products at issue.

[40] Senate Report (US-2), pages 10-11.

> lease may not exceed the amount of foreign sale and leasing income that the manufacturer would have earned with respect to that lease had it purchased the property for an arm's-length price on the day that the manufacturer entered into the lease.[41]

66. This means that section 941(a)(1)(A) of the Act provides an exclusion for 30 per cent of income directly attributable to a defined class of foreign economic activities based on arm's-length values. Such income appears to be precisely the type of income that would fall within the fifth sentence of footnote 59 even under the EC's interpretation. Indeed, it is the type of income that the EC claims its member states exempt through their "territorial" systems.

67. The United States, of course, does not agree with the tests and standards the EC has advanced regarding footnote 59. However, assuming *arguendo* that such tests and standards apply, the EC should at the very least explain why provisions of the Act that appear to be fully consistent with standards advocated by the EC are improper. The EC has ignored wholly foreign transactions and section 941(a)(1)(A) completely.

68. Therefore, the United States respectfully requests that, should the Panel adopt the EC's interpretation of footnote 59, the Panel should make findings as to whether the Act's treatment of income derived from wholly foreign transactions and "foreign sales and leasing income" are measures to avoid double taxation of foreign-source income under that interpretation. An abstract discussion of the "foreign content limitation" and the "foreign destination test", without more, would not promote resolution of this particular dispute or the aims of the multilateral system more generally.

Q43. Can a measure of a Member provided in respect of the production of a good outside the territory of that Member be a subsidy within the meaning of Article 1 of the SCM Agreement? Please explain your answer, taking into account any relevant provisions of the SCM Agreement.

Reply

69. With respect to paragraph 157 of the EC's answer to this question, the United States merely recalls that the policy reflected in section 351.527 of the US Department of Commerce countervailing duty regulations is subject to certain exceptions.[42]

Q45. Is export income foreign source income? Some may take the view that the "foreign-source income" referred to in footnote 59 should include export income since the footnote is accompanying item (e) that is dealing with a type of subsidy specifically related to export. Please comment.

Reply

70. In its answer to this question, the EC appears to take the position that the fifth sentence of footnote 59 does not qualify paragraph (e) of Annex I. As noted above in connection with the US comments on the EC's answer to Question 3, the EC position

[41] Senate Report (US-2), pages 10-11.
[42] US Answers to Questions from the Panel, para. 110.

is contradicted by the fact that footnote 59 is attached to paragraph (e) rather than Article 1. In addition, the EC position is inconsistent with prior EC statements regarding the meaning of the fifth sentence.

71. The EC position appears to be based on the use of the phrase "is not intended to" in the fifth sentence. According to the EC, if the drafters had intended that the fifth sentence qualify paragraph (e), they would have used different language. However, there are many, many ways to draft effective treaty provisions, and the universe of the WTO agreements provides numerous examples of different drafting styles. In the view of the United States, the phrase "is not intended to" constitutes a perfectly acceptable (and conventional) way of expressing the drafters' intent as to the scope of paragraph (e).

72. In this regard, the phrase "is not intended to" also appears in footnote 56 of the SCM Agreement, a footnote attached to Article 32.1. Article 32.1 provides as follows:

> No specific action against a subsidy of another Member can be taken except in accordance with the provisions of GATT 1994, as interpreted by this Agreement.

On its face, Article 32.1 arguably might limit action against a subsidy to action under the SCM Agreement or GATT Articles VI and XVI to which the SCM Agreement relates.

73. However, footnote 56 provides as follows:

> This paragraph is not intended to preclude action under other relevant provisions of GATT 1994, where appropriate.

The meaning of this footnote was at issue in the *Indonesia Autos* case in connection with Indonesia's argument that the SCM Agreement provided the exclusive remedy against measures that could be characterized as subsidies. In rejecting Indonesia's argument, the panel gave meaning to footnote 56, and cited it for the proposition that actions against subsidies remain possible under GATT 1994.[43]

74. Finally, other portions of footnote 59 belie the EC's claim that the fifth sentence is merely "declaratory" of principles that the drafters articulated elsewhere. In the second sentence of footnote 59, Members "reaffirm the principle" regarding arm's length pricing between related parties. Given the use of this language in the second sentence, if the fifth sentence was merely "declaratory" of a principle articulated in Article 1, as claimed by the EC, the drafters would have written the fifth sentence as follows:

> Members reaffirm the principle in Article 1 that a measure taken by a Member to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member is not a subsidy.

[43] Indonesia – Certain Measures Affecting the Automobile Industry, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, Report of the Panel adopted 23 July 1998, DSR 1998:VI, 2201, para. 14.36, note 659.

ANNEX F-7

COMMENTS OF THE UNITED STATES ON EC'S ANSWERS TO US QUESTIONS

Q1. What is the "prevailing standard" or "general rule" of taxation in a country which taxes some persons on a worldwide basis and some persons on an exemption basis, in some cases at their election (and subject in such cases to the discretion of the government)? Please explain the basis for your answer.

Reply

1. The EC's inability to respond to this question is rather peculiar. The EC has had little reluctance in characterizing what it perceives to be the "prevailing standard" or "general rule" of the US tax system. Indeed, the EC has even gone so far as to reject US descriptions of its own tax system, including descriptions made by the US Congress contemporaneous with passage of the Act.

2. It is difficult to escape the conclusion that the EC wants to avoid answering a rather difficult question. In particular, the EC does not want to acknowledge the fact that certain countries, including France, allow taxpayers to choose between a territorial/ exemption system and a worldwide/credits system. More generally, the EC appears reluctant to acknowledge the fundamental similarities between the US tax system after adoption of the Act and the tax systems of its own member states.

Q2. Is the tax exemption by a country of "foreign-source income" (for purposes of footnote 59) permissible under the SCM Agreement only if *all* "foreign-source income" is exempt from tax? Please explain the basis for your answer.

Reply

3. The EC's answer is incomplete and difficult to understand. In response to the US question of whether an exemption of foreign-source income under footnote 59 must be for all such income, the EC merely says "no," and then says that the problem with the Act in this regard is that it offers a choice to a limited number of privileged taxpayers. This makes no sense for two reasons.

4. First, the EC's answer of "no" to the question is directly contradictory to many of its arguments in this case – in particular, that the Act's exclusion is improper because it is conditioned on a number of factors and does not apply to products imported into the United States. The EC's arguments regarding Article 1 of the SCM Agreement are predicated on the contention that the Act's exclusion, unlike EC territorial exemptions, allegedly does not adhere to a neat and clean formula or principle but is subject to numerous exceptions and requirements. The EC's arguments regarding Article 3 of the SCM Agreement similarly are based on the notion that the exclusion, in the EC's view, applies to exports, a near empty set of wholly foreign transactions, and no imports. It would appear to be impossible to reconcile these EC's arguments with its answer of "no" to the question.

5. Second, as the United States has explained, the Act does not apply solely to "privileged taxpayers", and it does not provide such taxpayers with "a more advanta-

geous means of avoiding double taxation". The Act applies to all US taxpayers that engage in transactions giving rise to extraterritorial income. These taxpayers can be individuals or businesses, corporations or partnerships, and subsidiaries or branches. In fact, these taxpayers need not even be American, since the Act applies equally to non-US enterprises.

6. Moreover, the Act does not provide more generous relief than US tax credits, but rather an alternative means of relief. For some taxpayers, the Act may be more advantageous. For others, tax credits would be better. This outcome might change for taxpayers from transaction to transaction. In providing alternative options, the United States is doing precisely what many other countries do (including France, as noted in our comments on the EC's answer to U.S Question 1). As evidence of this fact, the Commentary to Article 23 of the OECD Convention notes that countries may use credits, exemptions, or both.

Q4. Are the EC member States prepared to relinquish all source-based taxation with respect to business profits in the absence of a "permanent establishment," as that term is defined in Article 5 of the OECD Model Income Tax Convention?

Reply

7. The EC's response fails to acknowledge four fundamental facts relevant to this dispute. First, countries draw their taxing boundaries differently, and many impose taxes on non-residents in the absence of a permanent establishment. Second, one reason countries enter into tax treaties is to avoid double taxation that can arise when other countries tax income earned within their borders even if no permanent establishments are involved. Third, no country has tax treaties with all other countries with which its citizens and businesses do business. And fourth, many if not most countries have domestic double taxation avoidance measures that operate in conjunction with, or in addition to, tax treaties.

8. Thus, it is difficult to understand how the EC can argue, as it does by implication in response to US Question 4, that a measure to avoid double taxation under footnote 59 can only apply to permanent establishments. The EC appears to be arguing that footnote 59 encompasses only tax treaties based on the OECD Convention or domestic double taxation avoidance measures that follow OECD principles. The OECD Convention is evidence of certain ways a number of countries have agreed to avoid double taxation in limited circumstances. However, it cannot be correct that the fifth sentence of footnote 59 applies only in instances where the OECD Convention calls for the use of the exemption or credit methods.

9. Because the EC seems to consider the concept of a permanent establishment to be so central not only to the right of a country to avoid double taxation, but also to the right of a country to tax income in the first place, the United States asked if the EC was taking the position that countries should not or cannot impose tax on non-residents in the absence of a permanent establishment. The first paragraph of the EC's answer – stating that countries are generally free to tax whatever income they wish – indicates that the EC recognizes that taxes may be levied even where there is no permanent establishment. Given this reality, countries may need flexible approaches to protect against double taxation. The EC's seemingly rigid adherence to the concept of a permanent establishment does not coincide with the more far-reaching approaches

of many tax systems and would not allow for double taxation avoidance where these more far-reaching approaches are employed.

10. The United States respectfully refers the Panel to its answer to Panel Question 12, in which the United States provides examples of a number of countries that do not rely on the concept of a permanent establishment in establishing taxing jurisdiction.

Q6. Does the OECD Model Income Tax Convention contain a definition of the term "foreign-source income"? If so, please identify the provision containing such definition.

Reply

11. It is noteworthy that the EC has conceded that the OECD Convention does not use, let alone define, the term "foreign source income". The EC, however, continues to cling to the baseless notion that the Convention somehow can supply a definition to this term by implication.

12. The passage from Article 4 of the Convention quoted by the EC merely reflects that two bases on which countries may claim the right to tax income are residency and source. Residency refers to whether a taxpayer resides in a country and thus can be subjected to tax on that basis. Source reflects whether income has a nexus to a country and thus can be subjected to tax. The former focuses on the location of the taxpayer; the latter focuses on the "location" of the income.

13. The EC does not explain how the quoted passage "expresses the same concept" as "foreign source income" in "a different way". The passage merely refers to taxing jurisdiction based on "sources" in a particular country. What those "sources" are or may be is not defined.

14. The United States respectfully refers the Panel to paragraphs 132-36 of its *Oral Statement*, in which it explained "that the provisions of the OECD Convention the EC cites do not support the EC's narrow construction [of the term "foreign source income"], but rather confirm the US position.".

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