

ANNEX D

Oral Statements of the Parties

Contents		Page
Annex D-1	Oral Statement of the European Communities	D-2
Annex D-2	Closing Oral Statement of the European Communities	D-16
Annex D-3	Oral Statement of the United States	D-23
Annex D-4	Closing Statement of the United States	D-54

ANNEX D-1

ORAL STATEMENT OF THE EUROPEAN COMMUNITIES

(13-15 March 2001)

TABLE OF CONTENTS

	<u>Page</u>
1. What are we discussing	3
2. Exclusion or Exemption	4
3. What is a category of income?	4
4. He who can do more cannot always do less	5
5. What is the correct analytical framework (or benchmark) for assessing export contingency?	5
6. There may be export-contingent subsidies within a broader programme	6
7. Article 3.1(b) of the <i>SCM Agreement</i> must be given meaning.....	7
8. The double taxation defence - international practice	8
9. The purpose of the last sentence of footnote 59	9
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.....	9
11. The last sentence of footnote 59 is limited to foreign-source income.....	10
12. Article III:4 of GATT prohibits incentives to domestic products	11
13. Confidential Exhibit US-9.....	14
List of Exhibits	15

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the US has correctly implemented the recommendations of the Panel in the original proceeding – indeed whether it has **withdrawn the subsidy** – within the time period set by the DSB.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 The immediate and easy answer to this question is clearly No. The FSC subsidies have not been withdrawn with effect from the 1 October 2000 and are, indeed, still available in their original form - and will remain so indefinitely.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

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, paragraph 7.28 (emphasis added).

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.

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 explained³, 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 Body⁴ 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 omits⁵ 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 submission⁶, 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:

⁴ Appellate Body Report, paragraph 90.

⁵ See e.g. first written submission of the US, paragraphs 64 and 74.

taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property;⁷

18. The EC notes that a similar categorisation 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

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).

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.

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 all¹³ 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.

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 analysed 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 analysed 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.

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

¹⁶ Second written submission of the US, paragraph 28.

¹⁷See 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.

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 **minimise 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 products²¹ 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 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

²⁰ Appellate Body Report, *Canada - Aircraft*, paragraph 167.

²¹ Second written submission of the US, paragraph 200.

²² Second written submission of the US, paragraphs 35 to 37.

²³ Second written submission of the EC, Section 4.6.2, (paragraphs 186-198).

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

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 submission²⁷ that, whatever the situation may have been in the 19th Century:

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.

²⁶ Second written submission of the US, paragraphs 61 to 64.

²⁷ Exhibit US-17.

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*.

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 income²⁸ 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.

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.

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
- 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

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.

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 does 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

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.

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*, paragraph 220.

³⁹ Panel Report, *Canada – FIRA*, paragraph 5.4.

⁴⁰ Panel Report, *Canada – FIRA*, paragraph 5.4 (emphasis added).

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 submission⁴¹ 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

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.

⁴¹ First written submission of the EC, paragraphs 191 ff.

⁴² Panel Report, *Canada – Automobiles*, paragraph 10.78; first written submission of the EC, paragraph 201 and footnote 73.

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 subsidiaries⁴³ of the US parent.

Thank you for your attention.

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

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.

- 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 explanations 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 Extraterritorial 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

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.

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.

⁸ Exhibit EC-17 – Government Press Release “Committee passes FSC Repeal and Extraterritorial Income Exclusion Act of 2000”, 27 July 2000.

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:

"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

⁹ Exhibit EC-18 – Worldwide Tax Daily, 24 July 2000, "US Congressional taxwriters discuss FSC legislation", Goulder, Robert; Donmoyer, Ryan J; Tax Analysts.

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 to 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 use 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 emphasised the significance of the internationally recognised 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 5.5¹⁰ 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"¹².

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.

¹⁰ Exhibit US-18.

¹¹ Commentary to Article 5.5 (paragraph 32).

¹² Commentary to Article 5.5 (paragraph 35).

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 Extraterritorial 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-20 US 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 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.

¹ DSU, Article 3.2.

² DSU, Article 3.4.

³ DSU, Article 3.2.

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".

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

⁴ *FSC (AB)*, para. 90 (emphasis in original).

⁵ *FSC (AB)*, para. 90 (emphasis in original).

⁶ *Id.*

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

⁷ *EC First 21.5 Submission*, para. 125.

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 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

⁸ See, e.g., *Senate Report*, page 4 (US-2).

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.

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

⁹ *EC Second 21.5 Submission*, para. 29.

¹⁰ EC-10, page 2749 (emphasis added).

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”, “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 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.

¹¹ The Act § 3, amending IRC § 942(a)(2).

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 proceedings¹³, 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 facie* 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 Article 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.

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, 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.

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, para. 5.14.

¹⁴ *EC Second 21.5 Submission*, para. 52, quoting *United States - Wool Shirts*, page 14.

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, para. 62 (emphasis added).

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.

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

¹⁷ *EC Second 21.5 Submission*, para. 45.

¹⁸ *EC Hormones*, para. 104.

¹⁹ *Id.*

²⁰ *Id.*

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,

²¹ *EC Second 21.5 Submission*, para. 67.

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 business.”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

²² *EC Second 21.5 Submission*, para. 68.

²³ *EC Second 21.5 Submission*, para. 80.

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 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 States, 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.

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.

²⁴ *EC First 21.5 Submission*, para. 86.

²⁵ *EC Second 21.5 Submission*, para. 112.

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 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

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, para.58.

²⁷ *EC Second 21.5 Submission*, para. 114.

²⁸ *EC Second 21.5 Submission*, para. 118.

²⁹ *EC Second 21.5 Submission*, para. 118.

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.

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

³⁰ *Id.*

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. 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

³¹ EC Second 21.5 Submission, para. 131.

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 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,

³² *EC Second 21.5 Submission*, para. 149.

³³ *EC Second Art. 21.5 Submission*, para. 183.

³⁴ *Id.*

³⁵ *EC Second 21.5 Submission*, para. 183.

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 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 engrafted *in toto* upon the SCM Agreement where there is no indication that this was the intention of the

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. 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.

³⁸ *US First 21.5 Submission*, paras. 178-86.

³⁹ *Id.*, note 153.

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 *industrialised* countries" follow the Convention, as the EC asserts⁴⁰, 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.

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.

⁴⁰ *EC Second 21.5 Submission*, para. 187.

⁴¹ *EC Second 21.5 Submission*, para. 186.

⁴² *Vienna Convention*, Article 32.

⁴³ *Id.*

⁴⁴ See *European Communities - Measures Affecting Importation of Certain Poultry Products*, WT/DS69/AB/R, Report of the Appellate Body adopted 23 July 1998, 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).

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 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

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 *Id.*

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

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

⁴⁸ *US Art. 21.5. Second Submission*, para. 62.

⁴⁹ *EC Art. 21.5 Second Submission*, paras. 196-98.

⁵⁰ *Id.*, para. 191.

⁵¹ The Act § 3, amending IRC § 942(b)(3).

⁵² *EC Second 21.5 Submission*, paras. 203-04.

⁵³ *Id.*, para. 201.

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 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.

⁵⁴ *Id.*, paras. 41 and 209.

⁵⁵ *Id.*, para. 218.

⁵⁶ *Id.*, para. 213.

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 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

⁵⁷ Annex EC-2, page 2 (US-5).

⁵⁸ US-7, page C(23)-10.

⁵⁹ *Id.*

⁶⁰ *EC Second 21.5 Submission*, section 4.6.4.

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 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.

IX. THE ACT’S EXCLUSION IS NOT CONTINGENT ON THE USE OF DOMESTIC OVER IMPORTED GOODS IN VIOLATION OF ARTICLE 3.1(B)

⁶¹ *House Report (US-3)*, page 18.

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 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

⁶² *EC Second 21.5 Submission*, para. 160.

⁶³ *Id.*, para. 175.

⁶⁴ *EC Second 21.5 Submission*, para. 173.

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.

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

⁶⁵ *Id.*

⁶⁶ *EC Second 21.5 Submission*, para. 162.

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.

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

⁶⁷ *Japan-Measures Affecting Consumer Photographic Film and Paper ("Japan Film")*, WT/DS44/R, Report of the Panel adopted 22 April 1998, paras. 10.381, 10.84.

⁶⁸ *EC Second 21.5 Submission*, para. 237.

⁶⁹ *US First 21.5 Submission*, paras. 217-218.

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 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 2000⁷² 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.

⁷⁰ *EC First 21.5 Submission*, Annex, para. 4.

⁷¹ The Act § 5(c)(1)(A).

⁷² The Act § 5(c)(1)(B).

⁷³ *EC Second 21.5 Submission*, para. 243.

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, 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.

⁷⁴ The Act § 5(a).

⁷⁵ See, e.g., *Argentina Textiles*, paras. 6.13-15.

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 exclusion 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-a-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.