

**GENERAL AGREEMENT
ON TARIFFS AND TRADE**

RESTRICTED
TRE/W/20
11 January 1994
Special Distribution

(94-0033)

Group on Environmental Measures and International Trade

BORDER TAX ADJUSTMENT

Note by the Secretariat

1. This note responds to the Group's request, made at the meeting of 5-6 October 1993, for a note on border tax adjustment. It is a factual note and is based, in large part, on the conclusions of the Working Party on Border Tax Adjustment and on panel findings. While this note does not attempt to cover all the sub-issues which might arise under this general heading, it does touch on some of those that may be useful to the work of the Group in understanding the application of taxes and tax adjustment in the GATT context. It is organized as follows: it first presents the accepted GATT definition of border tax adjustment, then looks at which taxes are eligible for adjustment. This latter section includes the conclusions of the Working Party on Border Tax Adjustment and the experience with Articles II and III in this regard. It then discusses the optional nature of tax adjustment under GATT which is followed by a discussion of adjustment from the point of view of exports.

2. The Working Party on Border Tax Adjustment was established on 28 March 1968 to examine the provisions of the General Agreement relevant to border tax adjustments; the practices of contracting parties in relation to such adjustments; and the possible effects of such adjustments on international trade. Its Report (BISD 18S/97) was adopted on 2 December 1970. For the purpose of its examination, the Working Party used the definition of border tax adjustments applied in the OECD:

"... border tax adjustments were regarded as any fiscal measures which put into effect, in whole or in part, the destination principle (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products)".

The destination principle is to be distinguished from the origin principle whereby products destined for export are to pay the tax charged in the domestic market and imported products are exempted from paying any taxes as they would have been paid at their point of origin.

3. The Working Party on Border Tax Adjustment also agreed that:

"the main articles it should consider were, on the import side, Articles II and III and, on the export side, Article XVI. Other relevant articles included Articles I, VI and VII.

There was general agreement that the main provisions of the GATT represented the codification of practices which existed at the time these provisions were drafted, re-examined and completed."

The Working Party considered that:

"... the philosophy behind these provisions was the ensuring of a certain trade neutrality ... the present rules served the purpose of trade neutrality of tax adjustment appropriately and that no motive could be found to change them ..."

A. Which taxes are eligible for adjustment?

(i) Conclusions of the Working Party on Border Tax Adjustment

4. One of the most significant conclusions of the Working Party reads:

"On the question of eligibility of taxes for tax adjustment under the present rules, the discussion took into account the term "... directly or indirectly ..." (*inter alia* Article III:2). The Working Party concluded that there was convergence of views to the effect that taxes directly levied on products were eligible for tax adjustment. Examples of such taxes comprised specific excise duties, sales taxes and cascade taxes and the tax on value added. It was agreed that the TVA, regardless of its technical construction (fractioned collection), was equivalent in this respect to a tax levied directly - a retail or sales tax. Furthermore, the Working Party concluded that there was convergence of views to the effect that certain taxes that were not directly levied on products were not eligible for tax adjustment. Examples of such taxes comprised social security charges whether on employers or employees and payroll taxes.

The Working Party noted that there was a divergence of views with regard to the eligibility for adjustment of certain categories of tax and that these could be sub-divided into:

- (a) "taxes occultes" which the OECD defined as consumption taxes on capital equipment, auxiliary materials and services used in the transportation and production of other taxable goods. Taxes on advertising, energy, machinery and transport were among the more important taxes which might be involved. It appeared that adjustment was not normally made for taxes occultes except in countries having a cascade tax;
- (b) certain other taxes, such as property taxes, stamp duties and registration duties ... which are not generally considered eligible for tax adjustment ..."

"... there were some taxes which, while generally considered eligible for adjustment, presented a problem because of the difficulty in some cases of calculating exactly the amount of compensation. Examples of such difficulties were encountered in cascade taxes ..."

"It was generally agreed that countries adjusting taxes should, at all times, be prepared, if requested, to account for the reasons for adjustment, for the methods used, for the amount of compensation and to furnish proof thereof."

(ii) Articles II and III

5. GATT Article III contains the principal provisions regulating the application of domestic policies, i.e. taxes and regulations, to imported products. Article III:1 provides that "internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products ... should not be applied to imported or domestic products so as to afford protection to domestic production." This general rule is followed by Article III:2 which provides that imported products ... "shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products." The second sentence adds that "no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1." Article III:4 then states that imported products "shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use."

6. The national treatment obligation of Article III applies to all products whether or not they are subject to any tariff concessions. This was confirmed in the first Report of the Working Party on "Brazilian Internal Taxes" which states that, "The Working Party agreed that a contracting party was bound by the provisions of Article III whether or not the contracting party in question had undertaken tariff commitments in respect of the goods concerned." (BISD Vol. II/181, para. 4). In addition, if there is a tariff concession on a product, Article II(b) requires that the product "be exempt from ordinary customs duties in excess of those set forth [in tariff schedules] ... Such products shall also be exempt from all other duties or charges of any kind imposed on or in connection with importation in excess of those imposed on the date of this Agreement". An exception is given, however, in Article II:2(a) for "a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part"; and in Article II:2(b) for "any anti-dumping or countervailing duty applied consistently with the provisions of Article VI ...". Thus, a bound product can be subject to internal taxes if they are applied consistently with Article III:2, but not to "customs duties in excess of those set forth ..." and "other duties or charges ... imposed on or in connection with importation ...".

The distinction between an "internal tax" (Article III) and "other duties or charges" (Article II)

7. The distinction between an "internal tax or charge" (Article III) and "other duties or charges" (Article II) is important in any consideration of whether the charge is eligible for adjustment. The Interpretative Note Ad Article III makes clear that the mere fact that an internal charge or regulation is collected or enforced on an imported product at the time or point of importation does not prevent it from being an "internal tax or other internal charge" and from being subject to the provisions of Article III. During discussions at Havana where the Note was added, it was stated that "the proposed additional paragraph was intended to cover cases where internal excise taxes were, for administrative reasons, collected at the time of importation ..." (E/CONF.2/C.3/SR.11 p. 1).

8. Another clarification was given by the Council Decision of 26 March 1980 on "Introduction of a Loose-Leaf System for the Schedules of Tariff Concessions" (BISD 27S/22, p. 24, para. 9). It states with regard to the term "other duties or charges" that "such 'duties or charges' are in principle only those that discriminate against imports". In other words, they do not include charges applied to imports and domestic goods alike. The Decision further states that

"As can be seen from Article II:2 of the General Agreement, such 'other duties or charges' concern neither charges equivalent to internal taxes, nor anti-dumping or countervailing duties, nor fees or other charges commensurate with the cost of services rendered."

9. Also, the Report of Sub-Committee A of the Third Committee at the Havana Conference, which considered Article 18 of the Charter (on national treatment) states:

"The delegations of Chile, Lebanon, and Syria inquired whether certain charges imposed by their countries on imported products would be considered as internal taxes under Article 18. The Sub-Committee, while not attempting to give a general definition of internal taxes, considered that the particular charges referred to are import duties and not internal taxes because according to the information supplied by the countries concerned (a) they are collected at the time of, and as a condition to, the entry of the goods into the importing country, and (b) they apply exclusively to imported products without being related in any way to similar charges collected internally on like domestic products. The fact that these charges are described as internal taxes in the laws of the importing country would not in itself have the effect of giving them the status of internal taxes under the Charter." (Havana Reports, p. 62, para. 42).

10. The most recent Panel finding relating to this question is contained in the Report of the Panel on EEC - Regulation on Imports of Parts and Components (BISD 37S/132, adopted 16 May 1990). In examining the argument by the EEC that the anti-circumvention duties at issue were customs or other duties imposed "on or in connection with importation" under Article II:1(b) or internal taxes or charges falling under Article III:2, the Report states:

"... The Panel recalled that the distinction between import duties and internal charges is of fundamental importance because the General Agreement regulates ordinary customs duties, other import charges and internal taxes differently: the imposition of 'ordinary customs duties' for the purpose of protection is allowed unless they exceed tariff bindings; all other duties or charges of any kind imposed on or in connection with importation are in principle prohibited in respect of bound items (Article II:1(b)). By contrast, internal taxes that discriminate against imported products are prohibited, whether or not the items concerned are bound (Article II:2).

The Panel noted that the anti-circumvention duties are levied ... on products that are introduced into the commerce of the Community, after having been assembled or produced in the Community. The duties are thus imposed ... not on imported parts or materials but on the finished products assembled or produced in the EEC. They are not imposed conditional upon the importation of a product or at the time or point of importation. The EEC considers that the anti-circumvention duties should, nevertheless, be regarded as customs duties imposed 'in connection with importation' within the meaning of Article II:1(b). The main arguments the EEC advanced ... were: firstly that the purpose of these duties was to eliminate circumvention of anti-dumping duties on finished products and that their nature was identical to the nature of the anti-dumping duties they were intended to enforce; and secondly, that the duties were collected by the customs authorities under procedures identical to those applied for the collection of customs duties, formed part of the resources of the EEC in the same way as customs duties and related to parts and materials which were not considered to be 'in free circulation' within the EEC.

In the light of the above facts and arguments, the Panel first examined whether the policy purpose of a charge is relevant to determining the issue of whether the charge is imposed in 'connection with importation' within the meaning of Article II:1(b) ... The relevant fact, according to the text of [Articles I, II, III, and the Note to Article III], is not the policy purpose attributed to the charge but rather whether the charge is due on importation or at the time or point of importation or whether it is collected internally ... The Panel further noted that the policy purpose of charges is frequently difficult to determine objectively. Many charges could be regarded as serving both internal purposes and purposes related to the importation of goods ... The Panel therefore concluded that the policy purpose of the charge is not relevant to determining the issue of whether the charge is imposed in 'connection with importation' within the meaning of Article II:1(b).

The Panel proceeded to examine whether the mere description or categorization of a charge under the domestic law of a contracting party is relevant to determining the issue of whether it is subject to requirements of Article II or those of Article III:2. The Panel noted that if the description or categorization of a charge under the domestic law of a contracting party were to provide the required 'connection with importation', contracting parties could determine themselves which of these provisions would apply to their charges. They could in particular impose charges on products after their importation simply by assigning collection of these charges to their customs administration and allocating the revenue generated to their customs revenue. With such an interpretation the basic objective underlying Articles II and III, namely that discrimination against products from other contracting parties should only take the form of ordinary customs duties imposed on or in connection with importation and not the form of internal taxes, could not be achieved. The same reasoning applies to the description or categorization of the product subject to a charge. The fact that the EEC treats imported parts and materials subject to anti-circumvention duties as not being 'in free circulation' therefore cannot ... support the conclusion that the anti-circumvention duties are being levied 'in connection with importation' within the meaning of Article II:1(b).

... the Panel found that the anti-circumvention duties are not levied 'on or in connection with importation' within the meaning of Article II:1(b), and consequently do not constitute customs duties within the meaning of that provision." (paras. 5.4-5.8).

11. In sum, the above Panel found that the policy purpose of the charge is not relevant in determining whether the charge is imposed in "connection with importation' within the meaning of Article II:1(b)", i.e. whether the charge is an internal tax or regulation or an import duty or charge. The Panel stated that "the relevant fact, ..., is not the policy purpose attributed to the charge but rather whether the charge is due on importation or at the time or point of importation or whether it is collected internally ..." Furthermore, the Panel considered that if the description or categorization of the charge under the domestic law of a contracting party were to provide the required 'connection with importation', contracting parties could determine themselves whether the charge is subject to requirements of Article II or those of Article III:2. The basic objective underlying Articles II and III, namely that discrimination against products from other contracting parties should only take the form of ordinary customs duties imposed on or in connection with importation and not the form of internal taxes, could not be achieved.

Equivalence

12. The term "equivalent", as stated in the Article II:2(a) exception (see para. 7 above) was clarified by the Legal Drafting Committee during the Geneva session of the Preparatory Committee. It agreed that it means that "for example, if a [charge] is imposed on perfume because it contains alcohol, the [charge] to be imposed must take into consideration the value of the alcohol and not the value of the perfume, that is to say the value of the content and not the value of the whole." (EPCT/TAC/PV/26, p. 21).

13. The Panel on United States - Taxes on Petroleum and Certain Imported Substances, which concerned the US Superfund Amendments and Reauthorization Act of 1986 which provided for an excise tax per ton on the sale of certain chemicals and on certain imported chemical substances which were derivatives of taxable chemicals, used the above clarification to determine whether the tax on certain imported substances met the national treatment requirement of Article III:2. The Report of the Panel (BISD 34S/136, adopted 17 June 1987) states:

"The Panel, having concluded that the tax on certain chemicals was in principle eligible for border tax adjustment, then examined whether the tax on certain imported substances meets the national treatment requirement of Article III:2, first sentence. This provision permits the imposition of an internal tax on imported products provided the like domestic products are taxed, directly or indirectly, at the same or a higher rate. Such internal taxes may be levied on imported products at the time or point of importation (Note Ad Article III). Paragraph 2(a) of Article II therefore clarifies that a tariff concession does not prevent the levying of

'a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part.'

... In the words which the drafters of the General Agreement used in the above perfume-alcohol example: The tax is imposed on the imported substances because they are produced from chemicals subject to an excise tax in the United States and the tax rate is determined in principle in relation to the amount of these chemicals used and not in relation to the value of the imported substance. The Panel therefore concluded that, to the extent that the tax on certain imported substances was equivalent to the tax borne by like domestic substances as a result of the tax on certain chemicals the tax met the national treatment requirement of Article III:2, first sentence." (paras. 5.2.7-5.2.8).

To be consistent with Article III, adjustments may be made only for "taxes on products"

14. The Report of the Panel on United States - Restriction on Imports of Tuna (DS21/R, 3 September 1991), which has not yet been adopted, underlined the link between tax adjustments and consistency with Article III by using the conclusion of the Working Party on Border Tax Adjustments, that "taxes directly levied on products were eligible for tax adjustment", as a basis for finding that, in order for other regulations to be consistent with Article III, they must also apply only to the product as such. The Report states:

"... Article III covers only measures affecting products as such. Furthermore, the text of the Note Ad Article III ... covers only measures applied to imported products that are of the same nature as those applied to the domestic products ...

A previous panel had found that Article III:2, first sentence, 'obliges contracting parties to establish certain competitive conditions for imported products in relation to domestic products'¹. Another panel had found that the words 'treatment no less favourable' in Article III:4 call for effective equality of opportunities for imported products in respect of the application of laws, regulations or requirements affecting the sale, offering for sale, purchase, transportation, distribution or use of products, and that this standard has to be understood as applicable to each individual case of imported products.² It was apparent to the Panel that the comparison implied was necessarily one between the measures applied to imported products and the measures applied to like domestic products.

The Panel considered that, as Article III applied the national treatment principle to both regulations and internal taxes, the provisions of Article III:4 applicable to regulations should be interpreted taking into account interpretations by the CONTRACTING PARTIES of the provisions of Article III:2 applicable to taxes. The Panel noted in this context that the Working Party Report on Border Tax Adjustments ... had concluded that

'there was convergence of views to the effect that taxes directly levied on products were eligible for tax adjustment ... Furthermore, the Working Party concluded that there was convergence of views to the effect that certain taxes that were not directly levied on products were not eligible for adjustment, [such as] social security charges whether on employers or employees and payroll taxes.'

Thus, under the national treatment principle of Article III, contracting parties may apply border tax adjustments with regard to those taxes that are borne by products, but not for domestic taxes not directly levied on products (such as corporate income taxes). Consequently, the Note Ad Article III covers only internal taxes that are borne by products. The Panel considered that it would be inconsistent to limit the application of this Note to taxes that are borne by products while permitting its application to regulations not applied to the product as such." (paras. 5.11-5.13).

15. The Panel emphasized, in this case, panel findings that concluded that Article III:2 and III:4 applied only to products. It concluded that since Article III applied to both regulations and internal taxes, the conclusions of the Working Party on Border Tax Adjustment regarding Article III:2's application to taxes would apply also to regulations.

16. The Panel on United States - Taxes on Petroleum and Certain Imported Substances, in its examination of whether the tax on certain chemicals was eligible for border tax adjustments, notes that the Working Party on Border Tax Adjustment only defined those taxes eligible for tax adjustment as those "directly" or "not directly" levied on products; it did not include any criteria related to the policy purposes of the tax as relevant to determining whether the tax was eligible for border adjustment.

¹The Report refers to the Panel Report on United States - Taxes on Petroleum and Certain Imported Substances, adopted 17 June 1987, BISD 34S/136.

²The Report refers to the Panel Report on United States- Section 337 of the Tariff Act of 1930, adopted 7 November 1989, BISD 36S/345.

"... As [the conclusions of the Border Tax Adjustments Working Party] clearly indicate, the tax adjustment rules of the General Agreement distinguish between taxes on products and taxes not directly levied on products; they do not distinguish between taxes with different policy purposes. Whether a sales tax is levied on a product for general revenue purposes or to encourage the rational use of environmental resources, is therefore not relevant for the determination of the eligibility of a tax for border tax adjustment. For these reasons the Panel concluded that the tax on certain chemicals, being a tax directly imposed on products, was eligible for border tax adjustment independent of the purpose it served. The Panel therefore did not examine whether the tax on chemicals served environmental purposes and, if so, whether a border tax adjustment would be consistent with these purposes." (5.2.4).

To be consistent with Article III, adjustments may only be made for like products

17. The Working Party on Border Tax Adjustments considered the interpretation of the term "... like or similar products ...". Its report states:

"... it was recalled that considerable discussion had taken place in the past, both in GATT and in other bodies, but that no further improvement of the term had been achieved. The Working Party concluded that problems arising from the interpretation of the term should be examined on a case-by-case basis. This would allow a fair assessment in each case of the different elements that constitute a "similar" product. Some criteria were suggested for determining, on a case-by-case basis, whether a product is "similar": the product's end-uses in a given market; consumers' tastes and habits, which change from country to country; the product's properties, nature and quality. It was observed, however, that the term "... like or similar products ..." caused some uncertainty and that it would be desirable to improve on it; however, no improved term was arrived at."

Several panels have examined the issue of "like products" in making their respective determinations and have built upon this basic conclusion of the Working Party.

18. In the 1987 Panel Report on Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages (BISD 34S/83, adopted 10 November 1987) the Panel examined the arguments of the parties regarding the application of Article III:2 to Japan's liquor tax system. The Report states:

"The drafting history confirms that Article III:2 was designed with 'the intention that internal taxes on goods should not be used as a means of protection' ... As stated in the 1970 Working Party Report on Border Tax Adjustments in respect of the various GATT provisions on taxation, "the philosophy behind these provisions was the ensuring of a certain trade neutrality". This accords with the broader objective of Article III to provide equal conditions of competition once goods had been cleared through customs ... This object and purpose of Article III:2 of promoting non-discriminatory competition among imported and like domestic products could not be achieved if Article III:2 were construed in a manner allowing discriminatory and protective internal taxation of imported products in excess of like domestic products.

Subsequent GATT practice in the application of Article III further shows that past GATT panel reports adopted by the CONTRACTING PARTIES have examined Article III:2 and 4 by determining, firstly, whether the imported and domestic products concerned were 'like' and, secondly, whether the internal taxation or other regulation discriminated against the imported products ... Past GATT practice has clearly

established that 'like' products in terms of Article III:2 are not confined to identical products but cover also other products, for instance if they serve substantially identical end-uses ...

The Panel concluded that the ordinary meaning of Article III:2 in its context and in the light of its object and purpose supported the past GATT practice of examining the conformity of internal taxes with Article III:2 by determining, firstly, whether the taxed imported and domestic products are 'like' or 'directly competitive or substitutable' and, secondly, whether the taxation is discriminatory (first sentence) or protective (second sentence of Article III:2) ..." (paras. 5.5).

19. An important point to note from the above Report is the emphasis on the importance of determining first whether the taxed imported and domestic products are "like" or "directly competitive or substitutable". Only then can any determination of discrimination or protection be made. It should be noted in this context, that the criterion "directly competitive or substitutable" applies only to Article III:2 and not to Article III:4. Ad Article III, paragraph 1, states, "A tax conforming to the requirements of the first sentence of paragraph [III:2] would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed."

20. The Report of the Panel on United States - Measures Affecting Alcoholic and Malt Beverages (DS23/R, adopted 19 June 1992) presents the most recent thinking regarding the determination of "like products" which, as evidenced by the second paragraph of the Panel Report cited in paragraph 18 above, is an essential step in determining whether or not an internal tax is eligible for border adjustment. It states:

"... the Panel noted that the CONTRACTING PARTIES have not developed a general definition of the term 'like products', either within the context of Article III or in respect of other Articles of the General Agreement. Past decisions on this question have been made on a case-by-case basis after examining a number of relevant criteria, such as the product's end-uses in a given market, consumers' tastes and habits, and the product's properties, nature and quality. The Panel considered that the like product determination under Article III:2 also should have regard to the purpose of the Article.

... The purpose of Article III is thus not to prevent contracting parties from using their fiscal and regulatory powers for purposes other than to afford protection to domestic production. Specifically, the purpose of Article III is not to prevent contracting parties from differentiating between different product categories for policy purposes unrelated to the protection of domestic production. The Panel considered that the limited purpose of Article III has to be taken into account in interpreting the term 'like products' in this Article. Consequently, in determining whether two products subject to different treatment are like products, it is necessary to consider whether such product differentiation is being made 'so as to afford protection to domestic production' ... (paras. 5.24-5.25).

... The Panel recalled ... its earlier statement on like product determination and considered that, in the context of Article III, it is essential that such determinations be made not only in the light of such criteria as the products' physical characteristics, but also in the light of the purpose of Article III, which is to ensure that internal taxes and regulations 'not be applied to imported or domestic products so as to afford protection to domestic production'. The purpose of Article III is not to harmonize the internal taxes and regulations of contracting parties, which differ from country to country ...

The Panel recognized that the treatment of imported and domestic products as like products under Article III may have significant implications for the scope of obligations under the General Agreement and for the regulatory autonomy of contracting parties with respect to their internal tax laws and regulations: once products are designated as like products, a regulatory product differentiation, e.g. for standardization or environmental purposes, becomes inconsistent with Article III even if the regulation is not 'applied ... so as to afford protection to domestic production'. In the view of the Panel, therefore, it is imperative that the like product determination in the context of Article III be made in such a way that it not unnecessarily infringe upon the regulatory authority and domestic policy options of contracting parties ..." (paras 5.71-5.72).

21. Two points are worth noting in the above case. The first is the Panel's consideration that the purpose of Article III is relevant to determining whether two products are "like". The Panel stated that "the purpose of Article III is thus not to prevent contracting parties from using their fiscal and regulatory powers for purposes other than to afford protection to domestic production." Thus, in determining whether two products are like, it is necessary to determine whether differentiation is being made "so as to afford protection to domestic production". The second point to note is that the Panel underlined the importance of "like product" determination to the obligations under the GATT and to the "autonomy of contracting parties with respect to their internal tax laws and regulations ...". An important sentence in this context follows: "... once products are designated as like products, a regulatory product differentiation, e.g. for standardization or environmental purposes, becomes inconsistent with Article III even if the regulation is not 'applied ... so as to afford protection to domestic production'."

Income Taxes and Exemptions from Income Taxes

22. During discussions in Sub-Committee A of the Third Committee at the Havana Conference, which considered Article 18 of the Charter (GATT Article III), it was stated that the sub-committee on Article 25 [GATT Article XVI] "had implied that exemptions from income taxes would constitute a form of subsidy permissible under Article 25 and therefore not precluded by Article 18." It was agreed that "neither income taxes nor import duties came within the scope of Article 18 since this Article refers specifically to internal taxes on products."

Methods of Taxation

23. The 1987 Panel Report on Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages (BISD 34S/83, adopted 10 November 1987) provides a useful analytical understanding of various methods of taxation and their consistency with Article III. The Panel examined Japanese excise taxes on alcoholic beverages, which provided different tax rates for different types of beverages, different quality grades of the same beverage, and beverages above and below a price threshold. The Report states:

"... The Panel further found that the wording 'directly or indirectly' and 'internal taxes ... of any kind' implied that, in assessing whether there is tax discrimination, account is to be taken not only of the rate of the applicable internal tax but also of the taxation methods (e.g. different kinds of internal taxes, direct taxation of the finished product or indirect taxation by taxing the raw materials used in the product during the various stages of its production) and of the rules for the tax collection (e.g. basis of assessment).

(a) Whiskies and brandies subject to the grading system: The Panel noted that the Japanese specific tax rates on imported and Japanese whiskies/brandies special grade ... were considerably higher than the Japanese specific tax rates on whiskies/brandies first

grade and second grade ... The Panel was unable to find that these tax differentials corresponded to objective differences of the various distilled liquors, for instance that they could be explained as a non-discriminatory taxation of their respective alcohol contents ... The Panel concluded, therefore, that (special and first grade) whiskies/brandies imported from the EEC were subject to internal Japanese taxes 'in excess of those applied ... to like domestic products' (i.e. first and second grade whiskies/brandies) in the sense of Article III:2, first sentence.

(b) Wines, spirits and liqueurs subject to the 'mixed' system of specific tax and ad valorem tax: The Panel noted that imported and domestic wines, whiskies, brandies, spirits and liqueurs were subject to ad valorem taxes in lieu of the specific tax when the manufacturer's selling price (CIF and customs duty for imported products) exceeded a specified threshold ... The Panel was of the view that a 'mixed' system of specific and ad valorem liquor taxes was as such not inconsistent with Article III:2, which prohibits discriminatory or protective taxation of imported products but not the use of differentiated taxation methods as such, provided the differentiated taxation methods do not result in discriminatory or protective taxation ... since liquors above the non-taxable thresholds were subjected to ad valorem taxes in excess of the specific taxes on 'like' liquors below the threshold ... the imposition of ad valorem taxes on wines, spirits and liqueurs imported from the EEC, which are considerably higher than the specific taxes on 'like' domestic wines, spirits and liqueurs, was inconsistent with Article III:2, first sentence.

(c) The different methods of calculating ad valorem taxes on imported and domestic liquors: The Panel shared the view expressed by both parties that Article III:2 does not prescribe the use of any specific method or system of taxation. The Panel was further of the view that there could be objective reasons proper to the tax in question which could justify or necessitate differences in the system of taxation for imported and for domestic products. The Panel found that it could be also compatible with Article III:2 to allow two different methods of calculation of price for tax purposes. Since Article III:2 prohibited only discriminatory or protective tax burdens on imported products, what mattered was, in the view of the Panel, whether the application of the different taxation methods actually had a discriminatory or protective effect against imported products. The Panel could therefore not agree with the EEC's view that the mere fact that the so-called 'fixed subtraction system' was available only for domestic liquors constituted in itself discrimination contrary to Article III:2 or 4.

(d) Taxation according to extract content: ... The Panel noted ... that GATT Article II:2 permitted the non-discriminatory taxation 'of an article from which the imported product has been manufactured or produced in whole or in part', and that such a non-discriminatory alcohol tax on like alcoholic beverages with different alcohol contents could result in differential tax rates on like products ... Having found that

liqueurs and sparkling wines with high raw material contents, imported into Japan, were subject to internal taxes in excess of those applied to like domestic liqueurs and sparkling wines with lower raw material contents ... and that

this differential taxation of like products depending on their extract and raw material content had not been, and apparently could not be, justified as resulting from a non-discriminatory internal tax on the raw material content concerned or as justifiable under any of the exception clauses of the General Agreement,

the Panel concluded that this imposition of higher taxes on 'classic' liqueurs and sparkling wines with higher raw material content was inconsistent with Article III:2, first sentence." (paras. 5.8-5.9).

24. In the above case, the Panel emphasized that tax differentials should correspond to objective differences. It also considered that a 'mixed' system of specific and ad valorem taxes was, as such, not inconsistent with Article III:2, "which prohibits discriminatory or protective taxation of imported products but not the use of differentiated taxation methods as such, provided the differentiated taxation methods do not result in discriminatory or protective taxation ..." The Panel also stated that Article III:2 does not prescribe the use of any specific method or system of taxation and that it could be also compatible with Article III:2 to allow two different methods of calculation of price for tax purposes. The Panel considered that what mattered was whether the application of the different taxation methods actually had a discriminatory or protective effect against imported products. Finally, the Panel noted that Article II:2(a) permitted the non-discriminatory taxation 'of an article from which the imported product has been manufactured or produced in whole or in part'.

B. Tax adjustments are optional under the GATT

25. The Working Party on Border Tax Adjustments notes:

"that there were differences in the terms used in [Articles I, II, III, VI, VII, and XVI], in particular with respect to the provisions regarding importation and exportation: for instance, the terms 'borne by' and 'levied on'. It was established that those differences in wording had not led to any differences in interpretation of the provisions. It was agreed that GATT provisions on tax adjustment applied the principle of destination identically to imports and exports.

It was further agreed that these provisions set maxima limits for adjustment (compensation) which were not to be exceeded, but below which every contracting party was free to differentiate in the degree of compensation applied, provided that such action was in conformity with other provisions of the General Agreement".

26. This latter conclusion provided a basis for one of the findings of the Panel on United States - Taxes on Petroleum and Certain Imported Substances. Concerning the excise tax per ton on the sale of certain chemicals and on certain imported chemical substances which were derivatives of taxable chemicals, the European Community considered the tax on certain chemicals not to be eligible for border tax adjustment because it was designed to tax polluting activities that occurred in the United States and to finance environmental programs benefiting only United States' producers. The EC argued that consistent with the Polluter-Pays Principle, the United States should have taxed only products of domestic origin because only their production gave rise to environmental problems in the United States (para. 5.2.3). The Report of the Panel (BISD 34S/136, adopted 17 June 1987) quotes the latter conclusion of the Working Party above and adds:

"... Consequently, if a contracting party wishes to tax the sale of certain domestic products (because their production pollutes the domestic environment) and to impose a lower tax or no tax at all on like imported products (because their consumption or use causes fewer or no environmental problems), it is in principle free to do so. The General Agreement's rules on tax adjustment thus give the contracting party in such a case the possibility to follow the Polluter-Pays Principle, but they do not oblige it to do so." (para. 5.2.5).

27. This Panel also found, consistent with the above latter conclusion of the Working Party, with regard to the excise tax on petroleum that "The rate of tax applied to the imported products is 3.5 cents per barrel higher than the rate applied to the like domestic products ... The tax on petroleum is ... inconsistent with the United States' obligations under Article III:2, first sentence." (para. 5.1.1).

28. Therefore, while GATT rules allow for adjustment of internal taxes at the border, such adjustment is optional; contracting parties have the right but not the obligation to impose the burdens borne by domestic products also on imported products. Equally, contracting parties may, but need not, apply to products sold abroad the measures applied to products sold domestically. This gives rise to four possible forms of tax treatment:

- a product destined for export could be exempted from domestic taxes or given a rebate or remission by the country of export, and then taxed by the country of import (destination principle);
- a product destined for export could be taxed by the country of export and exempted from taxes by the country of import (origin principle);
- a product destined for export could be taxed both by the country of export and the country of import (double taxation); and
- a product destined for export could be taxed by neither the country of export nor the country of import (tax exemption).

C. The Export Side - Article XVI

29. Paragraph 4 of Article XVI prohibits, "... either directly or indirectly, any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market."³ A Note to Article XVI allows, however, that "the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy." In discussions on this Note (paragraph 2 of Article 26 of the Havana Charter) at Havana, it was understood that paragraph 2 "covers the case of remission of duties or taxes imposed on raw materials and semi-manufactured products subsequently used in the production of exported manufactured goods." (E/CONF.2/C.3/51, p. 109).

³This paragraph was to go into effect "as from 1 January 1958 or the earliest practicable date thereafter...". A Working Party in 1960 drafted the "Declaration Giving Effect to the Provisions of Article XVI:4" which provides that the governments subscribing to it agree that the date on which Article XVI: 4 prohibitions of export subsidies would come into force is the date of entry into force for each government, party to the Declaration, which in most cases was 14 November 1962. Article XVI:4 is now in force for seventeen countries which have accepted this Declaration: Austria, Belgium, Canada, Denmark, France, Federal Republic of Germany, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Sweden, Switzerland, United Kingdom, United States and Zimbabwe.

30. The relevance of Article XVI to border tax adjustments was examined by the Working Party on Border Tax Adjustments which noted that "It was agreed that GATT provisions on tax adjustment applied the principle of destination identically to imports and exports."

31. Article VI provides for the ability to assess countervailing duties to offset material injury to industry in the importing country caused by subsidized imports. However, paragraph 4 of this Article provides that anti-dumping or countervailing duties cannot be assessed on imported products that were exempted "from duties or taxes borne by the like product when destined for consumption in the country of origin or exportation, or by reason of the refund of such duties or taxes."

32. The 1979 "Agreement on Interpretation and Application of Articles VI, XVI and XXIII", otherwise known as the "Agreement on Subsidies and Countervailing Duties" which was agreed at the end of the Tokyo Round, prohibits export subsidies on products other than certain primary products. An Illustrative List of export subsidies is annexed to the Agreement. This list includes:

"... (e) The full or partial exemption, remission, or deferral specifically related to exports of direct taxes⁴ ...

(g) The exemption or remission in respect of the production and distribution of exported products of indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.⁵

(h) The exemption, remission or deferral of prior stage cumulative indirect taxes⁶ on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like prior stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior stage cumulative indirect taxes may be exempted, remitted or deferred

⁴A distinction must be made between "direct taxes" and "taxes directly levied on products", the latter of which include excise duties, sales taxes, etc. and are eligible for border tax adjustment according to the Working Party on Border Tax Adjustment (see para, 7). "Direct taxes", according to the Subsidies Code include taxes on wages, profits, interest, rents, etc. and can be viewed as taxes directly levied on persons or entities as opposed to products. Accordingly, if such "direct taxes" are exempted, remitted or deferred on exports, they would constitute export subsidies, would be contrary to the Subsidies Code, and would not be eligible for border tax adjustment.

⁵According to the Subsidies Code, "indirect taxes" include "sales, excise, turnover, value added, franchise...border taxes and all taxes other than direct taxes and import charges". It appears, therefore, that "indirect taxes" in the context of the Subsidies Code are those that are "directly levied on products"; their exemption or remission in excess of those levied on the like product destined for domestic consumption would constitute an export subsidy, would be contrary to the Subsidies Code, and would not be eligible for border tax adjustment. However, non-excessive exemption or remission of such taxes would not constitute an export subsidy, would be allowed under the Subsidies Code and Article XVI, and would be eligible for border tax adjustment.

⁶"Prior stage" indirect taxes, as defined in the Subsidies Code, are those levied on goods or services used directly or indirectly in making the product. "Cumulative" indirect taxes are multi-staged taxes levied where there is no mechanism for subsequent crediting of the tax if the goods or services subject to tax at one stage of production are used in a succeeding stage of production.

on exported products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the prior stage cumulative indirect taxes are levied on goods that are physically incorporated (making normal allowance for waste) in the exported product.⁷

- (i) The remission or drawback of import charges in excess of those levied on imported goods that are physically incorporated (making normal allowance for waste) in the exported product ...⁸

33. The latter two examples of export subsidies, (h) and (i), deal with situations where there is an indirect tax or import charge (as defined in the Code) on a good (or also service in the case of (h)) that is physically incorporated in the export product. The Uruguay Round Agreement on Subsidies and Countervailing Measures replaces the term "physically incorporated" in (h) and (i) with the phrases "used in the production of" and "consumed in the production of" in (h) and (i) respectively of its Illustrative List of Export Subsidies (Annex I of the Uruguay Round Agreement). Annex II of the Uruguay Round Agreement, Guidelines on Consumption of Inputs in the Production Process, elaborates on the meaning of these two paragraphs:

"1. Indirect tax rebate schemes can allow for exemption, remission or deferral of prior stage cumulative indirect taxes levied on inputs that are consumed in the production of the exported product (making normal allowance for waste). Similarly, drawback schemes can allow for the remission or drawback of import charges levied on inputs that are consumed in the production of the exported product (making normal allowance for waste).

2. The Illustrative List of Export Subsidies in Annex I of this Agreement makes reference to the term "inputs that are consumed in the production of the exported product" in paragraphs (h) and (i). Pursuant to paragraph (h), indirect tax rebate schemes can constitute an export subsidy to the extent that they result in exemption, remission or deferral of prior stage cumulative indirect taxes in excess of the amount of such taxes actually levied on inputs that are consumed in the production of the exported product. Pursuant to paragraph (i), drawback schemes can constitute an export subsidy to the extent that they result in a remission or drawback of import charges in excess of those actually levied on inputs that are consumed in the production of the exported product. Both paragraphs stipulate that normal allowance for waste must be made in findings regarding consumption of inputs in the production of the exported product. Paragraph (i) also provides for substitution, where appropriate."

34. Finally, Annex II of the Uruguay Round Agreement contains an important footnote from the point of view of environmental protection policies. It states:

"Inputs consumed in the production process are inputs physically incorporated, energy, fuels and oil used in the production process and catalysts which are consumed in the course of their use to obtain the exported product."

⁷A footnote to this paragraph states that this paragraph "does not apply to value-added tax systems and border-tax adjustment in lieu thereof; the problem of the excessive remission of value-added taxes is exclusively covered by paragraph (g)."

⁸"Import charges" are defined in the Code as "tariffs, duties, and other fiscal charges...levied on imports."

Given that the Agreement allows for exemption, remission or deferral of prior stage cumulative indirect taxes (as defined in the Agreement) not in excess of the amount of such taxes actually levied on inputs that are consumed in the production of the exported product, presumably this footnote would allow for exemption, remission or deferral of taxes levied on the energy, fuel, and/or oil inputs "consumed in the production of" an exported product. This can have important implications for competitiveness issues that often arise with regard to proposals for such energy taxes.