

ANNEX B

Third Party Submissions

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ANNEX B-1

THIRD PARTY SUBMISSION BY AUSTRALIA

(14 February 2001)

Overview

1. Australia welcomes the opportunity to submit a third party submission for the Article 21.5 panel's examination on "United States – Tax Treatment for Foreign Sales Corporations (FSC)". As a medium size exporting country, Australia derives significant benefits from the rules-based framework of the WTO Agreements. The provision by the United States of prohibited export subsidies has a direct impact on the competitive trading opportunities of Australian exporters in all markets.

2. It is Australia's view that the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000", as enacted by the United States on 15 November 2000, remains WTO-inconsistent.

3. The FSC replacement measure provides a subsidy contingent upon export performance or the use of domestic over imported goods within the meaning of Article 3.1 of the Agreement on Subsidies and Countervailing Measures (the SCM Agreement). Moreover, the original FSC subsidies will continue to be provided until 1 January 2002. Australia will confine its comments to specific legal issues under the SCM Agreement.

The FSC Replacement Measure

4. As a general rule, the United States asserts the right to tax all income earned worldwide by its citizens and residents. The FSC measure provided certain tax exemptions to "foreign sales corporations" connected with the sale or lease of goods produced in the United States for export. This was found to be a prohibited export subsidy under Section 3.1(a) of the SCM Agreement, and under Articles 10.1 and 8 of the Agreement on Agriculture.

5. The "FSC Repeal and Extra-territorial Income Exclusion Act" (HR 4986) amended the Internal Revenue Code by repealing the FSC provisions and by exempting "extraterritorial income" from gross income on which tax liability is calculated. Extraterritorial income is defined as gross income attributable to "foreign trading gross receipts".¹

6. "Foreign trading gross receipts" includes gross receipts from sale, exchange, lease or rental of "qualifying foreign trade property", and related and subsidiary services.² It does not include receipts from transactions where the qualifying foreign trade property or services are for ultimate use in the United States.³

7. "Qualifying foreign trade property" is defined as property:

- (A) manufactured, produced, grown, or extracted within or outside the United States,
- (B) held primarily for sale, lease, or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and

¹ Section 114(a), (b) and (e) of the IRC, as amended by HR 4986.

² Section 942(a)(1)(A) and (B) of the IRC, as amended by HR 4986.

³ Section 942(a)(2) of the IRC, as amended by HR 4986.

- (C) not more than 50 per cent of the fair market value of which is attributable to:
- (i) articles manufactured, produced, grown or extracted outside the United States, and
 - (ii) direct costs for labor performed outside the United States.⁴

8. Property shall be treated as qualifying foreign trade property only if it is manufactured, produced, grown or extracted outside the United States by: a domestic corporation; a citizen or resident of the United States; a foreign corporation which has elected to be subject to United States taxation; or a partnership in which all the partners or owners fall within one of the first three categories.⁵

The United States Has Not Withdrawn the Original FSC Subsidies “Without Delay”

9. Section 59(c)(1)(A) provides a transition period for FSCs in existence on 30 September 2000 from the FSC legislation amendments. The amendments do not apply to transactions of such FSCs before 1 January 2002 and FSCs can continue to benefit from FSC taxation refunds until that date.

10. Australia recalls that the panel report, as modified by the Appellate Body, required the United States to withdraw the FSC subsidies by 1 October 2000. This period was extended by agreement between the United States and the EC until 1 November 2000.

11. Given that existing FSCs can continue – until 1 January 2002 - to benefit from the original FSC subsidies, the United States has not withdrawn the subsidies “without delay” and has not implemented the recommendations and rulings of the DSB.

The Replacement FSC Measure Constitutes a Prohibited Subsidy Under the SCM Agreement

12. The replacement FSC measure constitutes a prohibited subsidy “contingent ... upon export performance” under Article 3.1(a) of the SCM Agreement and “contingent ... upon the use of domestic over imported goods” under Article 3.1(b) of the SCM Agreement.

13. Article 1.1(a)(1)(ii) of the SCM Agreement deems a subsidy to exist where government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits). The term “otherwise due” implies a comparison between the revenues due under the contested measure and revenues that would be due in some other situation. As stated by the panel and Appellate Body in the examination of the original FSC measure, the basis of comparison is the tax rules applied by the United States.⁶

14. Under the new regime, “foreign trading gross receipts” is excluded from gross income on which tax liability is calculated. The effect of the exclusion is to reduce the tax liability of the beneficiary corporation. This represents a departure from the rules of taxation that would “otherwise” apply to such gross income. Accordingly, government revenue otherwise due is foregone or not collected within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement. A benefit is also conferred under Article 1.1(b) in the form of a reduction in tax liability.

15. The subsidy is a prohibited subsidy within the meaning of Article 3.1 of the SCM Agreement. The tax exemption applies in relation to “qualifying foreign trade property”. This is property

⁴ Section 943(a)(1) of the IRC, as amended by HR 4986.

⁵ Section 943(a)(2) of the IRC, as amended by HR 4986.

⁶ WT/DS108/AB/R, para. 90; WT/DS108/R, para. 7.42.

manufactured, produced, grown or extracted within or outside the United States and which satisfies two requirements:

- (1) it must be held primarily for sale, lease or rental for – in the ordinary course of business - direct use, consumption, or disposition *outside the United States*; and
- (2) *at least 50 per cent* of its fair market value is attributable to articles manufactured, produced, grown or extracted in the United States, and the direct costs for labour performed in the United States.

16. Two conclusions can be drawn from this. Firstly, for property manufactured, produced, grown or extracted *within* the United States to qualify for the tax exemption, it must be transacted for direct use, consumption or disposition *outside the United States*. The subsidy is therefore “contingent, in law or in fact ... upon export performance” within the meaning of Article 3.1(a) of the SCM Agreement. This is further reinforced by Section 942(a)(2) of the IRC which excludes from “foreign trading gross receipts” qualifying foreign trade property or services for ultimate use in the United States.

17. Australia emphasises it is not arguing the measure to be an export subsidy simply because it is provided to corporations that produce within the United States for sale, lease or rental outside the United States. Footnote 4 provides that the mere fact that a subsidy is granted to enterprises which export shall not, for that reason alone, be considered to be an export subsidy. However in the present case, the tax exemption to corporations that produce within the United States is *conditioned* on the sale, lease or rental of products for direct use, consumption or disposition *outside* the United States.

18. The measure is also “contingent, in law or in fact ... upon export performance” in relation to property manufactured, produced, grown or extracted *outside* the United States. For such property to qualify for the tax exemption, at least 50 per cent of its fair market value must be attributable to United States content and United States direct labour costs. This necessarily requires the *export* of United States product for the foreign producer to meet the 50 per cent United States content requirement.

19. Secondly, the subsidy is “contingent ... upon the use of domestic over imported goods” within the meaning of Article 3.1(b) of the SCM Agreement. For property to constitute “qualifying trade property” for which the tax exemption applies, at least 50 per cent of its fair market value must be attributable to articles manufactured, produced, grown or extracted *within the United States*, and direct costs for labour performed *within the United States*. Given the tax exemption only arises on the meeting of a 50 per cent local content requirement, it is contingent upon the use of domestic over imported goods.

It is Not a Measure To Avoid Double Taxation of Foreign-Source Income

20. Footnote 59 of the SCM Agreement provides that paragraph (e) of the Illustrative List of Export Subsidies is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

21. The FSC replacement measure cannot be justified as a measure “to avoid double taxation of foreign-source income”. Firstly, the general United States tax rules already provide income tax credits to minimise double taxation. Sections 27(a) and 901 of the IRC provides tax credits to United States citizens and domestic corporations for taxes imposed by foreign countries and possessions of the United States. The United States has also entered into agreements with other countries to avoid double taxation of income. For example, Article 22(1)(a) of the 1983 Australia-United States double tax agreement obliges the United States to provide tax credits to United States residents or citizens for income tax paid to Australia.

22. Secondly, the tax exemptions provided by the proposed measure are not calculated on, or limited to, the amount of foreign tax paid on “extraterritorial income”. It is calculated on receipts from the sale, exchange, lease or rental of “qualifying foreign trade property”.

Conclusion

23. The FSC replacement measure provides prohibited subsidies within the meaning of Article 3.1 of the SCM Agreement. The measure constitutes a subsidy by providing tax exemptions which forego government revenue otherwise due. The subsidy is “contingent ... upon export performance” by being conditioned on the sale, lease or rental of products for direct use, consumption or disposition *outside* the United States. It is also “contingent ... upon the use of domestic over imported goods” by being conditioned on a 50 per cent United States content requirement. Accordingly, the United States has also breached Article 3.2 of the SCM Agreement.

24. In making this submission, Australia is not disputing the United States’ right to maintain a worldwide taxation system as opposed to a territorial taxation system. However, Australia recalls the Appellate Body’s statement in the original dispute that: “A Member of the WTO may choose any kind of tax system it wishes – so long as, in so choosing, that Member applies that system in a way that is consistent with its WTO obligations”.

ANNEX B-2

THIRD PARTY SUBMISSION BY CANADA

(14 February 2001)

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I. EXECUTIVE SUMMARY

1. Canada's agrees with the European Communities that the United States has failed to bring its measures into compliance with the recommendations and rulings of the Dispute Settlement Body, and that the United States continues, through the *FSC Repeal and Extraterritorial Exclusion Act of 2000* (FSC Replacement scheme) to provide subsidies which are contingent upon export performance within the meaning of Article 3.1(a) of the *Agreement on Subsidies and Countervailing Duty Measures*. (*SCM Agreement*).

2. Canada only makes submissions with respect to Article 3.1(a) of the *SCM Agreement* and does not address the arguments raised by the European Communities under Article 3.1(b) of the *SCM Agreement*, Articles 8 and 10.1 of the *Agreement on Agriculture* and Article III:4 of the *General Agreement on Tariffs and Trade 1994*.

3. In Canada's view, the United States, through the FSC Replacement scheme, continues to provide both a financial contribution, in the form of government revenue foregone otherwise due, and

a benefit to US-based enterprises by excluding from taxation income that they earn on exports from the United States. Accordingly, there still exists a “subsidy” under Article 1.1 of the *SCM Agreement*.

4. Canada argues that the “subsidy” is contingent upon export performance and, therefore, prohibited under Article 3.1(a) of the *SCM Agreement* as in order to benefit from the “subsidy”, US-based enterprises must not sell their goods “for ultimate use in the United States.” Canada agrees with the European Communities that these words are simply “another way of saying that they must be exported”.

5. Finally, Canada argues that the fact that the FSC Replacement scheme is available to foreign manufacturers on the sale of foreign goods is irrelevant to the determination of whether the “subsidy” provided to US-based enterprises on the income earned from export transactions is contingent upon export performance.

II. INTRODUCTION

6. Canada is appreciative of the opportunity to participate in this proceeding under Article 21.5 of the Understanding on Rules and Procedures for the Settlement of Disputes.¹

7. Canada participated in previous proceedings before the Panel and the Appellate Body.²

III. BACKGROUND

A. FINDINGS OF THE PANEL AND APPELLATE BODY

8. On 24 February 2000, the Appellate Body upheld the Panel’s finding that various exemptions for certain types of income under the US Internal Revenue Code earned by foreign sales corporations (the FSC measure or FSC scheme), taken together, constituted a prohibited export subsidy under Article 3.1(a) of the *Agreement on Subsidies and Countervailing Measures (SCM Agreement)*.

9. More particularly, the Appellate Body agreed with the Panel that having decided to tax foreign-source income, the United States could not exclude certain types of this income from taxation without foregoing government revenue that would otherwise be due, and, therefore, without providing a financial contribution under Article 1.1(a)(ii) of the *SCM Agreement*. Having also agreed with the Panel that the FSC measure provided a “benefit” to the recipients of the exemption, the Appellate Body agreed that the FSC measure represented a “subsidy” within the meaning of Article 1.1 of the *SCM Agreement*. Finally, the Appellate Body upheld the Panel’s finding that the “subsidy” was contingent upon export performance and, therefore, prohibited under Article 3.1(a) of the *SCM Agreement*.³

¹ Although the European Communities raises several arguments in this 21.5 proceeding, Canada only makes submissions with respect to one of these arguments, i.e. the argument that the United States, through the *FSC Repeal and Extraterritorial Income Exclusion Act of 2000*, continues to provide prohibited export subsidies inconsistent with Article 3.1(a) of the *Agreement on Subsidies and Countervailing Duty Measures*.

² *United States – Tax Treatment for “Foreign Sales Corporations”*, Reports of the Panel (WT/DS 108/R, 8 October 1999 (Complaint by the European Communities) and of the Appellate Body (AB-1999-9, WT/DS 108/AB/R, 24 February 2000) (Appeal by the United States) adopted by the Dispute Settlement Body on 20 March 2000.

³ Report of the Appellate Body, *Ibid.* paras. 90 to 121. The Appellate Body also upheld the Panel’s finding that the United States acted inconsistently with its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture* by applying export subsidies, through the FSC measure, in a manner which resulted in, or which threatened to lead to, circumvention of its export subsidy commitments with respect to both scheduled and unscheduled agricultural products. Furthermore, having upheld the Panel’s findings under Article 3.1(a) of the *SCM Agreement*, the Appellate Body did not rule on the European Communities conditional appeal under Article 3.1(b) of the *SCM Agreement*.

10. The Appellate Body recommended that the Dispute Settlement Body (DSB) request the United States to bring the FSC measure into conformity with its WTO obligations⁴.

11. The Appellate Body emphasized that its ruling was in no way a judgment on the consistency or the inconsistency of the relative merits of the tax system chosen by the United States. The Appellate Body held that:

[a] Member of the WTO may chose any kind of tax system it wishes, so long as, in so choosing, that Member applies that system in a way that is consistent with its WTO obligations. Whatever kind of tax system a Member chooses, that Member will not be in compliance with its WTO obligations if it provides, through its tax system, subsidies contingent upon export performance that are not permitted under the covered agreements.⁵

12. The findings and conclusions of the Appellate Body were adopted by the DSB on 20 March 2000.⁶

B. MEASURES TAKEN BY THE UNITED STATES

13. In order to comply with the recommendations and rulings of the DSB, the United States adopted the *FSC Repeal and Extraterritorial Income Exclusion Act of 2000*⁷ on 15 November 2000.

14. According to the United States, the new taxing rules contained in the FSC Replacement scheme are consistent with US obligations under the WTO. The United States argues that the new legislation does not confer a “subsidy”, rendering moot the issue of “export contingency”. Nonetheless, the United States argues that in the event the Panel finds that there still exists a subsidy, it is not prohibited under Article 3.1(a) of the *SCM Agreement*, as it does not limit the income that is excluded from US taxing authority to export income. The United States also argues that the FSC Replacement scheme is meant to achieve some level of tax parity with European territorial tax systems in a WTO-consistent manner.

15. More specifically, the United States argues that by adopting the FSC Replacement scheme, it has withdrawn the export subsidy at issue, as the provisions relating to taxation of foreign sales corporations have been repealed.

16. Relying on the finding of the Appellate Body that a WTO Member has the sovereign right not to tax certain categories of income, the United States argues that the FSC Replacement scheme is WTO consistent as it creates a general rule exempting “extraterritorial income” from the definition of “gross income” in the Internal Revenue Code. According to the United States, the fact that this exclusion does not apply to all categories of “extraterritorial income” does not render the measure WTO inconsistent, as the exclusion is from a general rule of non-taxation rather than taxation. The United States argues that, as a sovereign nation, it is free not to tax certain categories of “extraterritorial income” and that the WTO does not compel Members to adopt pure territorial tax regimes.

17. The United States argues that the measure is not contingent upon export performance as the exclusion applies to qualifying income, whether it is earned in the United States or abroad, a

⁴ Report of the Appellate Body, *Ibid.* para. 178.

⁵ Report of the Appellate Body, *Ibid.* para. 179.

⁶ Doc. WT/DS 108/10, 24 March 2000.

⁷ US Public Law No. 106-519; Similar to the EC, Canada refers to the *FSC Repeal and Extraterritorial Income Exclusion Act* as the FSC Replacement scheme when we refer to the measure as a whole and as the FSC Replacement Act when we refer to particular sections.

substantially broader category of income than that which was exempted from tax under the FSC measure.

IV. ISSUE AND CANADA'S POSITION BEFORE THIS PANEL

18. The issue before this Panel is whether the FSC Replacement scheme is consistent with the recommendations of the DSB to withdraw the FSC measure found to be a prohibited export subsidy inconsistent with Article 3.1(a) of the *SCM Agreement*.⁸ In order to be found to have complied, the United States must have ceased providing prohibited export subsidies.⁹

19. As noted by the Appellate Body, the Panel's task is not to examine the merits of the tax system chosen by the United States. Rather, the Panel's task is limited to determining whether the measure put in place by the United States is consistent with its obligations under the WTO.

20. Canada agrees with the EC that the FSC Replacement scheme fails to bring the United States into compliance with the DSB recommendations and rulings and that the United States, through the FSC Replacement scheme, continues to provide subsidies which are contingent upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*.

V. LEGAL ANALYSIS

A. THE FSC REPLACEMENT SCHEME PROVIDES A "SUBSIDY" TO US-BASED ENTERPRISES EARNING "DOMESTIC INCOME FROM EXPORT TRANSACTIONS" WITHIN THE MEANING OF ARTICLE 1.1 OF THE *SCM AGREEMENT*

21. The definition of "subsidy" under Article 1.1 of the *SCM Agreement* consists of two discrete elements: (1) a financial contribution by a government or any public body; and (2) a benefit is thereby conferred.¹⁰ Both of these elements must be present in order for there to be a "subsidy" under Article 1.1 of the *SCM Agreement*, and, correspondingly, under Article 3.1 of that Agreement.

1. There is a "Financial Contribution" to US-based Enterprises Within the Meaning of Article 1.1(a)(ii) of the *SCM Agreement*

22. In Canada's view, the United States continues, through the FSC Replacement scheme, to provide a financial contribution to US-based enterprises by excluding from taxation domestic income that they earn from export transactions.

23. The Appellate Body stated the following regarding the meaning to be attributed to the words "foregoing" of government revenue "otherwise due":

[i]n our view, the "foregoing" of revenue "otherwise due" implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, "otherwise". Moreover, the word "foregone" suggests that the government has given up an entitlement to raise revenue that it would "otherwise" have raised.¹¹

⁸ Canada does not address arguments raised by the EC under Article 3.1(b) of the *SCM Agreement*, Articles 10.1 and 8 of the *Agreement on Agriculture*, and Article III:4 of the *General Agreement on Tariffs and Trade 1994*.

⁹ *Canada – Measures Affecting the Export of Civilian Aircraft, Recourse by Brazil to Article 21.5 of the DSU*, Report of the Panel (WT/DS70/RW, 9 May 2000), para. 5.63.

¹⁰ *Canada – Measures Affecting the Export of Civilian Aircraft*, Report of the Appellate Body (AB-1999-2, WT/DS70/AB/R, 2 August 1999), para. 156.

¹¹ Report of the Appellate Body, *supra*, note 1, para. 90.

24. The Appellate Body held that the decision as to whether the government has given up an entitlement to raise revenue that it would “otherwise” have raised implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. The Appellate Body agreed with the Panel that the basis for comparison must be the tax rules applied by the Member in question.¹²

25. As noted above, the Appellate Body ruled that a WTO Member has the sovereign authority to tax any particular categories of revenue it wishes, and that it is also free not to tax any particular categories of revenue. However, the Appellate Body ruled that, in both instances, the WTO Member must respect its WTO obligations. The Appellate Body held that what is “otherwise due” depends on the rules of taxation that each Member, by its own choice, establishes for itself.¹³

26. The Appellate Body held that the “but for” test established by the Panel, that is, “the situation that would prevail but for the measure in question”, provided “a sound basis for comparison” in the case of the FSC scheme, because it was “not difficult to establish in what way the foreign-source income would be taxed “but for” the contested measure”. The Appellate Body stated that it had “certain abiding reservations about applying any legal standard, such as this “but for” test, in the place of the actual treaty language”, and “particular misgivings about using a “but for” test if its application were limited to situations where there actually existed an alternative measure, under which the revenues in question would be taxed, absent the contested measure.” The Appellate Body believed that it would “not be difficult to circumvent such a test by designing a tax regime under which there would be no general rule that applied formally to the revenues in question, absent the contested measure.” The Appellate Body, therefore, observed that, although the Panel’s “but for” test worked in the case of the FSC scheme, that it might not work in other cases.¹⁴

27. It appears that the United States has relied on this “but for” test in implementing the recommendations and rulings of the DSB. Essentially, the United States’ position is that it has brought its measures into conformity with its WTO obligations by reversing the situation under its tax rules from one of having decided to tax a particular category of income and then excluding part of that income from taxation to one of having decided to exclude from taxation a category of income which includes the previously excluded income. In the view of the United States, since there is no general rule that formally applies to tax the revenues in question, there can be no foregoing of government revenue, as absent the contested measure, there would be no tax due.

28. The United States appears to have designed the precise type of tax regime the Appellate Body believed a Member could design in order to circumvent the “but for” test. Canada, therefore, submits that the analysis conducted by the Panel does not work in this case to determine whether the government has given up an entitlement to raise revenue that it would “otherwise” have raised. The exclusion of “extraterritorial income” from the definition of “gross income” in section 114(a) of the *FSC Replacement Act*¹⁵ is, therefore, not determinative of the issue of whether the government has foregone revenue otherwise due.

29. In Canada’s view, the finding of the Appellate Body clearly stands for the proposition that, absent a rule formally taxing the revenues in question, a more complete analysis of domestic tax rules must be conducted in order to determine what situation would apply to the revenues in question absent the contested measure. Canada submits that such an analysis of US tax rules in this case reveals that income earned by US-based enterprises on export transactions, which is part of the

¹² *Ibid.*

¹³ *Ibid.*

¹⁴ Report of the Appellate Body, *supra* note 1, para. 91.

¹⁵ Section 114(a) of the *FSC Replacement Act* provides as follows:

EXCLUSION.— Gross income does not include extraterritorial income

income excluded from taxation under the definition of “extraterritorial income”, would otherwise be subject to tax, absent the FSC Replacement scheme.

30. It is clear that although the FSC Replacement scheme excludes “extraterritorial income” from the definition of “gross income”, that the “true exclusion” from taxation under this scheme is only for “qualifying foreign trade income”.¹⁶ Accordingly, only certain categories of “extraterritorial income” are excluded from tax.¹⁷

31. The definition of “qualifying foreign trade income” in the *FSC Replacement Act* encompasses two very different types of income that must be clearly distinguished for purposes of the analysis. On the one hand, it includes income earned from export transactions by US-based enterprises, that is, transactions entered into by an enterprise located in the United States entailing the shipments of goods from the territory of the United States to the territory of another country. The definition of “qualifying foreign trade income” also includes foreign-source income earned by enterprises (through a branch of a US corporation, a subsidiary of a US corporation or other entities otherwise eligible under the scheme) located outside the United States, that is, entailing the sales of goods from a territory other than that of the United States.

32. Canada agrees with the EC that income earned from export transactions under the FSC Replacement scheme “corresponds arithmetically to the exempt foreign source income of the FSC scheme”.¹⁸ Canada submits that the United States continues to provide subsidies to US-based enterprises earning this type of income.

33. The United States has argued that the exclusion of “extraterritorial income” from the definition of “gross income” is a measure to avoid double taxation of foreign source income, and, therefore, the income covered under this exclusion would normally not be subject to domestic tax. Canada agrees that the “foreign income” component of “extraterritorial income” is the type of income typically subject to a measure designed to avoid double taxation. However, in Canada’s view, the United States has added this new category of income to the measure in question in an attempt to confuse the domestic tax situation that would otherwise apply to the “domestic export income” component of “extraterritorial income”.¹⁹

34. In Canada’s view, income earned from export transactions is income that would generally be taxable only in the United States, since it is sourced in the United States, that is, it arises from economic activities taking place in the United States. The fact that the proceeds of sales are from

¹⁶ Section 114(b) of the *FSC Replacement Act*, which, in Canada’s view, is the critical section in the Act provides as follows:

EXCEPTION.— Subsection (a) shall not apply to extraterritorial income which is not qualifying foreign trade income as determined under subpart E of part III of subchapter N.

¹⁷ The highly selective application of the income exclusion under the scheme is achieved by imposing conditions and providing elections to taxpayers in order for them to maximise the amount of the exclusion to fit their specific circumstances. Canada therefore agrees with the EC that “the FSC Replacement Act does not *qualitatively* define a *class* or *category of income* that is excluded from the tax base – it lays down *conditions* for the partial non-taxation of income that would otherwise be taxed” (First Submission of the European Communities, para. 57).

¹⁸ First Written Submission of the European Communities, para. 35.

¹⁹ It must be noted that the FSC Replacement scheme does not purport to replace the foreign tax credit as the means by which double taxation of foreign income earned by US taxpayers is relieved. The foreign tax credit provisions of the US Internal Revenue Code have not been repealed by the *FSC Replacement Act* and still provide the basic approach used by the United States to relieve double taxation with respect to income subject to tax in other countries. If, as the United States allege, the exclusion of “extraterritorial” income is a measure to avoid double taxation, then it cannot, at the same time, be argued that the exclusion constitutes “a defined normative benchmark for taxing income earned on foreign transactions”, since there cannot be two benchmarks. Canada submits that the US taxation of foreign income subject to a foreign tax credit remains the true benchmark despite the enactment of the *FSC Replacement Act*, and that the latter cannot be regarded as a “new” benchmark for the taxation of foreign income in the United States.

foreign sources does not transform the export income into “foreign income” for tax purposes. Exporting goods in a foreign country does not create a sufficient nexus to trigger taxation in the importing country, even when one takes into account the “foreign economic processes” required under the FSC Replacement scheme.²⁰ Canada submits that such processes do not create a taxable presence abroad, and, therefore, would not be considered foreign business income subject to double taxation. Therefore, no double taxation needs to be relieved with respect to this component of “extraterritorial” income.²¹

35. In Canada’s view, since income earned from export transactions cannot by definition face double taxation, the exclusion from taxation provided for this income under the FSC Replacement scheme can only reduce US tax otherwise payable.

36. Canada therefore submits that the revenue or tax that would otherwise be due on “income earned from export transactions”, which is part of the income excluded from taxation under the FSC Replacement scheme, would be the tax applicable to such income under US taxation rules. Thus, the US Government is providing a financial contribution to US-based enterprises earning this type of income by foregoing revenue that would otherwise be due in the sense of Article 1.1(a)(ii) of the *SCM Agreement*.

2. The “Financial Contribution” Confers a “Benefit” to US-based Enterprises Earning “Domestic Income from Export Transactions”

37. The Panel held as follows regarding the issue of “benefit”:

Having found that the various tax exemptions under the FSC scheme give rise to a financial contribution, our next task is to consider whether a benefit is thereby conferred. In our view, the financial contribution clearly confers a benefit, in as much as both the FSCs and their parents need not pay certain taxes that would otherwise be due. Further, that benefit can be quite substantial; according to the US Department of Commerce, “the tax exemption can be as great as 15 to 30 per cent on gross income from exporting.”²²

38. The Appellate Body upheld the Panel’s finding on this issue. Canada submits that this reasoning is equally applicable to the FSC Replacement scheme, as it applies to US-based enterprises by exempting from taxation the domestic income they earn on export transactions.

39. Accordingly, Canada submits that there still exists a “subsidy” within the meaning of Article 1.1 of the *SCM Agreement*, as the two elements of a “subsidy” continue to be present, i.e. a “financial contribution” and a “benefit”.

²⁰ These “foreign economic processes” may consist of one or more of the following five categories: (1) advertising and sales promotion; (2) processing of customer orders and arranging for delivery; (3) transportation outside the United States in connection with delivery to the customer; (4) billing activities; and (5) the assumption of credit risks.

²¹ This is certainly the case under US tax treaties that adopt the approach of the *Model Tax Convention on Income and on Capital* (OECD Committee on Fiscal Affairs, Paris), under which the need for double tax relief with respect to income derived from sales made in a foreign country does not arise unless the sales activities occur through a fixed based that the taxpayer maintains in that foreign country, thereby ruling out the possibility that such relief may be granted to “domestic export income”. Under Article 7 of the OECD Model Tax Convention “a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein.” Article 5 defines a permanent establishment as being “a fixed place of business, through which the business of an enterprise is wholly or partly carried on.” In this definition, “place of business” means facility such as premises or, in certain instances, machinery or equipment.

²² Report of the Panel, *supra*, note 1, para. 7.10.

B. THE SUBSIDY PROVIDED UNDER THE FSC REPLACEMENT SCHEME TO US-BASED ENTERPRISES IS PROHIBITED UNDER ARTICLE 3.1(A) OF THE *SCM AGREEMENT*, AS IT IS “CONTINGENT UPON EXPORT PERFORMANCE”

40. Canada submits that the “subsidy” provided to US-based enterprises is clearly “contingent upon export performance”, as in order to benefit from the “subsidy”, goods must not be sold “for ultimate use in the United States.”²³ Canada agrees with the EC that this is simply “another way of saying that they must be exported”²⁴, and that these words are sufficient to make the subsidy *de jure* export contingent. As stated by the Appellate Body in *Canada – Certain Measures Affecting the Automotive Industry*²⁵:

a subsidy is ... properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfilment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.²⁶

41. In Canada’s view, the fact that the FSC Replacement scheme is available to foreign manufacturers is irrelevant to the determination of whether the “subsidy” provided to US-based enterprises on the income earned from export transactions is contingent on export performance.

42. It is clear that, under the FSC Replacement scheme, a US-based enterprise must export in order to qualify for the exclusion from tax. Whether, in addition to US-based enterprises, a foreign entity may qualify or not for the scheme does not modify the requirement imposed on US-based enterprises and the fact that it explicitly discriminates amongst US-based enterprises on the basis of export performance.

43. As indicated earlier, the FSC Replacement scheme, when applied to income earned from exports of domestic goods of US-based enterprises, results in the permanent reduction of US taxes otherwise payable, in particular as compared to taxes payable on equivalent domestic sales of US-based enterprises. The export-contingent nature of the scheme leaves no doubt that the only way that income derived from the sale of a domestic good can qualify under the scheme is if the good is exported.

44. Canada submits that this export-contingent nature of the scheme cannot be eliminated or otherwise mitigated by the fact that the scheme applies to goods sold by a foreign branch or a foreign corporation subject to US taxation. Discrimination among sales of US domestic goods on the basis of export performance is not ameliorated by the imposition of a similar discrimination with respect to sales of goods by foreign entities. In Canada’s view, the only way that the scheme could be non-export-contingent is if it conferred benefits to the sales of US domestic goods that are not exported. Such is not the case under the FSC Replacement scheme. Canada agrees with the EC that the proper basis of comparison must necessarily be with the tax treatment of domestic sales of domestic goods.²⁷ In Canada’s view, the Reports of the Panel and of the Appellate Body in *Canada – Measures Affecting the Export of Civilian Aircraft*²⁸ provide clear support for Canada and the EC’s position in this case.

²³ *FSC Replacement Act*, section 942(a)(2)(A)(i).

²⁴ First Submission of the European Communities, *supra* note 1, para. 71.

²⁵ WT/DS 139/AB/R, WT/DS 142/AB/R, Report of the Appellate Body adopted 19 June 2000.

²⁶ *Ibid.* para. 100.

²⁷ First Submission of the European Communities, *supra* note 1, para. 71.

²⁸ Report of the Panel, WT/DS70/R, 14 April 1999; Report of the Appellate Body, *supra* note 9.

46. In *Canada – Aircraft*, Canada argued that a “subsidy” provided through Technology Partnerships Canada (TPC) was not contingent upon export performance as TPC provided support to a broad base of sectors and technologies that touched on virtually all industrial sectors of Canada. According to Canada, the fact that some of the contributions provided under the programme were made to companies that were involved in exports did not make the program export contingent. The Panel rejected Canada’s arguments and found that the “subsidy” was contingent upon export performance.

47. Canada appealed the finding of the Panel. One of the issues raised by Canada on appeal was the fact that the Panel had given “no indication that ... the operation of the TPC programme as a whole” had been considered. The Appellate Body rejected this argument and ruled as follows:

the fact that some of the TPC’s contributions, in some industry sectors, are *not* contingent upon export performance, does not necessarily mean that the same is true for all of TPC’s contributions. It is enough to show that one or some of TPC’s contributions do constitute subsidies “contingent ... in fact... upon export performance.”²⁹

48. Canada submits that this reasoning equally applies to the financial contribution or “subsidy” being provided to US-based enterprises on domestic income earned on export transactions. The fact that the exclusion provided to foreign source income may not be contingent on export performance does not mean that the same is true for income earned on export transactions. It is enough to show that part of the contribution under the FSC Replacement scheme is export contingent.

49. Canada therefore submits that the United States continues to provide prohibited export subsidies inconsistent with Article 3.1(a) of the *SCM Agreement*.

VI. CONCLUSION

50. Accordingly, Canada respectfully requests that the Panel find that the United States has not complied with the recommendations and rulings of the DSB and that the United States continues to provide prohibited export subsidies under the FSC Replacement scheme inconsistent with Articles 3.1(a) of the *SCM Agreement*.

²⁹ Report of the Appellate Body, *Ibid.* para. 179.