

***UNITED STATES – TAX TREATMENT FOR
"FOREIGN SALES CORPORATIONS"***

REPORT OF THE PANEL

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I. INTRODUCTION

1.1 On 18 November 1997, the European Communities requested consultations with the United States under Article 4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU"), Article XXIII:1 of GATT 1994, and Article 4 of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement") with respect to "Sections 921-927 of the Internal Revenue Code and related measures establishing special tax treatment for "Foreign Sales Corporations" ("FSCs)".¹

1.2 On 4 March 1998, the European Communities requested the consultations "to be extended also to include consultations under Article 19 of the Agreement on Agriculture" ("AA").²

1.3 The European Communities and the United States held consultations on 17 December 1997, 10 February 1998, and 3 April 1998, but failed to reach a mutually satisfactory solution. On 1 July 1998, the European Communities requested the establishment of a panel under Article 6 of the DSU, Article 4 of the SCM Agreement, Article 19 of the AA, and Article XXIII of GATT 1994.³

1.4 At its meeting on 22 September 1998, the Dispute Settlement Body ("DSB") established a panel in accordance with Article 6 of the DSU with the following standard terms of reference:

"To examine, in the light of the relevant provisions of the covered agreements cited by the European Communities in document WT/DS108/2, the matter referred to the DSB by the European Communities in document WT/DS108/2, and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements."⁴

1.5 Barbados, Canada, and Japan reserved their rights to participate in the panel proceedings as third parties.

1.6 On 9 November 1998, the parties to the dispute agreed on the composition of the Panel as follows:

Chairman: Mr. Crawford Falconer

Members: Mr. Didier Chambovey

Professor Seung Wha Chang

1.7 The Panel met with the parties on 9-10 February 1999 and 16 March 1999. It met with the third parties on 10 February 1999.

II. FACTUAL ASPECTS

2.1 A FSC is a corporation created, organised, and maintained in a qualified foreign country or US possession outside the customs territory of the United States under the specific requirements of Sections 921-927 of the US Internal Revenue Code. A FSC obtains a US tax exemption on a portion of its earnings ("foreign trade income"), which means the gross income of a FSC attributable to "foreign trading gross receipts". Foreign trading gross receipts means the gross receipts of any FSC which are generated by qualifying transactions, which generally involve the sale or lease of "export property". Export property is:

¹ See the European Communities' request for consultations, WT/DS108/1 (28 November 1997).

² WT/DS108/1/Add.1 (12 March 1998).

³ WT/DS108/2 (9 July 1998).

⁴ WT/DS108/3 (11 November 1998).

- property held for sale or lease;
- manufactured, produced, grown, or extracted in the United States;
- by a person other than a FSC;
- sold, leased, or rented for use, consumption, or disposition outside the United States; and
- with no more than 50 per cent of its fair market value attributable to imports.⁵

2.2 A FSC must meet certain requirements of foreign presence.⁶ For example, a FSC must maintain an office outside the customs territory of the United States. That office must be equipped to transact the FSC's business. Also, in order for a FSC, other than a small FSC, to be treated as having foreign trading gross receipts for the taxable year, the management of the corporation during the taxable year must take place outside the United States, and the corporation can have foreign trading gross receipts from any transaction only if economic processes with respect to the transaction take place outside the United States.⁷

2.3 A portion of the "foreign trade income" is deemed to be "foreign source income not effectively connected with a trade or business in the United States" and is therefore not taxed in the United States⁸; this untaxed portion is referred to as the "exempt foreign trade income".⁹ The remaining portion is taxable to the FSC. Dividends paid by the FSC out of exempt and non-exempt income to the shareholder (ordinarily, the "related supplier") generally qualify for a full dividends-received deduction.¹⁰

2.4 Special rules apply for agricultural cooperatives. Under certain circumstances, all of the foreign trade income that a FSC owned by a related qualified cooperative earns from the sale of agricultural or horticultural products will be treated as exempt foreign trade income.¹¹ However, no dividends-received deduction is permitted on a portion of the foreign trade income of a shareholder of an agricultural cooperative.¹²

2.5 With respect to the functions for which the FSC is responsible, in the case of a sale of export property to a FSC by a person described in Section 482 of the IRC (*i. e.*, by a related supplier), income is to be allocated to FSCs under one of three methods. One of these methods uses the prices actually charged between the FSC and the "related supplier" (*i.e.*, the United States parent), subject to the standard United States transfer pricing rules in Section 482 of the Internal Revenue Code.¹³ The other two methods are "administrative pricing" rules, which FSCs and their parents are allowed to apply for the allocation of income between them.¹⁴

⁵ Certain exceptions to this definition of export property may be found in Section 927(a)(2) of the IRC. They are: (a) property leased or rented by a FSC for use by any member of a controlled group of corporations of which such FSC is a member; (b) patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), good will, trademarks, trade brands, franchises, or other like property; (c) oil or gas (or any primary product thereof); (d) products the export of which is prohibited or curtailed to effectuate the policy set forth in paragraph (2)(C) of section 3 of the Export Administration Act of 1979 (relating to the protection of the domestic economy); and (e) any unprocessed timber which is a softwood. For purposes of subparagraph (e), the term "unprocessed timber" means any log, cant, or similar form of timber.

⁶ Section 922(a) of the IRC.

⁷ Section 924(b) of the IRC.

⁸ Such income is generally exempt from tax under section 882 of the Internal Revenue Code, if it is earned by a corporation resident outside the United States.

⁹ See Section 923(a) of the IRC.

¹⁰ Section 926(a) and 245(c) IRC.

¹¹ See Section 923(a)(4) of the IRC.

¹² See Section 245(c)(2)(B) of the IRC.

¹³ Exhibit EC-1.

¹⁴ See Sections 925(a) (1) and (2) of the IRC.

2.6 The first administrative pricing rule apportions 23 per cent of the total combined taxable income (that is, net income earned by the related supplier and the FSC together) derived from the sale of export property by the FSC and the remaining 77 per cent to its related supplier. This rule further provides that 15/23 (approximately 65 per cent) of the FSC's foreign trade income is exempt from US tax.¹⁵ Thus, this rule provides an exemption for 15 per cent (23 per cent x 15/23) of the total combined taxable income earned in the transaction.

2.7 The second administrative pricing rule allows the FSC to take 1.83 per cent of the total foreign trading gross receipts from the sale of export property as foreign trade income, not to exceed twice the amount allocable to the FSC under the combined taxable income method; *i.e.*, 46 per cent of the total combined (net) income earned in FSC transactions.¹⁶ This rule further provides that 15/23 (approximately 65 per cent) of the FSC's foreign trade income is exempt from US tax. Thus, this rule provides an exemption for up to 30 per cent (46% x 15/23) of the total combined taxable income earned in the transaction. This 30 per cent exemption amount is only available, however, in limited circumstances. Because the ceiling for the gross receipts method is linked to the combined taxable (net) income method, it is not mathematically possible to receive the full 30 per cent exemption unless the profit margin on a transaction is 4 per cent or less. At a profit margin of 8 per cent or more, the exemption amount under the gross receipts method will be no more than 15 per cent under any circumstances.

2.8 A FSC must either itself perform or pay for specific economic processes related to the relevant export transaction. By statute, in order to qualify for the partial tax exemption, a FSC that uses administrative pricing rules must perform, contract, or pay for *all* of the distribution activities attributable to the export transaction.¹⁷ These include the solicitation (other than advertising), negotiation, or making of the contract for the relevant FSC export transaction. At least one of these three important activities must be performed outside the United States. Additionally, the FSC must take responsibility for all of the following distribution activities, which must also be performed predominantly outside the United States:

- (a) Advertising and sales promotion;
- (b) Processing of customer orders and arranging for delivery;
- (c) Transportation of goods involved in the transaction to the customer;
- (d) Determination and transmittal of final invoice or statement of account, and receipt of payment; and,
- (e) Assumption of credit risk.¹⁸

III. FINDINGS AND RECOMMENDATIONS REQUESTED BY THE PARTIES

A. FINDINGS OF LAW

3.1 The European Communities requests the Panel to make the following findings of law:

3.2 That, by maintaining the tax exemptions and special administrative pricing rules contained in the FSC scheme, the United States has violated:

- a) Article 3.1(a) of the SCM Agreement by granting subsidies contingent in law upon export performance;

¹⁵ See Sections 923(a)(3) and 291(a)(4) of the IRC.

¹⁶ See Section 925(d) of the IRC.

¹⁷ See Section 925(c) of the IRC.

¹⁸ Section 924(d) and (e) of the IRC.

- b) Article 3.1(b) of the SCM Agreement by granting subsidies contingent in law upon the use of domestic over imported goods; and
- c) Articles 3 and 8 read in conjunction with Articles 9.1(d), 10.1, and 10.3 of the AA by granting export subsidies to agricultural goods in excess of its reduction commitments under that Agreement (e. g. wheat, maize, soya beans, and cotton);
- d) And that, by doing so, it has nullified and impaired benefits accruing to the European Communities under those agreements.

3.3 The **United States** requests the Panel to make the following findings of law:

That neither the FSC tax exemption nor the FSC administrative pricing rules violate:

- a) Article 3.1(a) of the SCM Agreement;
- b) Article 3.1(b) of the SCM Agreement; or
- c) Articles 3 and 8 read in conjunction with Articles 9.1(d), 10.1, and 10.3 of the AA; and
- d) That neither the FSC tax exemption nor the FSC administrative pricing rules nullify or impair benefits accruing to the European Communities under the SCM Agreement or the AA.

B. RECOMMENDATIONS

3.4 In its first oral and second written submissions, the **European Communities** requests the Panel to recommend that the United States withdraw the two FSC subsidies before the beginning of the next tax year (fiscal year 2000).

3.5 The **United States** maintains that it is premature to address questions of implementation, an issue which could be taken up, if necessary, during the interim review process. The United States further maintains that the time-frame suggested by the European Communities is inappropriate and unrealistic.

3.6 In its second oral submission to the Panel, the European Communities requests the Panel to recommend that the United States withdraw the two FSC subsidies by 1 October 1999 in the absence of an appeal and, in any event, before 1 October 2000 (the beginning of its fiscal year 2001).

IV. MAIN ARGUMENTS OF THE PARTIES

A. PRELIMINARY OBJECTIONS

4.1 In its Request for Preliminary Findings, the **United States** requests that the Panel:

- (1) dismiss the European Communities' claims under Article 3 of the SCM Agreement due to the European Communities' failure to include in its request for consultations a statement of available evidence with regard to the existence and nature of the subsidy in question, as it was required to do by Article 4.2 of the SCM Agreement;
- (2) dismiss or defer the European Communities' complaint due to the European Communities' failure to raise transfer pricing concerns regarding the FSC, in the first instance, in an appropriate tax forum, as it was required to do by footnote 59 of the SCM Agreement;

- (3) find that, by failing to identify the agricultural products covered by its claims under the AA, the European Communities' request for the establishment of a panel failed to comply with Article 6.2 of the DSU; and that because of this failure, the European Communities' claims under the AA should be dismissed; and
- (4) find that the measures at issue in this dispute are limited to Section 921-927 of the US Internal Revenue Code (the FSC statute).

The **European Communities** makes the following general comments:

4.2 A number of the objections raised by the United States are matters which the United States ought to have raised before the establishment of the Panel, during the consultations or at the meeting of the DSB at which the request for the establishment of the Panel was considered. It did not do so, and the European Communities was led to believe that the United States had no objections to the information which the European Communities had provided about the nature of its complaint or to the jurisdiction of a panel to hear this case. The United States is in any event estopped from raising these objections now. Raising these issues after the Panel has been established obstructs the efficient conduct of dispute settlement.

4.3 A WTO Member against whom the establishment of a Panel is requested has at least two formal occasions at which to raise objections as to the jurisdiction of a dispute settlement panel and the regularity of the procedure leading up to the establishment of the panel. This is at the meetings of the DSB. Objections raised at this time can and do lead to a withdrawal of the request and a rectification of any defect.

4.4 In the present case, no objections were made at the meetings of the DSB when the establishment of this Panel was discussed. Indeed, at the meeting of the DSB at which this Panel was established, the representative of the United States, after referring to her statement at the previous meeting of the DSB on 23 July 1998, stated that:

“She only wished to state that the European Communities' reinstatement of a matter considered by the United States as resolved was a legally unwarranted and commercially unjustified action which would not prove helpful to the multilateral trading system or to the United States bilateral relationship with the European Communities and its member States. The United States was confident to prevail on the merits of this case and would state its arguments before the panel.”

4.5 The European Communities therefore considers that raising procedural objections to the jurisdiction of the Panel and the regularity of the pre-establishment procedure instead of arguing on the merits is deliberately obstructive of the dispute settlement process and an abuse of procedure. The first, second, and third of the United States requests for preliminary findings should therefore be dismissed already for this reason.

4.6 The European Communities requests the Panel to reject the requests by the United States for “preliminary findings” and other rulings at its first meeting or as soon as possible thereafter.

The **United States** makes the following general comments:

4.7 In the United States' Request for Preliminary Findings and the First US Submission¹⁹, the United States objected to the European Communities' failure to provide a “statement of available evidence with regard to the existence and nature of the subsidy in question” and its failure to identify the agricultural products at issue in its claims under the AA. These failings were in violation of the

¹⁹ Request by the United States for Preliminary Findings (4 December 1998); First Submission of the United States of America (25 January 1999).

requirements of Article 4.2 of the SCM Agreement and Article 6.2 of the DSU.²⁰ In addition, because the European Communities has failed to specify any “related measures”, it necessarily has limited its claims to the FSC statute itself.

4.8 Because of these procedural failings, it was not until the European Communities presented its First Submission to the Panel on 21 December 1998 (“First European Communities Submission”) that the United States first learned the European Communities' theory of its case and its perceptions of the purpose and operational effects of the FSC. That submission revealed for the first time that the European Communities based its claims on a legal premise that the United States finds to be remarkable; namely, that the principle that Members may, but need not, tax income generated from foreign economic activities – a principle originally proposed by European Communities member States and endorsed by the European Communities itself – is not a part of the SCM Agreement or otherwise applicable to this case. The First European Communities Submission revealed that, at the very least, the European Communities and the United States have fundamentally different views of the legal framework within which this dispute should be decided.

4.9 The First European Communities Submission further revealed an European Communities perception of the FSC and of the purpose underlying its enactment that is totally different from that which the Congress of the United States articulated at the time the FSC was adopted. Accordingly, the European Communities has made numerous arguments that, in the view of the United States, are irrelevant in light of the legislative purpose that Congress sought to achieve through the FSC. When combined with entirely different views of key legal provisions – the meaning of the term “arm’s length” in footnote 59, for example – the arguments of the First European Communities Submission and the arguments of the United States in its First Submission do not address common issues.

4.10 Because such fundamental differences were never exposed and addressed during the consultations phase of this case, the real issues before the Panel will be joined, if at all, only very late in the Panel process. Both this rebuttal brief and the European Communities' simultaneous rebuttal brief, rather than engaging one another on the fine points and implications of the opposing parties' main arguments, will in many respects still be attempting to define the basic issues in this case. One resulting risk is that the central issues will not have been explored and tested as fully as they might have been had the true issues been identified earlier in the process.

4.11 More important, perhaps, is that the procedural failings in the early stages of this dispute have effectively foreclosed – as subsequent submissions to this Panel have confirmed – meaningful consultations on the complex issues of this case. Because the fundamental differences in the views of the European Communities and the United States on the controlling legal standard emerged only through submissions to the Panel, it was not possible to engage that issue and explore the implications of the two contrasting views during the consultation process. Similarly, because it was only the European Communities' submission on the merits to this Panel that surfaced what, in the view of the United States, is a fundamental misperception by the European Communities of the purpose and rationale of the FSC, there was no opportunity during the consultation period to engage in a dialogue about those basic, primarily factual, differences.

4.12 The consultation process is an integral part of the WTO dispute settlement process. The requirements that a complaining Member must identify the measures at issue, indicate the legal basis for its complaint, and provide a statement of the available evidence on the nature of any alleged subsidy are all mandatory steps in making a request for consultations, which the complaining Member is required to do. Their obvious purpose is to enable the parties to engage in informed, meaningful consultations. In this case, consultations took place without any statement of available evidence or

²⁰ To clarify matters for the Panel, the United States hereby confirms that, in light of the discussion that took place at the first meeting of the Panel, it has withdrawn its objection concerning the European Communities' failure to identify *non-scheduled* agricultural products. The United States continues to maintain, however, that the European Communities' failure to identify *scheduled* agricultural products in its request for the establishment of a panel violated Article 6.2 of the DSU.

disclosure of the legal basis and factual assumptions that emerged for the first time in the First European Communities Submission. Although a Panel cannot monitor consultations or force them to be substantive, a Panel at least can ensure that the required preconditions to consultations are satisfied.

4.13 These procedural preconditions, and the consultation process for which they are intended to prepare the way, are singularly important in the context of this dispute. This is a particularly complex case. As reflected in the first submissions of the parties and the questioning that took place at the first meeting of the Panel, questions relating to the controlling legal standard are themselves complicated and implicate provisions of the SCM Agreement that have lineages that stretch back decades. The tax provisions of the FSC are also complex, as they must be construed and understood in the context of the tax system of the United States, of the *Tax Legislation Cases* decided by a GATT panel in the 1970s, of the GATT Council Decision of 1981, of the Congressional purpose of implementing and adhering to that Decision, and of provisions of the SCM Agreement that incorporate many years of prior practice. It would be difficult to posit a case in which careful consultations would have been more important.

4.14 The significance of the European Communities' procedural failings is reinforced, finally, by the last procedural requirement that the United States has referenced and that the European Communities has failed to honour. In contrast to the treatment of most other types of disputes, footnote 59 of the SCM Agreement specifically requires that when a Member believes that another Member is acting contrary to the "arm's length" principle of footnote 59, those Members shall attempt to resolve their differences through an alternative forum specialized in the technical aspects of the dispute. The language used in footnote 59 – that Members "shall normally" seek to resolve such differences in an alternative forum – has been construed by a panel in another context to be a mandatory requirement.²¹

4.15 This unusual provision deferring to more specialised facilities and mechanisms – which first appeared in footnote 2 to the Illustrative List attached to the Tokyo Round Subsidies Code and for which there does not appear to be any comparable provision in the realm of the WTO – has direct applicability to the technical dispute before this Panel. Not only are the intricate details of the tax provisions at issue in this case complex, but also the implications that any final Panel decision on the merits may have on the varied tax systems of the WTO's more than 130 Members could be very far-reaching. Issues of such scope deserve the concentrated attention of specialised fora.

4.16 In the context of the procedural issues in this case, the provision of footnote 59 referring Members to alternative fora reinforces the importance of detailed, substantive consultations. If the SCM Agreement goes so far as to urge Members to take such issues to more specialised fora, that provision, even if this Panel were to deem it non-binding, plainly underscores the importance of enforcing the procedural provisions designed to lead to informed, detailed consultations before asking a Panel to decide the matter on its merits.

4.17 For all of these reasons, the United States believes that this Panel should decline to decide the merits of this case at this time. The European Communities' procedural failings here have prevented meaningful consultations. The issues are just now being joined. The factual claims and counter-claims have not yet been explored or reconciled, and the parties have had no meaningful dialogue on the implications of the issues of this case for both worldwide and territorial tax systems. The United States therefore urges, first, that this matter be dismissed in order to allow the Parties to first address the issues raised, as footnote 59 requires, through bilateral or multilateral tax mechanisms and authorities. Alternatively, the United States urges that this case be dismissed in order to assure that

²¹ *United States - Imposition of Anti-Dumping Duties on Imports of Stainless Steel Hollow Products from Sweden*, ADP/47, Report of the Panel issued 20 August 1990 (unadopted), paragraph 5.20, in which the panel, referring to the phrase "shall normally" as used in Article 5.1 of the Tokyo Round Antidumping Code with respect to the "on behalf of" requirement, stated that "[t]he plain language in which this provision is worded, and in particular the use of the word 'shall', indicates that this is an essential procedural requirement for the initiation of the investigation to be consistent with the Agreement."

the merits of this dispute, if not otherwise resolved, come to a WTO panel only after the procedural requirements designed to facilitate meaningful consultations have been satisfied.

1. Statement of available evidence – Article 4.2 of the SCM Agreement

The United States argues as follows:

4.18 In making its request for consultations in this dispute, the European Communities failed to include a “statement of available evidence” as required by Article 4.2 of the SCM Agreement. As a result, the European Communities' claims under Article 3 of the SCM Agreement are not properly before the Panel and should be dismissed.

4.19 The general rules governing requests for dispute settlement consultations are found in Article 4.4 of the DSU, which provides as follows:

"All such requests for consultations shall be notified to the DSB and the relevant Councils and Committees by the Member which requests consultations. Any request for consultations shall be submitted in writing and shall give the reasons for the request, including identification of the measures at issue and an indication of the legal basis for the complaint."

4.20 Thus, under Article 4.4, a valid request for consultations must meet the following requirements:

- (1) The request must be notified to the DSB and the relevant Councils and Committees by the Member requesting consultations.
- (2) The request must be submitted in writing.
- (3) The request must identify the measures at issue.
- (4) The request must identify the legal basis for the complaint.

These four requirements are not at issue here.

4.21 However, Article 4.2 of the SCM Agreement adds a fifth requirement in the case of requests for consultations concerning alleged prohibited subsidies, a requirement that the European Communities did not satisfy. Specifically, Article 4.2 provides as follows: “A request for consultations under paragraph 1 *shall* include a statement of available evidence with regard to the existence and nature of the subsidy in question.” (Emphasis added)

4.22 The European Communities invoked Article 4 of the SCM Agreement as the basis for both its consultations and panel requests with respect to the SCM Agreement. Accordingly, the obligation to include a “statement of available evidence” under Article 4.2 is *mandatory*, as the drafters of the SCM Agreement made clear by using the term “shall”.²² Therefore, by the terms of Article 4.2, any request for consultations under Article 4.1 *must* include a statement of available evidence.

4.23 As noted, the requirement of Article 4.2 to include a statement of available evidence applies to this proceeding. Under Appendix 2 to the DSU, Article 4.2 is identified as a special or additional rule and procedure. As such, under Article 1.2, first sentence, of the DSU, the requirements for consultation requests in Article 4.4 of the DSU “apply subject to” the requirements of Article 4.2 of

²² Such an interpretation accords to Article 4.2 the ordinary meaning of its terms in their context, consistent with the customary principles of treaty interpretation as set forth in Article 31 of the *Vienna Convention on the Law of Treaties*. See, e.g., *Japan – Taxes on Alcoholic Beverages*, WT/DS8/AB/R, Report of the Appellate Body adopted 1 November 1996, p. 11.

the SCM Agreement. Thus, a request for consultations that complies with Article 4.4 of the DSU, but that fails to include a statement of available evidence as required by Article 4.2 of the SCM Agreement, is not a proper request.²³

4.24 In its recent decision in the *Guatemala Cement* case, the Appellate Body interpreted the relationship between the general provisions of the DSU and the “special or additional rules and procedures” listed in Appendix 2. The Appellate Body stated as follows:

"[T]hese special or additional rules and procedures “shall prevail” over the provisions of the DSU “[t]o the extent that there is a *difference* between” the two sets of provisions (emphasis added). Accordingly, if there is no “difference”, then the rules and procedures of the DSU apply *together with* the special or additional provisions of the covered agreement.”²⁴

4.25 Because Article 4.2 of the SCM Agreement adds to and is otherwise consistent with Article 4.4 of the DSU, it must be read together with Article 4.4. Together, these two provisions establish the requirements for consultation requests concerning claims under Article 3 of the SCM Agreement. These requirements are mandatory, and should be enforced in this dispute.

4.26 As is by now well-established, the provisions of the various WTO agreements must be interpreted in accordance with Article 31 of the *Vienna Convention on the Law of Treaties* (“VCLT”), paragraph 1 of which provides as follows: “A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.” An application of Article 31(1) of the *VCLT* to Article 4.2 of the SCM Agreement reveals that the European Communities' request for consultations failed to satisfy the requirements of Article 4.2.

4.27 The ordinary meaning of the term “evidence” is as follows: “Facts or testimony in support of a conclusion, statement or belief.”²⁵ Thus, based on its ordinary meaning, and as applied to this dispute, Article 4.2 required the European Communities to include in its request for consultations a statement of available *facts* from which one could conclude that the FSC provisions constitute a prohibited subsidy. The European Communities was required to do something more than merely assert the ultimate conclusion.

4.28 This result is reinforced by considering the context of Article 4.2, which under Article 31(2) of the *VCLT* includes other provisions of the SCM Agreement.²⁶ Article 11.2 of the SCM Agreement, which deals with the contents of countervailing duty applications, provides as follows:

4.29 "An application under paragraph 1 shall include sufficient evidence of the existence of (a) a subsidy and, if possible, its amount, (b) injury within the meaning of Article VI of GATT 1994 as interpreted by this Agreement, and (c) a causal link between the subsidized imports and the alleged injury. Simple assertion, unsubstantiated by relevant evidence, cannot be considered sufficient to meet the requirements of this paragraph." (Underscoring added)

²³ This conclusion is reinforced by Article 30 of the SCM Agreement, which provides that the provisions of the DSU “shall apply to *consultations* and the settlement of disputes under this Agreement, *except as otherwise specifically provided herein*.” (Emphasis added)

²⁴ *Guatemala - Anti-Dumping Investigation Regarding Portland Cement from Mexico*, WT/DS60/AB/R, Report of the Appellate Body adopted 25 November 1998, paragraph 65 (emphasis in original).

²⁵ *The New Shorter Oxford English Dictionary* (1993).

²⁶ *Brazil - Measures Affecting Desiccated Coconut*, WT/DS22/AB/R, Report of the Appellate Body adopted 20 March 1997, p. 18, in which the Appellate Body interpreted Article 32.3 of the SCM Agreement in conjunction with Articles 10 and 32.1 of that agreement.

4.30 The second sentence of Article 11.2 makes clear that the drafters of the SCM Agreement carefully distinguished between an “assertion” and “evidence.”

4.31 Nothing in the European Communities' initial request for consultations even purports to be a statement of available *evidence*.²⁷ Instead, the pertinent part of the European Communities' request contains simply a conclusory legal assertion, merely citing the provisions of the SCM Agreement on which the European Communities relies. As demonstrated above, *assertions* are not *evidence*. Therefore, the European Communities' request failed to satisfy the requirements of Article 4.2.

4.32 Likewise, the European Communities' second request for consultations with the United States did not contain a statement of available evidence. Rather, this second request merely sought to extend the ongoing consultations to include consultations under Article 19 of the AA.²⁸ This second consultation request did not refer to or modify the European Communities' claims under Article 3 of the SCM Agreement, and, thus, did not cure the defect in the European Communities' initial request for consultations.

4.33 In short, the European Communities' two requests for consultations in this dispute contain no information whatsoever as to the evidence available to the European Communities regarding the existence and nature of the alleged subsidy in question. As such, the European Communities' claims under Article 3 of the SCM Agreement do not conform to the requirements of Article 4.2 of that agreement.

4.34 In view of the mandatory requirement of Article 4.2 of the SCM Agreement, and the European Communities' failure to meet it, the Panel should dismiss the European Communities' prohibited subsidy claims. Any other result would render Article 4.2 ineffective, an outcome that the Appellate Body repeatedly has stated is not acceptable under applicable rules of treaty interpretation.²⁹

4.35 Moreover, the Appellate Body recently clarified in the clearest possible terms that a complainant in a WTO dispute is not free to disregard procedural requirements. In the *Guatemala Cement* case, the Appellate Body threw out an entire dispute that had been fully litigated before a panel because Mexico had failed to specify, as it was required to do by Article 6.2 of the DSU, whether it was challenging Guatemala's preliminary or final anti-dumping determination on cement from Mexico.³⁰ According to the Appellate Body, “the Panel did not consider whether Mexico had properly identified a relevant anti-dumping measure in its panel request and, therefore, it erred in finding that this dispute was properly before it.”³¹

4.36 The clear requirement of Article 4.2, the European Communities' failure to satisfy that requirement, and the Appellate Body's teachings in the *Guatemala Cement* case require the Panel to dismiss the European Communities' claims under Article 3 of the SCM Agreement. The European Communities' consultations request was fatally flawed, and therefore the European Communities' panel request with respect to the SCM Agreement is also fatally flawed.

4.37 The European Communities' failure to include a statement of available evidence has deprived (1) the United States of its *right* to learn of the existence of such evidence in advance of the consultations held in this matter, and (2) the dispute settlement system of the benefits that Article 4.2 was designed to provide. By requiring a complainant to include a statement of available evidence in its request for consultations, Article 4.2 creates conditions that are more favourable to Members reaching a mutually acceptable resolution of a dispute. It does so by allowing for a more thorough

²⁷ WT/DS108/1

²⁸ WT/DS108/1/Add. 1

²⁹ See, e.g., *United States - Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R, Report of the Appellate Body adopted 20 May 1996, p. 23 (“An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility.”).

³⁰ *Guatemala - Anti-Dumping Investigation Regarding Portland Cement from Mexico*, *supra*.

³¹ *Id.*, paragraph 88.

airing of the factual basis on which the complaining party requested consultations and by providing a preview of the evidence the complaining party is likely to rely on if the matter is presented to a panel.

4.38 Article 4.3 of the SCM Agreement makes this point explicitly, stating that “[t]he purpose of the consultations is to clarify the facts of the situation and to arrive at a mutually agreed solution.” This objective of clarifying the facts cannot be fulfilled when, as in this case, the party requesting consultations fails to comply with an express requirement that it state what facts are available to it.

4.39 In light of the European Communities' failure to comply with Article 4.2 of the SCM Agreement, fundamental fairness requires that the European Communities not be given the inappropriate advantage of relying on evidence during the Panel's proceedings that it was required to identify in its consultation request. As the Appellate Body has stated:

4.40 “[A]ll parties engaged in dispute settlement under the DSU must be fully forthcoming from the very beginning both as to the claims involved in a dispute and as to the facts relating to those claims. Claims must be clearly stated. Facts must be disclosed freely. This must be so in consultations as well as in the more formal setting of panel proceedings. In fact, the demands of due process that are implicit in the DSU made this especially necessary during consultations. For the claims that are made and the facts that are established during consultations do much to shape the substance and the scope of subsequent panel proceedings.”³²

4.41 The Appellate Body's reasoning is particularly pertinent to the present dispute. Had the European Communities complied with Article 4.2, the United States would have been afforded a more meaningful opportunity to assess the strength or weakness of the European Communities' allegations, the United States would have had the opportunity to comment on the European Communities' evidence during consultations, and, accordingly, the consultations between the European Communities and the United States might have resulted in a mutually agreeable resolution of the dispute.

4.42 To fail to dismiss the European Communities' claims with respect to the SCM Agreement would, in effect, permit the European Communities (or any other WTO Member) to ignore Article 4.2 with impunity. Article 4.2 would be reduced to redundancy or inutility, an outcome that, as noted above, is contrary to basic principles of public international law.

4.43 Because the European Communities' request for consultations did not contain a statement of available evidence, as required by Article 4.2 of the SCM Agreement, the Panel should dismiss the European Communities' claims under Article 3 of the SCM Agreement.

The European Communities responds as follows:

4.44 The United States does not seem to be arguing that Article 4.2 of the SCM Agreement requires a statement of available evidence in a *separate document*. Nor can it argue that there must be a *separate section* in any request for consultations under Article 4 of the SCM Agreement (or indeed Article 7 of the SCM Agreement, which contains in Article 7.2 a similar provision to Article 4.2) using the words “available evidence”. Nothing in the wording of Article 4.2 of the SCM Agreement requires this. The practice under Article 4.2 of the SCM Agreement, including consultation requests made by the United States, support this. The European Communities refers the Panel to the United States requests for consultations in *Brazil - Certain Measures Affecting Trade And Investment In The Automotive Sector*³³; *Indonesia – Certain Measures Affecting The Automobile Industry*³⁴;

³² *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, Report of the Appellate Body adopted 16 January 1998, paragraph 94.

³³ There were two requests. See documents WT/DS52/1-G/L/99-G/SCM/D5/1-G/TRIMS/D/2 (14 August 1996) and WT/DS65/1-G/L/139-G/SCM/D10/1-G/TRIMS/D/6 (17 January 1997).

³⁴ Document WT/DS59/1-G/L/117-G/TRIMS/D/5-G/SCM/D8/1-IP/D/6 (15 October 1996).

*Australia - Subsidies Provided to Producers and Exporters of Automotive Leather*³⁵; *Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products*³⁶; *European Communities - Measures Affecting the Exportation of Processed Cheese*³⁷; *Belgium - Certain Income Tax Measures Constituting Subsidies*³⁸; *Netherlands - Certain Income Tax Measures Constituting Subsidies*³⁹; *Greece - Certain Income Tax Measures Constituting Subsidies*⁴⁰; *Ireland - Certain Income Tax Measures Constituting Subsidies*⁴¹; *France - Certain Income Tax Measures Constituting Subsidies*.⁴² The only one of these requests which expressly refers to “evidence” is the United States second request for consultations in *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather*⁴³ which, significantly, involves a complex case of *de facto* export subsidy and the evidence provided by the United States related to the export contingency.

4.45 Article 4.2 of the SCM Agreement, just like Article 7.2 of the SCM Agreement in the case of actionable subsidies, is a specific application to the case of subsidies of the general principle set out in the second sentence of Article 4.4 of the DSU that “[a]ny request for consultations shall be submitted in writing and shall give the reasons for the request, including identification of the measures at issue and an indication of the legal basis for the complaint.” The purpose of these provisions is to ensure that the problem that is to be the subject of the consultations is clearly explained. The reason why Article 4.2 of the SCM Agreement (and Article 7.2 of the SCM Agreement) specifically provide for the available evidence to be stated is that in subsidy cases the factual circumstances will often be important for understanding the problem.

4.46 The European Communities did provide a statement of available evidence. We are not concerned in this case with a disguised subsidy arising out complex factual circumstances in a particular sector but with a straightforward subsidy arising out of a generally applicable law. The European Communities referred to the relevant United States legal provisions – Sections 921 to 927 of the IRC. That was the available evidence.

4.47 In contrast to the case of *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather*, referred to above, the FSC scheme is a case where the export contingency derives from the law and therefore no further “evidence” is required than the law itself. The same is also true of the requirement to use domestic over imported goods.

4.48 The United States insists that “evidence” means facts and claims that the European Communities' request contains none. It bases this claim on an obvious error. It refers to the legal claim (the “conclusory legal assertion”) as being the pertinent part of the request for consultations. The facts referred to by the European Communities are stated before the legal claim in the earlier part of the request for consultations.

4.49 The facts of this case are the United States law, and the European Communities' request for consultations did refer to it, as this was the available evidence. The United States must be presumed to know its own law and is presumably not arguing that the European Communities should have set out the text of the law in its request.

4.50 The European Communities' approach in this case of referring to the legal provisions and not setting out the detail in the request for consultations was also followed by the United States in its requests for consultations under Article 4 of the SCM Agreement.

³⁵ There were two requests. See documents WT/DS106/1-G/SCM/D17/1 and WT/DS126/1-G/SCM/D20/1.

³⁶ WT/DS103/1-G/L/192-G/AG/GEN/12-G/SCM/D15/1-G/LIC/D/13 (13 October 1997)

³⁷ WT/DS104/1

³⁸ WT/DS127/1

³⁹ WT/DS128/1

⁴⁰ WT/DS129/1

⁴¹ WT/DS130/1

⁴² WT/DS131/1

⁴³ WT/DS126/1-G/SCM/D20/1

4.51 The United States, ignoring the fact that the European Communities did refer to the available evidence, continues its false reasoning by invoking Article 11.2 of the SCM Agreement. It relies on the distinction made in this provision between “sufficient evidence” and “simple assertion” and suggests that the European Communities has merely stated its conclusion that the FSC scheme is a prohibited export subsidy and not provided evidence.

4.52 This argument is misguided for a number of reasons. The United States attempts to justify reference to Article 11.2 of the SCM Agreement as part of the *context* of Article 4.2 of the SCM Agreement within the meaning of Article 31(2) of the *VCLT*. The European Communities doubts whether Article 11.2 of the SCM Agreement, which occurs in Part V of the Agreement relating to countervailing duty proceedings, can be considered part of the context of Article 4.2, which is in Part II dealing with prohibited subsidies.⁴⁴

4.53 Parts II and V of the SCM Agreement involve very different proceedings and remedies. This is particularly clear in relation to Articles 4.2 and 11.2 of the SCM Agreement. Article 4.2 relates to consultations between States on prohibited subsidies, whereas Article 11.2 deals with the evidence to be produced by complainants to domestic competent authorities in order to justify the opening of a countervailing duty investigation. There is no justification for comparing the requirements for the holding of consultations between WTO Members to the requirements for the initiation of a countervailing duty investigation.

4.54 Article 11.2 requires applicants to provide “sufficient evidence” of a series of facts. The purpose of stating that “simple assertion, unsubstantiated by relevant evidence, cannot be considered sufficient to meet the requirements of this paragraph” is merely to make clear that applicants in countervailing duty cases need to annex documentary proof of their assertions.

4.55 Indeed, the quoted sentence is explaining what is meant by “sufficient” for the purposes of Article 11.2, not what is “evidence”. Article 4.2 does not refer to “sufficient evidence” but to “available evidence”.

4.56 The different contexts of Articles 4 and 11 also make clear that the “statement of available evidence” to be contained in a request for consultations within the meaning of Article 4.2 is referring to a *description of the problem* whereas the “sufficient evidence” to be included in a domestic application to an administrative authority within the meaning of Article 11.2 is referring to *supporting documentation*.

4.57 The practice under Article 4.2, including that of the United States, demonstrates, if anyone should ever doubt this, that WTO Members do not annex *documentary evidence* to their requests for consultations in order to justify their statements.

4.58 Even if (*quod non*), the European Communities had not fully complied with Article 4.2, there would still be no basis for the Panel to accept the United States request to dismiss the claims under Article 3 of the SCM Agreement.

4.59 According to WTO case law, a complainant does not need to establish the adequacy of consultations, only the fact that they have been held or at least requested.⁴⁵ The state of the law was

⁴⁴ See *Oppenheim's International Law* 9th Edition (1996) Volume 1 at page 1273, footnote 12, where it is stated that “the context is the treaty as a whole . . . unless the part of the treaty under consideration is self contained.”

⁴⁵ Reports of panel on *European Communities — Regime For The Importation, Sale, And Distribution Of Bananas*, WT/DS27/ECU, WT/DS27/GTM, WT/DS27/HND, WT/DS27/MEX, 1997, paragraph 7.19.

well expounded by the panel in *Korea - Taxes on Alcoholic Beverages*⁴⁶ where the panel stated at paragraph 10.19 that:

“In our view, the WTO jurisprudence so far has not recognized any concept of “adequacy” of consultations. The only requirement under the DSU is that consultations were in fact held, or were at least requested, and that a period of sixty days has elapsed from the time consultations were requested to the time a request for a panel was made. What takes place in those consultations is not the concern of a panel. The point was put clearly by the Panel in *Bananas III*, where it was stated: Consultations are . . . a matter reserved for the parties. The DSB is not involved; no panel is involved; and the consultations are held in the absence of the Secretariat. While a mutually agreed solution is to be preferred, in some cases it is not possible for parties to agree upon one. In those cases, it is our view that the function of a panel is only to ascertain that the consultations, if required, were in fact held . . .”⁴⁷

We do not wish to imply that we consider consultations unimportant. Quite the contrary, consultations are a critical and integral part of the DSU. But, we have no mandate to investigate the adequacy of the consultation process that took place between the parties and we decline to do so in the present case.”

4.60 This does not render Article 4.2 of the SCM Agreement “ineffective,” as argued by the United States in paragraph 34 of its Request, any more than the above quoted principles established in past DSU cases renders Article 4.5 of the DSU “ineffective”.

4.61 The United States cites the Appellate Body report in the case *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*⁴⁸, in support of its contention that the Article 3 claims should be dismissed because of the alleged defect in the request for consultations. It is true that the Appellate Body stressed the importance of openness during both the panel and consultation phases, and the European Communities entirely shares these sentiments. But *India - Patent Protection* does not support the United States position in this case – quite the reverse. In that case, the Appellate Body did not consider that the failure of India to disclose all relevant facts (the existence of an administrative procedure) could have any consequences for the panel process, even though it had prevented the United States from making a claim it otherwise would have made.

4.62 In any event, the fact that such provisions cannot be relied on as a defence to a WTO violation in panel proceedings does not reduce them to “redundancy and inutility” as the United States argues in paragraphs 34 and 41 of its Request. The procedural rules referred to here are intended to have their effectiveness during the consultation phase. It is clear from the cases referred to above that the only matter relating to the conduct of consultations that may be verified by a panel is “that consultations were in fact held, or were at least requested, and that a period of sixty days has elapsed from the time consultations were requested to the time a request for a panel was made” and that a panel has “no mandate to investigate the adequacy of the consultation process that took place between the parties.”⁴⁹

4.63 Article 4.2 of the SCM Agreement, like Article 4 of the DSU, applies to and has legal effects in the consultation phase, not the panel phase. The United States’ remedy, if it felt that the European Communities had not presented the available evidence, would have been to request further information and possibly to have declined to engage in consultations until the European Communities had done so. The United States did not ask for any further information, unsurprisingly since it was

⁴⁶ Reports WT/DS75/R and WT/DS84/R (31 July 1998) upheld on appeal WT/DS75/AB/R and WT/DS84/AB/R (18 January 1999).

⁴⁷ The panel’s footnote (343) refers to paragraph 7.19 of the *Bananas III* panel report.

⁴⁸ *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, Report of the Appellate Body adopted 16 January 1998. The United States quoted paragraph 94.

⁴⁹ See paragraph 7.19 of the Report in *Korea - Taxes on Alcoholic Beverages* quoted above.

fully aware of the FSC scheme. On the contrary, the United States accepted the consultations and did not even ask for any further particulars. The United States also did not contest the adequacy of the consultations before the DSB. It cannot therefore in any event do so now.

4.64 The principle that panels should not be concerned with the adequacy of consultations discussed above also disposes of the United States argument based on the recent report of the Appellate Body in the *Guatemala Cement* case⁵⁰ in support of its contention that the European Communities' claims under Article 3 of the SCM Agreement should be dismissed.

4.65 The Appellate Body came to the conclusion it did in that case because Mexico had failed to specify, *in its request of the establishment of a panel*, the measure that it was challenging, as it was required to do by Article 6.2 of the DSU. The United States Request for dismissal of the European Communities' claims under Article 3 of the SCM Agreement is based on an alleged defect in the request for consultations, not in the request for a panel.

4.66 The United States argues that the alleged defect in the consultation request has deprived it of its right to learn of the existence of evidence against it and undermines the dispute settlement system. This is an entirely unmeritorious claim. First, as explained above, the request for consultations did contain the available evidence and the United States never complained during the consultations that it did not. Secondly, the United States was well aware of the features of the FSC scheme, indeed was better aware than the European Communities. Thirdly, the European Communities held three rounds of consultations with the United States on the FSC. The United States had ample opportunity to ask questions and did ask questions about the legal and economic basis of the European Communities' case and its political wisdom (which the European Communities answered) but did not ask for further evidence about the existence and nature of its own FSC scheme. The United States has absolutely no basis for claiming that it has been deprived of its right to learn of the existence of evidence against it or that the dispute settlement system has been undermined.

4.67 The European Communities has shown above that it did refer to the available evidence in its request for consultations and that in any event the United States is misguided in its view that the remedy for an alleged failure on the part of the European Communities to do so is the dismissal of the European Communities' claims under Article 3 of the SCM Agreement.

4.68 The European Communities therefore asks the Panel to dismiss the claim.

The **United States** rebuts the European Communities' response as follows:

4.69 The First European Communities Submission includes eighteen exhibits. Excluding certain exhibits that relate solely to the procedural history of this dispute (EC-13-15) and one exhibit that relates to the European Communities' claims under the AA (EC-16), the remainder of the exhibits are offered as evidence in support of the European Communities' claims that the FSC constitutes a prohibited subsidy under the SCM Agreement. With only a few exceptions, these exhibits predate the European Communities' 18 November 1997 request for consultations, in some cases by more than a decade.⁵¹ Therefore, these documents clearly were available to the European Communities long before it requested consultations. However, these documents are not mentioned, or even alluded to, in the European Communities' request for consultations. As stated in the United States' Request for Preliminary Findings, there is nothing in the European Communities' request for consultations that can be construed as a statement of available evidence.

4.70 Moreover, while these exhibits do not lend factual support relevant to the controlling legal standard *i.e.*, whether the FSC results in domestic-source income, as opposed to foreign-source

⁵⁰ *Guatemala - Anti-Dumping Investigation Regarding Portland Cement from Mexico*, WT/DS60/AB/R, Report of the Appellate Body adopted 25 November 1998, paragraph 65 (emphasis in original).

⁵¹ For example, the document contained in Exhibit EC-6 was published in 1985.

income, being exempted from taxation to a "significant" extent – it is clear that, from the European Communities' perspective, these materials are central to the case it seeks to make. As but one example, the First EC Submission, which contains the European Communities' factual arguments on transfer pricing, dwells at length on the OECD Guidelines. However, the European Communities' request for consultations does not even allude to the OECD Guidelines, which were published in 1995.

4.71 The European Communities does not dispute the applicability of Article 4.2, but instead argues that its identification of the challenged measures is, in and of itself, a statement of available evidence. This position is untenable. By listing Section 921 to 927 of the US Internal Revenue Code, the European Communities may have complied with the general rule governing requests for consultations, Article 4.4 of the DSU, which requires "identification of the measures at issue." Article 4.2 of the SCM Agreement, however, requires more. It imposes an additional obligation to provide a statement of available evidence. To equate the two rules would ignore the obvious differences in their language. It also would be inconsistent with the *Guatemala Cement* case, in which the Appellate Body ruled that a special or additional rule, such as Article 4.2, and a general rule, such as Article 4.4, must be applied in a complementary manner, and that a complainant must comply with both rules.

4.72 The examples cited in Exhibit EC-19 do not support the European Communities' position. The European Communities ignores the fact that in the five consultation requests by the United States involving European tax subsidies – WT/DS127 through WT/DS131 – each consultation request separately identified the measure and then separately identified the information on which the United States was relying; namely, unofficial translations of the measures in question and secondary sources describing the measures. There is no such separate identification of the measure and the evidence in the European Communities' request for consultations concerning the FSC.

4.73 In addition, even assuming that the European Communities' characterization of these examples is accurate, they do not constitute a "subsequent practice" within the meaning of Article 31(3)(b) of the *Vienna Convention on the Law of Treaties* that would allow the Panel to ignore the plain language of Article 4.2 requiring that a request for consultations include a statement of available evidence.

4.74 In its 25 January submission, the European Communities also engages in a discussion of Article 11.2 of the SCM Agreement that leads it to the conclusion that Article 4.2 does not require Members to annex documentary evidence to their requests for consultations. This discussion is both irrelevant and inaccurate. It is irrelevant because the United States has not argued that the European Communities was required to annex documentary evidence to its consultation request – Article 4.2 simply requires a "statement" of the available evidence. Instead, what the United States did argue in its submission of 4 December 1998 is that the ordinary meaning of the term "evidence" – which the European Communities has not contested – is "facts or testimony in support of a conclusion, statement or belief", and that the assertion of a conclusion – which is all that the European Communities consultation request contained – cannot constitute a "statement of available evidence" within the meaning of Article 4.2. The United States then cited Article 11.2 merely as contextual support for the ordinary meaning of the term "evidence" and for the simple proposition that the drafters of the SCM Agreement understood the difference between an "assertion" and "evidence".

4.75 The European Communities' discussion of Article 11.2 is, moreover, inaccurate because the European Communities asserts that Article 11.2 does not form part of the context of Article 4.2. This position is at odds with numerous panel and Appellate Body reports, such as the *Reformulated Gasoline* case, in which the Appellate Body, at page 18, stated that the context of GATT Article XX(g) included all of GATT 1994. In addition, the European Communities offers no support for its suggestion that either Part II or Part V of the SCM Agreement is "self-contained". Indeed, footnote 35 of the SCM Agreement demonstrates the inter-relationship between the various parts of the agreement.

4.76 Stripped of its irrelevancies and inaccuracies, the European Communities' argument amounts to nothing more than an assertion that because it identified the FSC statute and referred to unidentified "related measures" as the challenged measures, as it was required to do by DSU Article 4.4, the United States should have known that this identification also constituted the requisite "statement of available evidence" under Article 4.2 of the SCM Agreement. Essentially, the European Communities is asserting that the United States should have known that a reference to the FSC statute as the challenged measure constituted the European Communities' statement of available evidence, because the United States should have agreed with the European Communities that the FSC statute is, on its face, a prohibited subsidy. Obviously, an interpretation of Article 4.2 that requires a responding Member to accept the complainant's characterization of the challenged measure as a prohibited subsidy cannot be correct.

4.77 In the view of the United States, all of this is nothing more than an *ex post facto* argument designed to conceal the fact the European Communities simply ignored Article 4.2. If the "available evidence" truly was limited to the FSC statute, then the European Communities could have made a "statement" to that effect. The European Communities did not do so, and now argues essentially that the United States should have known that the European Communities was relying solely on the FSC statute as its evidence. However, Article 4.2 required that the European Communities make a statement, and that it make that statement in a sufficiently clear manner so that United States did not have to guess at the evidence on which the European Communities was relying. In addition, the European Communities' arguments never address the question of what constituted the statement of available evidence with respect to the as yet unidentified "related measures".

4.78 Moreover, the First EC Submission makes it abundantly clear that the evidence available to the European Communities consisted of much more than the FSC statute. The European Communities would have this Panel believe for example, that the European Communities did not discover the OECD Transfer Pricing Guidelines, on which it relies extensively, until *after* it submitted its request for consultations.

4.79 Although claiming that it acted in conformity with Article 4.2, the European Communities goes on to argue – remarkably – that its transgression should be excused because the United States did not bring the European Communities' failure to comply with its obligations to its attention during consultations. Nowhere in the DSU or the SCM Agreement is it required that a responding party must identify for the complaining party the procedures with which it must comply. Instead, each party is responsible for meeting its own obligations, especially when they are plainly established in the text of the relevant WTO Agreement.

4.80 The European Communities also argues that the Panel should not be concerned if the European Communities failed to comply with a mandatory rule pertaining to requests for consultations, because panels should not be concerned with the adequacy of consultations. Whatever may be the merits of this contention, it is irrelevant to the issue before this Panel. The United States is not asking this Panel to examine what transpired *during* the consultations – although the European Communities spends a good deal of time talking about that very topic. Instead, the United States is asking the Panel to examine what transpired *before* the consultations; namely, the compliance of the European Communities' request for consultations with Article 4.2 of the SCM Agreement. None of the factors invoked by the panel in the *Korea Liquor* case, such as the absence during consultations of the DSB, the panel, and the Secretariat, applies to the examination of a document. Moreover, even the *Korea Liquor* panel, on which the European Communities relies, acknowledged that it could consider whether consultations were requested. If a panel can consider whether consultations were requested, it should be able to consider whether consultations were *properly* requested.

4.81 In this regard, the United States cannot resist pointing out the inconsistency in the European Communities' arguments. For example, the European Communities' 25 January submission is rife with statements to the effect that the consultations served as an adequate substitute for the statement of available evidence missing from the European Communities' consultation request.

However, in the very same submission, the European Communities tells the Panel that it cannot concern itself with what transpired at consultations.

4.82 Finally, the European Communities asserts that Article 4.2 cannot be enforced by dispute settlement panels. Instead, the European Communities argues that Article 4.2 is either self-enforcing or not enforceable at all. According to the European Communities, a recipient of a defective request for consultations must insist on being provided with a statement of available evidence or refuse to participate in consultations. Not only does this argument improperly shift the burden of ensuring that a complaining party meet its WTO procedural obligations to the responding party, but it also ignores the fact that refusing to participate in consultations is unlikely to induce the complaining party to identify its evidence. Instead, the failure of a responding party to participate in consultations simply permits the complaining party to immediately request the establishment of a panel, as expressly provided in Article 4.3 of the DSU. And, according to the European Communities, once a panel is established, the panel is powerless to address the complainant's failure to comply with Article 4.2.

4.83 In the view of the United States, the same logic that requires panels to scrutinize panel requests dictates panel scrutiny of consultation requests. Because of the "reverse consensus" rule in the WTO dispute settlement system, panels are established automatically regardless of whether a complainant has complied with WTO procedures in the process leading up to panel establishment. This led the Appellate Body in the *Bananas* case, at paragraph 142, to conclude that "it is incumbent upon a panel to examine the request for the establishment of the panel very carefully to ensure its compliance with both the letter and the spirit of Article 6.2 of the DSU". The same logic equally requires panel scrutiny of consultation requests.

4.84 Indeed, if one carries the European Communities' logic to its extreme, a complainant could make an oral request for consultations that does not identify a measure or an agreement (e.g., "I want to consult with you"), and there is nothing that either the responding Member or a panel can do about it. The responding Member can refuse to consult, but this simply gives the complainant the option of having a panel established sooner rather than later. Once the panel is established, there is nothing, according to the European Communities, that the panel can do about the deficient consultation request.

4.85 The United States submits that there is nothing in either the DSU or the SCM Agreement that requires such a result. In the context of this case, the European Communities' request for consultations failed to comply with Article 4.2 of the SCM Agreement, and this Panel has the authority to address that failure by dismissing the European Communities' claims under Article 3 of the SCM Agreement.

The **European Communities** further responds as follows:

4.86 The United States attempts to substantiate its claim that the European Communities did not make a sufficient statement of available evidence in its request for consultations by referring in its First Written Submission to the fact that most of the exhibits to the European Communities' First Written Submission pre-date that the request for consultations of 18 November 1997. Apart from the basic legal provisions, which the European Communities did refer to in its request for consultations, the documents annexed to the European Communities' First Written Submission were gathered after the request for consultations was made. Indeed many of them were provided to the European Communities by the United States during the consultations. If anything, this confirms the European Communities' position. The European Communities cannot have been expected to refer to documents it did not have!

4.87 The European Communities was aware of the existence of the OECD pricing guidelines when it made its request for consultations but did not and does not consider them to be "evidence". The fact that the FSC scheme provides for the use of special administrative pricing rules is evident from the law itself. The OECD guidelines are in the nature of a supporting argument; the European Communities' case that the FSC scheme gives rise to two subsidies is valid even if the

OECD guidelines did not exist. In any event, as a public document well known to the United States, its existence and content does not need to be proved.

The **United States** further rebuts the European Communities response in its Oral Statement at the First Meeting of the Panel as follows:

4.88 While it is not necessary to look behind the text of the procedural provisions we have been discussing where, as here, they impose clear requirements, it is important to remember that procedural requirements exist for a reason. In the case of Article 4.2 of the SCM Agreement, the inclusion by the drafters of the requirement to include a statement of available evidence undoubtedly was designed to render consultations more meaningful than might otherwise be the case. The European Communities' failure to comply with Article 4.2 is particularly troubling in light of the highly technical and complex issues that have been raised. Had the European Communities been more forthcoming with the evidence on which it was relying, perhaps this panel proceeding could have been avoided.

2. Appropriate tax forum – Footnote 59 of the SCM Agreement

The **United States** argues as follows:

4.89 The provisions of the SCM Agreement relating to exemptions of direct taxes expressly direct WTO Members to resolve certain issues raised by such exemptions in an appropriate tax policy forum, not the WTO. The explicitness of this unusual language suggests that the preference for a non-WTO forum reflects important institutional considerations and that until such preferred alternative mechanisms are exhausted, the text implies, WTO dispute settlement should be avoided.

4.90 The European Communities' allegations in this case relate directly to the provisions on exemptions of direct taxes. Specifically, the European Communities has alleged that the FSC regime provides a subsidy that is prohibited by Article 3.1(a) of the SCM Agreement.⁵² Article 3.1(a), in turn, references the Illustrative List of Export Subsidies contained in Annex I to the Agreement. The paragraph of the Illustrative List that corresponds to the European Communities' claim is paragraph (e), which states that the "full or partial exemption, remission, or deferral specifically related to exports, of direct taxes" is a probable export subsidy for purposes of the SCM Agreement. Subsection (e) is both qualified and further explained in footnote 59 of the Agreement.

4.91 Footnote 59, which deals with exemptions of direct taxes, clearly indicates the intent of WTO Members that certain disputes over direct taxes in export transactions should not be resolved before the WTO in the first instance, but instead should be resolved through mechanisms specific to the tax area. The footnote provides that "[a]ny Member may draw the attention of another Member to administrative or other practices which contravene [the] principle [of arm's length pricing] and which result in a significant saving of direct taxes in export transactions." However, the text further provides that:

"[I]n such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994 . . ." (emphasis added).

4.92 This language is not an expression of concurrent jurisdiction. The language directing complainants to alternative channels is mandatory – "Members shall normally attempt to resolve their differences . . ." (emphasis added). Although the "without prejudice" language makes clear that a Member does not sacrifice its WTO rights by referring the matter to an alternative forum, it also makes clear that WTO Members should exhaust alternative available tax fora before attempting to resolve the issue through the WTO dispute settlement process.

⁵² WT/DS108/2

4.93 The forum preference, or exhaustion, language is grounded in sound policy considerations and reflects the risks of attempting to treat issues of fundamental tax policy as trade issues. As recognised in the 1981 Council Decision, WTO rules are not intended to mandate one particular tax system over another or to penalise countries for choosing one tax system over another. Footnote 59 acknowledges that when disagreements over technical transfer pricing practices or fundamental tax policy do arise, recognised bilateral channels for resolving tax issues or international entities that deal with tax policy issues are better equipped alternatives than the WTO.⁵³

4.94 Indeed, the likely purpose of footnote 59 was in part to avoid a repeat of the complications and controversies that arose from the GATT's last foray into the field of basic tax policy – the cases against the DISC and the territorial tax regimes of three members of the European Communities. The reasoning and the results of those cases were strongly criticized by both the United States and the European Communities. The disagreements were ultimately resolved, and the panel decisions adopted, only by the negotiation of a special “understanding” that in 1981 was adopted by the Contracting Parties and incorporated into a GATT Council Decision. That Council Decision articulates the principles that continue to govern similar disputes today.

4.95 In this case, the European Communities has failed to avail itself of the “facilities of bilateral tax treaties or other specific international mechanisms” to address its concerns over the FSC. First, the European Communities has failed to raise the FSC issues about which it now complains in the international forum that is now immersed in those issues. The Organization for Economic Cooperation and Development (“OECD”) has been the international forum primarily responsible for addressing international tax issues since its formation in 1961. A host of such issues is currently before the OECD.⁵⁴ These active OECD projects confirm that the OECD is the appropriate international mechanism for addressing issues such as the ones that the European Communities seeks to raise in this case.

4.96 All of the European Communities Member States are members of the OECD.⁵⁵ Moreover, an OECD Protocol specifically provides for European Communities participation in OECD activities.⁵⁶ Notwithstanding the availability of this obviously appropriate “international mechanism,” the European Communities has failed to avail itself of this forum.

4.97 Nor have European Communities Members States invoked the bilateral tax treaty competent authority process through which tax disputes are routinely addressed. “Competent authority” is a term defined under bilateral income tax treaties. Under tax treaties, the term refers to the official representatives of national tax administrations that communicate with each other on a regular, bilateral basis in order to resolve disputes, including those relating to proper treatment where two countries assert jurisdiction over the taxation of a specific taxpayer's income and to extend mutual administrative assistance in tax matters, including the exchange of information. Competent authority is often invoked when resolving issues raised under bilateral tax treaties and is often called upon to assist in resolving cross-border transfer pricing issues.

⁵³ Similarly, in another paragraph of footnote 59, Members disavow any intention to regulate tax policies designed to ameliorate double taxation by more than one taxing authority: “[P]aragraph (e) [of the Annex I list of 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.”

⁵⁴ In particular, the OECD is deeply involved in transfer pricing. For example, the OECD issued comprehensively updated transfer pricing guidelines in July 1995, and remains the international entity most involved with respect to this issue. See US Exhibit 2 (table of contents of OECD Transfer Pricing Guidelines). Other examples of the OECD's areas of competence include Tax Avoidance and Evasion, Harmful Tax Competition, Double Taxation, Taxation of Electronic Commerce, Taxation of Financial Instruments and Global Trading, and Consumption Taxes.

⁵⁵ Attached as US Exhibit 3 is a list, found on the OECD's Web Page, of OECD members.

⁵⁶ Attached as US Exhibit 4 is a copy, found on the OECD's Web Page, of the OECD Convention and the relevant Protocol.

4.98 Until the European Communities has exhausted the alternative channels to which footnote 59 expressly refers, it has failed to comply with the very provision that it likely will now seek to invoke. Under these circumstances, the panel should dismiss or defer the European Communities' complaint until such time as the European Communities has "attempt[ed] to resolve" the issues it raises through "the facilities of existing bilateral tax treaties or other specific international mechanisms."

The **European Communities** responds as follows:

4.99 The second United States request for a preliminary finding is broader than the first. It asks the Panel to find on the basis of hortatory wording in a footnote to the Illustrative List to the SCM Agreement that the European Communities is "precluded from invoking WTO dispute settlement procedures with the respect to the FSC" until it has exhausted alleged alternative channels for the resolution of tax disputes⁵⁷, whereas the first claim only requested the dismissal of the claims under Article 3 of the SCM Agreement.

4.100 The United States is in fact attempting to impose a requirement on the European Communities to address its complaint about the export subsidies arising out of the FSC scheme to a tax forum. For the European Communities it is clear that the present dispute is about a prohibited export subsidy and is not a tax dispute.

4.101 Footnote 59 is attached to Item (e) of the Illustrative List of Export Subsidies in Annex I to the SCM Agreement. It states in relevant part that:

"The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence."

4.102 The first point to note about this text is that it is deliberately couched in non-obligatory language. It allows a Member to "draw the attention" of another Member to transfer pricing practices of enterprises and then provides that Members shall "normally attempt to resolve their differences" using tax mechanisms. This is however expressly "without prejudice to the rights and obligations under GATT 1994".

4.103 The European Communities does not agree with view expressed in paragraph 48 of the United States Request that:

"the likely purpose of footnote 59 was in part to avoid a repeat of the complications and controversies that arose from the GATT's last foray into the field of basic tax policy – the cases against the DISC and the territorial tax regimes of three members of the European Communities."

4.104 On the contrary, it is necessary not to lose sight of the fact that footnote 59 is a comment on Item (e) of the Illustrative list, the purpose of which is to make quite clear that exemptions from direct taxes do constitute subsidies, at least when "specifically related to exports" and are therefore covered by GATT/WTO disciplines.

⁵⁷ Paragraphs 53 and 54 of the US Request.

4.105 The European Communities takes the part of footnote 59 quoted above to be a reminder to Members of the existence of tax mechanisms which may provide a better forum for resolving difficulties resulting from arm's length pricing disputes than WTO dispute settlement. However it is left to the discretion of the Member concerned whether to do so. This intention is clearly expressed through the use of the word "normally" and the express statement that the reference to tax mechanisms is "without prejudice to the rights and obligations of Members".

4.106 As mentioned above, the European Communities is complaining about the FSC scheme because it results in export subsidies, not as an aberrant tax practice. It is not complaining that the right of European Communities Member States to tax is being impaired or that the income of European Communities persons is being doubly or unfairly taxed. It is rather complaining that the United States is *exempting* income from the export of United States goods from tax that it would normally collect. The European Communities is also complaining that the availability of special administrative pricing rules for the FSCs compounds the export subsidy and, since it is only available on the export of United States goods, can also be considered an export subsidy. However the European Communities is not complaining about availability of special administrative pricing rules *as such*, only their effect as an export subsidy. That is why the European Communities brings its complaint to this Panel and not to a tax forum. A tax forum might be more appropriate if the United States were to apply the special administrative pricing rules of the FSC scheme to all transactions between related enterprises, including domestic and import transactions, and not just to transactions involving the export of United States goods. However that is not the case. Since the European Communities is complaining about an export subsidy, the WTO is the appropriate forum.

4.107 Not only is the WTO the appropriate forum for export subsidy complaints, it is also clear that the alternatives mentioned by the United States would not be appropriate. The United States mentions first the OECD and then the bilateral tax treaties and the European Communities will follow the same order.

4.108 The United States describes the OECD as "the international forum that is now immersed in [tax] issues" and "the international forum primarily responsible for addressing international tax issues since its formation in 1961." It refers in a footnote to the OECD's involvement in Transfer Pricing, Tax Avoidance and Evasion, Harmful Tax Competition, Double Taxation, Taxation of Electronic Commerce, Taxation of Financial Instruments and Global Trading, and Consumption Taxes.

4.109 The European Communities does not disagree with the United States statements quoted in the last paragraph. The European Communities does not agree however that the OECD is the appropriate forum to deal with a complaint about an export subsidy that is prohibited by the SCM Agreement. The persons participating in the various groups and committees mentioned by the United States are tax experts and their knowledge and abilities, great as they may be, are not suited to examining export subsidies, still less whether there is a violation of a WTO Agreement. They would also no doubt be the first to recognise that this would not be an appropriate task for them to undertake. The same can be said for the OECD itself.

4.110 The United States claims that the other facility to which the European Communities or its Member States should have had recourse is the "bilateral tax treaty competent authority process."⁵⁸ It is misleading to suggest that this procedure is applicable for a number of reasons. The European Communities will explain its position by referring to the OECD Model Tax Convention, on which most bilateral tax treaties are based and which is annexed as Exhibit EC-20.

4.111 First, bilateral tax treaties only apply to the residents of the contracting parties. This is made clear in Article 1 of the OECD Model Tax Convention. The European Communities assumes that the United States does not consider FSCs to be resident in the United States. Accordingly, the bilateral tax treaties between the United States and European Communities Member States are simply not applicable to FSCs except in the rare cases (if any exist) where an FSC may be resident in the relevant

⁵⁸ Paragraph 51 of the US Request for Preliminary Rulings.

Member State. Indeed it would surely be unacceptable for an European Communities Member State to seek to regulate with its bilateral tax treaty with the United States the bilateral tax relationship between the United States and an FSC haven such as Barbados.

4.112 Second, that the purpose of bilateral tax treaties is to avoid double taxation and to protect the tax base of the parties by preventing tax evasion. They do not provide a basis for one country to object to the tax practices of another when there is no issue of double taxation or loss of tax revenue for that country.

4.113 Third, that, in any event, the purpose of what the United States refers to as the “competent authority process” under a tax treaty is to resolve specific cases of application of the treaty. The process is set out in Article 25 of the OECD Model Tax Convention where it is called the “mutual agreement procedure”. It is immediately apparent from paragraph 1 of this provision that the procedure is set in motion at the request of an individual taxpayer who “considers that the actions of one or both of the Contracting States result or will result for him in taxation which is not in accordance with the provisions of” the convention. In other words, the purpose is to resolve specific disputes with taxpayers. Competent authorities are also mentioned elsewhere, e.g. in Article 26 of the Model Convention on exchange of information, but nowhere are they given authority to deal with a dispute such as the present. The competent authorities would not therefore be the appropriate forum for attempting to resolve a difference of views concerning the FSC scheme, even if one were to consider that the FSC scheme comes at all within the scope of the bilateral tax treaties between the United States and the Member States of the European Communities.

4.114 The United States refers to an alleged requirement for the European Communities to exhaust alternative “channels” available to it before resorting to dispute settlement. The use of the vague term “channels” masks an important feature of the relevant sentence of footnote 59, which directs Members to “normally attempt to *resolve their differences* using the *facilities* of existing bilateral tax treaties or other specific international *mechanisms*.”

4.115 Even if the OECD and bilateral tax treaties may provide an opportunity to *discuss* issues such as the FSC if all participants agree (and it is not clear that the United States would agree), this cannot be considered a “facility” or a “mechanism” for “resolving differences”. The language used in footnote 59 refers to something more than an opportunity to discuss. It was probably intended to refer some kind of dispute resolution mechanism⁵⁹. For a “mechanism” or a “facility” to exist there must at the very least be a legal basis for the matter to be raised and resolved.

4.116 If, contrary to what is submitted above, the terms “facilities” and “mechanisms” in footnote 59 should be taken to include a simple opportunity to discuss problems, the European Communities would also mention that its Member States did attempt, unsuccessfully, to discuss FSCs with the United States from a tax point of view. This is described at paragraph 113 of the European Communities' First Written Submission, where it is also explained that the discussions terminated with the failure of the United States to respond to a detailed note submitted to it. If exhaustion of an opportunity to discuss is required to bring dispute settlement proceedings under the SCM Agreement, then the condition is in any event satisfied.

4.117 If the fourth sentence from footnote 59 to the SCM Agreement did constitute a requirement to “exhaust alternative available tax fora before attempting to resolve the issue through the WTO dispute settlement process” as claimed by the United States in paragraph 46 of its Request, it would have been mentioned in Appendix 2 to the DSU. It is however conspicuous by its absence from Appendix 2. By contrast, footnote 35 to the SCM Agreement, which regulates the parallel application of countervailing duty action and dispute settlement, is referred to in Appendix 2 to the DSU. This

⁵⁹ Such a mechanism does exist between EC Member States in the form of a Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises published in the Official Journal of the European Communities OJ L 225 of 20 August 1990 at page 10.

demonstrates that footnote 59 to the SCM Agreement was not intended to constitute a special rule applicable in the conduct of dispute settlement.

4.118 Even if (*quod non*) there were some basis for the United States jurisdictional argument based on footnote 59 that the European Communities is “precluded” from pursuing dispute settlement until it had exhausted alleged “alternative channels,” this would apply as much to consultations as to the panel procedure. Therefore the United States should have raised it during consultation phase. It did not and so should not in any event be allowed to do so now.

4.119 For the sake of good order, the European Communities finally draws the attention of the Panel to the fact that footnote 59 only relates Item (e) of the Illustrative List and is not therefore relevant for any of the other provisions invoked by the European Communities and in particular not for the first part of Article 3.1(a) of the SCM Agreement, Article 3.1(b) of the SCM Agreement, and the AA.

4.120 In addition, an argument based on the above quoted part of footnote 59 to Item (e) relates only to the issue of transfer pricing. It can therefore only be relevant for what the European Communities terms in its first written submission the “special administrative pricing rule subsidy” and not the “tax exemption” subsidy.

4.121 For the above reasons, the United States request that the Panel find that the European Communities is precluded from invoking dispute settlement until it has exhausted its alleged “alternative channels” is unfounded and should be rejected.

The **United States** rebuts the European Communities' response as follows:

4.122 The First EC Submission is incorrect in implying that the European Communities has satisfied the procedural requirements of footnote 59 of the SCM Agreement. The European Communities alleges that, beginning in January 1997, “formal contact” was made with US authorities. The European Communities never raised the matter at all. Instead, officials of three European Communities member States and officials of the US Department of the Treasury met in Washington. Thereafter, officials of four EC member States and Treasury officials met on the margins of meetings of the OECD Committee on Fiscal Affairs. At these meetings, it was agreed by all participants that the meetings were not held pursuant to any treaty or other international agreement, nor were they in any way a formal or informal consultation concerning the matters discussed. At no time has the European Communities or an European Communities member State formally invoked the “facilities of existing bilateral tax treaties or other specific international mechanisms” within the meaning of footnote 59 of the SCM Agreement. For example, at no time has the European Communities or any European Communities member State referred its concerns regarding the FSC to the OECD.

4.123 The First European Communities Submission establishes that the issue of transfer pricing is central to the European Communities' case. According to the European Communities, the FSC administrative pricing rules constitute a subsidy in and of themselves.⁶⁰ If that is the European Communities' belief, then that demonstrates all the more why the European Communities should have first raised this transfer pricing issue in an appropriate tax forum, as it was required to do by footnote 59 of the SCM Agreement. The highly unusual language of footnote 59 is expressed in mandatory terms, and reflects the concern of the drafters about attempting to resolve technical issues of tax policy in a trade forum. As indicated above, the European Communities never has satisfied this requirement of footnote 59; the contacts referred to in the First European Communities Submission were all informal discussions with representatives of a few European Communities member States. There have never been formal contacts between the United States and the European Communities or its member States with respect to the FSC administrative pricing rules, and at no time has the European Communities or a member State formally invoked the facilities of existing bilateral tax treaties or other specific international mechanisms within the meaning of footnote 59. Therefore, the

⁶⁰ First EC Submission, paragraphs 127-128.

European Communities has failed to comply with footnote 59, and its claims regarding the FSC administrative pricing rules should be dismissed or deferred until it has.

4.124 The European Communities claims that footnote 59 is "couched in non-obligatory language". This is, at best, a half-truth. It is true that the third sentence of footnote 59 (which is referred to in the last sentence as a "right of consultation") does not compel a Member to "draw the attention" of another Member to a transfer pricing concern. However, if a Member chooses to do so, as the European Communities has done in this case, footnote 59 requires that the Members concerned "shall normally attempt to resolve their differences" by using one of the other referenced fora. The European Communities ignores the mandatory word "shall" and chooses instead to focus on the word "normally". While the United States does not disagree with the proposition that there may be some unusual situations where recourse to these other fora is not practicable, the European Communities has made no showing that recourse to these other fora was impracticable in this case. Indeed, taking the European Communities at its word that it has been deeply concerned about the FSC for over 14 years, it is implausible to believe that during all that time it never was practicable for the European Communities to formally raise its concerns in another forum, such as the OECD, where transfer pricing issues have been deliberated by tax specialists in enormous detail.

4.125 The European Communities asserts that its failure to resort to other fora is excused because it "is complaining about the FSC scheme because it results in export subsidies, not as an aberrant tax practice" and that it "is not complaining about availability of special administrative pricing rules *as such*, only their effect as an export subsidy". The United States fails to see the relevance of this point. The text of footnote 59 clearly indicates that the drafters recognized that transfer pricing practices that contravene the arm's length principle of the second sentence of footnote 59, *and* that result in a significant saving of direct taxes in export transactions, can give rise to an export subsidy. However, the text also indicates that the drafters recognized that those practices could give rise to both trade and tax concerns. In such circumstances, the drafters, no doubt taking a lesson from the tortuous history of the *Tax Legislation Cases*, expressed an institutional preference for referring such matters, in the first instance, to appropriate tax fora. Notably, the drafters did not provide that Members should resort to such alternative fora only if the tax concerns could be separated from the trade concerns.

4.126 The European Communities opines that the OECD is not an appropriate forum for dealing with a complaint about an export subsidy. This position is very odd, because in the First EC Submission, the European Communities argues that the OECD Guidelines serve as a benchmark for determining whether the FSC administrative pricing rules comply with the arm's length principle of footnote 59. Although the United States does not agree with the proposition that the OECD Guidelines have been incorporated into the SCM Agreement or that those Guidelines necessarily would dictate the outcome of discussions in the OECD, that does appear to be the European Communities' view. That being the case, the European Communities cannot argue, in one breath, that the OECD's expertise is dispositive of its subsidy claim, and then, in the next breath, argue that the OECD's expertise is irrelevant.

4.127 With respect to bilateral tax treaties, the European Communities argues that the competent authority process would not be appropriate for addressing the transfer pricing issues involved in this case because (1) bilateral tax treaties generally apply only to the residents of the signatories; (2) bilateral tax treaties do not provide a basis for one country to object to the tax practices of another when there is no issue of double taxation or loss of tax revenue for that country; and (3) the purpose of the mutual agreement procedure under a tax treaty is to resolve specific cases of application of the treaty in a specific taxpayer dispute with a country.

4.128 The United States does not share the European Communities' overly restrictive view of the utility of the competent authority process in transfer pricing matters, as this process both in aim and practice extends beyond specific cases of double taxation or tax evasion. As a matter of routine, competent authorities consult extensively. Their consultations can and often do extend to the proper administration of the tax laws of the parties and to types of transactions in which the interaction between two tax systems results in non-taxation, including transactions involving entities established

in low-tax jurisdictions. On transfer pricing matters, competent authorities have substantial expertise stemming from their administration of provisions incorporated into all income tax treaties dealing with the allocation of profits between associated enterprises. Obviously, the drafters of footnote 59 fully appreciated the transfer pricing expertise of competent authorities, and deliberately required potential disputants to fully avail themselves of such expertise in an effort to resolve their differences over whether certain practices have contravened the principles embodied in footnote 59 and, by reference, the 1981 GATT Council Decision.

4.129 The European Communities suggests that the drafters of footnote 59 could not have intended recourse to bilateral tax treaties or the OECD, because the drafters "probably intended to refer [to] some kind of dispute resolution mechanism". The European Communities offers no support for this proposition, and the reference of footnote 59 to "the facilities of existing bilateral tax treaties or other specific international mechanisms" seems to us to mean nothing more than that Members should attempt to work out a mutually acceptable solution in another forum before invoking the dispute settlement provisions of the WTO. That is not an alien concept. Indeed, DSU Article 4.7 provides that mutually acceptable solutions through discussion are to be preferred to litigation. The only noteworthy difference between footnote 59 and Article 4.7 is that footnote 59 directs that such discussions take place, in the first instance, in an appropriate tax forum.

4.130 The European Communities argues that footnote 59 does not apply to this dispute because it is not listed as a special or additional rule in the DSU. Here, the United States simply will note that with respect to its claims under the AA, the European Communities has invoked Article 10.3 for the proposition that the burden of proof in this case somehow shifts to the United States. However, Article 10.3 is not identified in the DSU as a special or additional rule. Thus, there is a fundamental inconsistency in the European Communities' position.

4.131 The European Communities attempts to excuse its procedural failings by arguing that it was incumbent upon the United States to raise its objections during consultations. This is simply a recycling of the European Communities' arguments regarding Article 4.2 of the SCM Agreement in which it attempts to obscure its own shortcomings by suggesting that the United States bore an obligation to bring the European Communities' failures to its attention at a moment that was more convenient for the European Communities.

4.132 Finally, the European Communities asserts that this particular United States objection implicates only the European Communities' claims under Article 3.1(a) of the SCM Agreement. The United States disagrees. If the FSC administrative pricing rules are consistent with item (e) and footnote 59, then they are neither prohibited by Article 3.1(a) nor by Article 3.1(b). This is because the FSC administrative pricing rules would not involve the foregoing of revenue that is "otherwise due" within the meaning of Article 1.1(a)(1)(ii), and because footnote 59 would render the FSC administrative pricing rules immune from any other prohibition in the SCM Agreement. Similarly, the FSC administrative pricing rules would not violate the AA because, given the absence of anything to the contrary in the AA, item (e) and footnote 59 establish the standard for determining whether the administrative pricing rules constitute an export subsidy under that Agreement.

4.133 In other words, in order to establish that the FSC administrative pricing rules violate Article 3.1(b) or the AA, the European Communities must establish that those rules are inconsistent with footnote 59. Footnote 59, in turn, requires that, as a threshold matter, the European Communities first raise its concerns in an appropriate tax forum. This is true regardless of whether the European Communities' claim is based on Article 3.1(a), Article 3.1(b), or the export subsidy provisions of the AA. Any other result would frustrate the clear intent of the drafters of footnote 59 that subsidy-related transfer pricing concerns be raised, in the first instance, in an appropriate tax forum.

The **European Communities** further responds as follows:

4.134 The United States attempts to strengthen its argument by referring to the European Communities' First Written Submission and alleging that "According to the European Communities, the FSC administrative pricing rules constitute a subsidy in and of themselves." This is of course a misrepresentation of the European Communities' position. The European Communities is complaining that the special administrative pricing rules for the FSC give rise to an export subsidy *since they are only available for the export of United States goods - not "in and of themselves"*.

4.135 The European Communities also explained that the alternative "channels" mentioned by the United States (the OECD and bilateral tax treaties) were not available for dealing with the European Communities' complaint and could not resolve it. The only available and appropriate forum was the WTO.

4.136 To the extent that the United States is simply arguing that these alternative channels provide an opportunity to discuss the issues (rather than resolve it), the European Communities would point out that its Member States did hold informal discussions on the FSC and these discussions included persons who were Competent Authorities. If this is what is required, the European Communities has fulfilled the requirement.

4.137 Finally, on this point it is worth repeating that if footnote 59 to the SCM Agreement did constitute a requirement to "exhaust alternative available tax fora before attempting to resolve the issue through the WTO dispute settlement process" as claimed by the United States, it would have been mentioned in Appendix 2 to the DSU. It is not, although footnote 35 to the SCM Agreement, which regulates the parallel application of countervailing duty action and dispute settlement, is. This demonstrates that footnote 59 to the SCM Agreement was not intended to constitute a special rule applicable in the conduct of dispute settlement.

The **United States** further rebuts the European Communities response in its Oral Statement at the First Meeting of the Panel as follows:

4.138 With respect to the procedural requirements of footnote 59, this provision obviously reflects the drafters' decision to tread cautiously with respect to issues involving the relationship between tax and trade rules. The European Communities' failure to follow this procedural requirement frustrates that objective by immediately dropping into the Panel's lap complex and technical transfer pricing issues that should have been subject to an initial airing in an appropriate tax forum.

3. Specificity of claims – Article 6.2 of the DSU

The **United States** argues as follows:

4.139 Under Article 6.2 of the DSU, a request for the establishment of a panel must, *inter alia*, "identify the specific measures at issue." Nothing in the AA alters this requirement.⁶¹

4.140 Depending on the nature of the alleged WTO violation in question, it may or may not be necessary under Article 6.2 to identify the products that are subject to the measure in dispute. For example, in the case of a prohibited subsidy claim under Article 3 of the SCM Agreement concerning a non-agricultural product, an identification of the product(s) subject to the alleged prohibited subsidy would not be necessary. This is because Article 3 prohibits export subsidies with respect to any non-agricultural product.

4.141 However, the situation is different in the case of allegations involving the provision of export subsidies to agricultural products, because the AA does not prohibit the maintenance of export

⁶¹ Article 19 of the AA simply states that the general dispute settlement rules apply to disputes under that Agreement. In addition, no provision of the AA is identified as a special or additional rule and procedure in Appendix to the DSU.

subsidy programmes *per se*. Instead, the AA permits the use of export subsidies in accordance with the obligations set forth in that Agreement. The nature of those obligations will differ depending on the particular agricultural product in question. Thus, a particular export subsidy may constitute a violation of the AA in the case of "Product X," but not in the case of "Product Y."

4.142 Therefore, in the case of a request for a panel involving claimed violations of the export subsidy provisions of the AA, it is not enough for the request to identify the alleged export subsidy. Instead, the request must identify the particular agricultural products that are alleged to receive an export subsidy in violation of the AA. Only then will the panel request fulfill its mandatory function of "form[ing] the basis for the terms of reference of the panel pursuant to Article 7 of the DSU . . . and . . . inform[ing] the defending party and the third parties of the legal basis of the complaint."⁶²

4.143 The Appellate Body reached a similar conclusion in the European Communities *LAN* case. In that case, which involved an alleged violation of Article II:1 of GATT 1994, the Appellate Body stated:

"We note that Article 6.2 of the DSU does *not* explicitly require that the products to which the "specific measures at issue" apply be identified. However, with respect to certain WTO obligations, in order to identify "the specific measures at issue", it may also be necessary to identify the products subject to the measures in dispute."⁶³

4.144 In that case, the Appellate Body went on to find, as had the panel, that the panel request had adequately identified the products at issue.

4.145 In contrast to the European Communities *LAN* case, where the litigants disagreed over the specificity of the product description included in the panel request, in the instant case, the European Communities' request for a panel contained no product identification or description whatsoever. As a result, because the FSC is not prohibited *per se* by the AA (assuming *arguendo* that the FSC is an export subsidy at all), it was not until the United States received the First European Communities Submission that the United States learned the nature of the case against it; *i.e.*, that the European Communities was challenging the alleged provision of the FSC with respect to exports of wheat, cotton, soybeans, and maize. It is as if the European Communities accused the United States of violating Article II:1 of GATT 1994 without specifying the product or the tariff binding in question.

4.146 Under Article 6.2 of the DSU, a defending party is not expected to have to wait until the complainant files its first submission to learn of the specific WTO violations that it allegedly has committed.⁶⁴ Therefore, because the European Communities' request for a panel failed to "identify the specific measures at issue," the Panel should dismiss the European Communities' claims under the AA.⁶⁵

⁶² *European Communities - Customs Classification of Certain Computer Equipment*, WT/DS62/AB/R, Report of the Appellate Body adopted 22 June 1998, paragraph 69, quoting from *European Communities - Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/AB/R, Report of the Appellate Body adopted 25 September 1997, paragraph 142.

⁶³ *Id.*, paragraph 67 (italics in original).

⁶⁴ Of course, even this statement assumes that the First European Communities Submission, as opposed to some later European Communities submission, establishes the subject matter of this proceeding. The European Communities may add additional agricultural products to its claims as this case moves along. Suffice it to say that at this point, given the European Communities' failure to comply with Article 6.2, neither the United States nor this Panel knows the full or final scope of the European Communities' claims under the AA.

⁶⁵ In its second submission to the Panel, the United States remarks: To clarify matters for the Panel, the United States hereby confirms that, in light of the discussion that took place at the first meeting of the Panel, it has withdrawn its objection concerning the European Communities' failure to identify *non-scheduled* agricultural products. The United States continues to maintain, however, that the European Communities'

The **European Communities** responds as follows:

4.147 The United States requests that the Panel dismiss the European Communities' claims under the AA on the grounds that the European Communities has not specified the agricultural products concerned. It claims that since the AA does not prohibit export subsidies generally, but only if they exceed certain limits, Article 6.2 of the DSU requires the products concerned to be specified. It claims that "it is as if the European Communities accused the United States of violating Article II:1 of GATT 1994 without specifying the product or the tariff binding in question".

4.148 The European Communities does not agree. Article 6.2 of the DSU requires identification of the specific United States measures at issue and the legal basis for the complaint. The measure at issue here is the FSC scheme and the legal basis for the complaint is the violation of the AA. The situation is not comparable to a breach of a tariff binding where the measure (the applied tariff) relates to a particular product.

4.149 The European Communities is complaining about the fact that the FSC scheme can lead to circumvention of reduction commitments under the AA. The four products were mentioned as concrete examples of where this might happen, as the European Communities expressly stated at paragraph 168 of the European Communities' First Written Submission.

4.150 The main reason why the European Communities mentions these examples is that it is invoking reversal of the burden of proof provided for in Article 10.3 of the AA for these products and wanted to limit the burden on the United States to just those four products which the United States exports to the European Communities.

4.151 The European Communities' conclusion on the AA contains an error and is perhaps ambiguous. It would be clearer if it read:

"The European Communities requests the Panel to find that by maintaining the tax exemptions and special administrative pricing rules contained in the FSC scheme, the United States has violated:

...

Articles 3 and 8 read in conjunction with Articles 9.1(d), 10.1, and 10.3 of the Agreement on Agriculture by granting export subsidies to agricultural goods in excess of its reduction commitments under that Agreement (e.g. wheat, maize, soya beans, and cotton)."

4.152 The European Communities asks the Panel to read the relevant part of the conclusion to the European Communities' First Written Submission as thus corrected.

4. Scope of measures at issue

The **United States** argues as follows:

4.153 In its request for establishment of a panel, the document that established the Panel's terms of reference, the European Communities identified the measures at issue as "Sections 921-927 of the [US] Internal Revenue Code and related measures" Although the phrase "related measures" is not without ambiguity, in the view of the United States, such a request would satisfy WTO standards if (1) the unspecified measures were subsidiary or closely related to the measures specified in the panel

request, and (2) if the unspecified measures were identified in the first submission of the complainant.⁶⁶

4.154 In this dispute, however, the European Communities has yet to identify what its other “related measures” are. Instead, in the First European Communities Submission, the European Communities continues to assert that “the measures subject of this proceeding” are “Sections 921-927 of the US Internal Revenue Code and related measures”.⁶⁷ However, the European Communities still does not tell either the Panel or the United States what these other “related measures” are. At most, the European Communities makes a cryptic reference to regulations of the US Internal Revenue Service relating to the FSC, stating as follows: “The European Communities considers that it is the United States primary legislation that creates the violations of the WTO Agreements and does not expect that it will be necessary to refer to these regulations.”⁶⁸

4.155 With due respect, what is relevant is not the European Communities' litigation “needs,” but rather that basic considerations of due process entitled the United States to know with certainty, as of the date on which the European Communities filed its first submission, which of its measures the European Communities was challenging.⁶⁹ With respect to the European Communities' “related measures”, the United States has been denied the opportunity to make an initial submission because the European Communities has not identified what those measures are or why they violate any of the WTO agreements.⁷⁰

4.156 Basic principles of due process entitled the United States to know no later than the date on which it filed its first submission the identity of the measures that allegedly violate United States obligations under the WTO. At this point, it simply is too late for the European Communities to introduce other measures into this dispute.

4.157 The United States only can speculate as to whether the European Communities' failure to identify its “related measures” is due to litigation tactics or a continuing inability to determine the basis of its case. Regardless of the reason, the Panel should not reward this failure by permitting the European Communities to subsequently identify these “related measures” and present arguments concerning them, all the while denying the United States an opportunity to present a defense. Instead, the Panel should make a preliminary finding at the first meeting of the Panel that the measures at issue in this dispute are limited to Sections 921-927 of the US Internal Revenue Code.

The European Communities responds as follows:

4.158 The United States complains that the European Communities' request for establishment of a panel identified the measures at issue as “Sections 921-927 of the US Internal Revenue Code and related measures ... “ and claims that the European Communities has not specified what it means by “related measures” in its First Written Submission. It therefore asks⁷¹ the Panel to make a preliminary finding at the first meeting of the Panel that the measures at issue in this dispute are limited to Sections 921-927 of the US Internal Revenue Code.

⁶⁶ One prior panel reached a similar conclusion. *Japan - Measures Affecting Consumer Photographic Film and Paper*, WT/DS44/R, Report of the Panel adopted 22 April 1998, paragraphs 10.1-10.11.

⁶⁷ First EC Submission, paragraph 2.

⁶⁸ *Id.*, paragraph 23.

⁶⁹ In this regard, the Appellate Body repeatedly has emphasized the importance of due process considerations in the WTO system. *See, e.g., United States - Restrictions on Imports of Cotton and Man-Made Fibre Underwear*, WT/DS24/AB/R, Report of the Appellate Body adopted 25 February 1997, at 15; and *Brazil - Measures Affecting Desiccated Coconut*, WT/DS22/AB/R, Report of the Appellate Body adopted 20 March 1997, at 22.

⁷⁰ As the Appellate Body has recognized, “[a] fundamental tenet of due process is that a party be provided with an opportunity to respond to claims made against it.” *Australia - Measures Affecting Importation of Salmon*, WT/DS18/AB/R, Report of the Appellate Body adopted 6 November 1998, paragraph 278.

⁷¹ Paragraph 75 of the US First Written Submission.

4.159 This claim is entirely unfounded. This case is about the tax treatment of FSCs. The European Communities has explained that it is complaining about the tax exemption subsidy and the transfer pricing subsidy accorded to United States exported goods and that this is contained in a body of law it has described as “the FSC scheme”. This is also the case of the local content requirement. The European Communities has explained in detail what the FSC scheme is, how it works and that it is instituted by Sections 921-927 of the US Internal Revenue Code. The European Communities has also identified many other provisions of United States law which relate to it. It is wrong to say that the European Communities has not identified the “related measures”. The European Communities can provide a list of related provisions if the Panel wishes.

4.160 The United States request to limit the measures at issue in this dispute to Sections 921-927 of the US Internal Revenue Code must be rejected.

B. WHETHER FSC MEASURES ARE SUBSIDIES CONTINGENT UPON EXPORT PERFORMANCE WITHIN THE MEANING OF ARTICLE 3.1(A) OF THE SCM AGREEMENT

The **European Communities** argues in its First Submission as follows:

Factual Background

The US Tax System

4.161 Official US explanation of the FSC scheme and the other elements of the US tax system relevant to an understanding of its background can be found in the exhibits to this submission. A policy explanation is contained in the testimony of Joseph J. Guttentag, International Tax Counsel, Department of the Treasury, to the Committee on Finance to the US Senate on July 21 1995 (Exhibit EC-2). A briefer and more focussed explanation confined to the FSC scheme is contained in “*Foreign Sales Corporations – A Tax Incentive for US Exporters*” published by the US Office of the Chief Counsel for International Commerce, US Department of Commerce⁷² (Exhibit EC-3). There is also useful information in the reports of the Department of the Treasury entitled *The Operation and Effect of the Foreign Sales Corporation Legislation*. These were supposed to be published periodically pursuant to Section 804(a) Tax Reform Act 1984 but only two exist, that for the period 1 January 1985 to 30 June 1988 (Exhibit EC-4), published in January 1993, at and that for 1 July 1992 to 30 June 1993, published in November 1997 (Exhibit EC-5). References will be made to these publications as appropriate in the following explanation as elsewhere in this submission.

4.162 The US has an advanced and sophisticated tax system which has evolved complex sets of rules which seek to eliminate or at least reduce both double taxation and tax avoidance.

4.163 Like in most countries, liability to US income taxes is based on both the residence of the taxpayer and the source of the income. Thus, the United States taxes its citizens and residents (including US corporations) on both domestic and foreign source income⁷³, and it eliminates or reduces international double taxation by allowing a credit for foreign taxes paid or accrued on foreign source income.⁷⁴ The US tax system is widely considered unusual in the way that it taxes the income of its citizens, taxing them regardless of where in the world they may be resident.⁷⁵ However when it comes to taxing companies the US system is in reality similar to that of other countries.

⁷² Available on the Internet at <http://www.ita.doc.gov/legal/fsc.html>

⁷³ The US has developed a comprehensive set of source rules for determining what is considered US or foreign source income. Under these rules, which are also used for allocating deductions, income is first categorised according its nature and type and then is characterised as sourced within or without the US

⁷⁴ See Testimony of Joseph J. Guttentag, International Tax Counsel, Department of the Treasury, at p.3. (Exhibit EC-2).

⁷⁵ This approach of taxing worldwide income of individuals regardless of their resident status is also for example by the Philippines and Bulgaria.

4.164 In defining which corporations are considered domestic for tax purposes, the US tax code (the Internal Revenue Code or “IRC”) adopts the - purely formal - nationality principle⁷⁶ under which “US corporations” are those organised under the laws of the United States, any individual state or the District of Columbia.

4.165 A US corporation conducting operations abroad through a separately incorporated foreign corporation pays no US tax on the foreign corporation’s foreign-source earnings which are not effectively connected with a trade or business in the United States⁷⁷ until those earnings are repatriated to the United States through a dividend or otherwise (the “deferral” principle). The deferral principle provides a good incentive for taxpayers to shift their investments in low-taxing jurisdictions obtaining an unlimited deferral, and in practice tax-free earnings, as long as they do not repatriate their profits. To prevent abuses, a number of exceptions to the deferral rule have been introduced that are directed at certain types of mobile or low-taxed foreign income. The exception which is relevant for an understanding of the FSC scheme is the controlled foreign corporations provisions of Subpart F of the IRC.⁷⁸ These provisions require the US shareholders that own stock in the controlled foreign corporation to include in its gross income its *pro rata* share of the foreign corporations undistributed income, thus eliminating the benefits of deferral for such shareholders.⁷⁹ Most other developed countries have similar legislation. The foreign trade income of FSCs is exempted from this regime.⁸⁰

4.166 Double taxation arises when the same income of the same taxpayer is subjected to comparable taxes both in the source country and in the country of residence for identical periods. Many countries have unilateral mechanisms for preventing some or all of such double taxation. In addition, however, OECD countries and many non-member countries have a range of bilateral double taxation treaties to eliminate double taxation as well as to prevent tax evasion and to ensure non-discrimination. Tax treaties prevent double taxation by allocating the right to tax various categories of income between the two countries concerned. Generally, where income can be taxed in the State of source, the State of residence eliminates the double taxation. The State of residence can accomplish this either by exempting the income from the State of source (often referred to as the capital-import neutrality principle) or by giving a credit for the tax paid there (the capital-export neutrality principle). These two methods are defined in Articles 23A and 23B of the OECD Model Tax Convention.

4.167 The US rules designed to avoid double taxation of income are inspired by a “capital-export neutrality principle,”⁸¹ under which the decision to invest locally or abroad should not be affected by local or foreign tax considerations, namely the US investor should pay the same total (US and foreign) tax on all income, regardless of where the income is earned. The US double taxation rules operate by allowing a foreign tax credit (FTC) for foreign income taxes paid on foreign source income which is subject to tax in the United States. This effectively mitigates or eliminates multiple taxation by allowing a US taxpayer to deduct the amount of the foreign tax credit from US income taxes otherwise payable on foreign source income, with certain limitations⁸². Because no US tax is payable on the exempt part of FSC income, any foreign tax paid on this income cannot give rise to a foreign tax credit.

⁷⁶ Section 7701(a)(4) IRC.

⁷⁷ See Section 882 IRC (tax on income of foreign corporations connected with a US business).

⁷⁸ Sections 951-964 IRC. The other exceptions are the foreign personal holding company provisions (IRC secs.551-558), the foreign investment company provisions (IRC sec.1246-1247) and the passive foreign investment company (PFIC) provisions (IRC secs.1291-1297).

⁷⁹ See Testimony of Joseph J. Guttentag, International Tax Counsel, Department of the Treasury, at p.5 et seq. (Exhibit EC-2).

⁸⁰ See Section 951(e) and 954(d) IRC and the explanations in the Testimony of Joseph J. Guttentag, International Tax Counsel, Department of the Treasury, at p.11. (Exhibit EC-2).

⁸¹ See explanation in the Testimony of Joseph J. Guttentag, International Tax Counsel, Department of the Treasury, at p.2. (Exhibit EC-2).

⁸² See Sections 901 et seq. IRC and the explanations in the testimony of Mr. Guttentag (Exhibit EC-2).

4.168 An essential component of these rules is of course the application of certain rules to define the source of the income to be taxed. The development of source rules is very important for taxing countries because taxpayers always have a strong incentive to manipulate them in order to have domestic source taxable income characterised as foreign source non-taxed income. The IRC contains a comprehensive set of source rules.⁸³ Under these rules, which are also used for allocating deductions, income is first categorised according its nature and type and then is characterised as sourced within or without the United States.⁸⁴ Active income, which is defined as “effectively connected with a US trade or business”, is taxed on a net basis, whereas passive income is taxed on a gross basis, mainly through a withholding mechanism.

4.169 These rules are important to an understanding of the FSC scheme because the technique used to exempt part of the income of FSCs from US tax is to deem it to be “foreign source income which is not effectively connected with the conduct of a trade or business in the United States”⁸⁵ which it otherwise would be and then to exempt the parent company from tax on the dividends attributable to that income⁸⁶.

The Introduction of the Domestic International Sales Corporation

4.170 In order to promote US exports at a time of increasing trade deficit⁸⁷, the Nixon administration introduced the Domestic International Sales Corporation (DISC) legislation in 1971⁸⁸ as part of a package of “new economic policy”. The Original Act was called the “Deficit Reduction Act of 1971⁸⁹”. Congress sought to generate additional exports, while keeping the loss of tax revenues as low as possible.

4.171 DISCs are US corporations whose income derives from exportation. They are required to be incorporated in the United States and at least 95 per cent of the gross receipts of the corporation have to consist of qualified export receipts. US corporate tax is deferred on a portion of a DISC’s export-related income. Under the DISC regime, the profits of a DISC are not taxed to the DISC, but are taxed to the shareholders of the DISC when distributed or deemed distributed to them. Each year, a DISC is deemed to have distributed a portion of its income, thereby subjecting that income to current taxation in the hands of its shareholders. Tax can generally be deferred on the remaining portion of the DISC’s taxable income until (i) the income is actually distributed to the DISC shareholders, (ii) a shareholder disposes of the DISC stock, (iii) the DISC is liquidated, (iv) the stock of the DISC is distributed, exchanged or sold, (v) the corporation ceases to qualify as a DISC or (vi) the DISC election is terminated or revoked. In the typical case, a DISC is a wholly owned US subsidiary of a US corporation, with the result that distributions and deemed distributions from DISCs are typically subject to parent corporate tax and, eventually, to shareholder-level tax when distributed to individuals.

⁸³ See Sections 861-865 IRC.

⁸⁴ Categories of income include: interest, dividends, rentals and royalties, compensation for personal services, sale of real property, sale of personal property, etc.

⁸⁵ See Section 921(a) IRC.

⁸⁶ Under Sections 926 and 245(c) IRC. See explanation in the Testimony of Joseph J. Guttentag, International Tax Counsel, Department of the Treasury, at p.11. (Exhibit EC-2).

⁸⁷ See e.g. the introduction to the legal article *The Making of an Export Subsidy: DISCs and FSCs in compliance with the GATT* by Leif Weizman published in the "World Competition" Law Review Vol. 12 1989 N.3 page 57 at pages 57-58. The first Treasury Report on FSCs (Exhibit EC-4) states that “after years of a diminishing trade surplus, Congress created the DISC program in 1971 in an effort to stimulate exports” (first sentence of Section entitled “Detailed Description of the FSC Program” in Chapter 2 on page 3). Obviously there are different ways of measuring the trade balance.

⁸⁸ Now codified in Sections 991-997 IRC.

⁸⁹ See footnote 1 to the Extract in Exhibit EC-6 from the *General Explanation of the Revenue Provisions of the Tax Reform Act 1984* prepared by the staff of the Joint Committee on Taxation. Published in Federal Taxes, 17 January 1985.

4.172 The DISC scheme provided further tax benefits through special inter-company pricing rules and certain rules on producers' loans. The availability of two alternative methods of allocation of income to the DISC served to increase the DISC's profit that would otherwise result under arm's length pricing. It allowed a substantial part of the parent company's profit to be attributed to the DISC.

4.173 As is well known, the European Communities objected to the introduction of the DISC legislation and succeeded in having it declared an illegal export subsidy contrary to Article XVI:4 GATT 1947.⁹⁰ The report was adopted in December 1981 together with the reports in three retaliation cases that the United States brought against three EC Member States. They were adopted by the GATT Council together with an understanding that stated:

"The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income".⁹¹

4.174 Although the United States claimed that its DISC legislation was compatible with the above understanding, it was isolated and multinational trade negotiations on the Subsidies Code also identified export related tax exemptions and deferral as prohibited under item (e) of the Illustrative List to the Tokyo Round Subsidies Code.

4.175 Although the United States never officially conceded that the DISC scheme violated the GATT, the Reagan Administration decided to remove the issue as an irritant in US trade relations by introducing the FSC scheme and amending the DISC legislation to introduce an interest charge for deferred taxes. In addition, DISC benefits were limited to relatively small DISCs with taxable income attributable to a maximum of \$10 million of qualified export receipts.

The FSC Legislation

Introduction

4.176 It appears from the extract from *the General Explanation of the Revenue Provisions of the Tax Reform Act 1984* prepared by the staff of the Joint Committee on Taxation⁹² (contained in Exhibit EC-6) that the FSC legislation⁹³ was designed to be functionally equivalent to the DISC⁹⁴ while being easier to defend under the GATT. The FSC legislation has some important technical differences to the DISC legislation but the economic effect of the FSC, i.e. the promotion of exports of products manufactured in the United States, and the means to achieve this goal, i.e. income tax exemptions, remained the same. This view is supported by a number of independent legal authors.⁹⁵

⁹⁰Panel Report *"US - Tax Legislation (DISC)"*, L/3851, adopted on 7-8 December 1981, BISD 23S/98, 114.

⁹¹BISD 28S/114.

⁹²Published in *Federal Taxes*, 17 January 1985.

⁹³The legislation is now codified in Sections 921 to 927 IRC (Exhibit EC-1).

⁹⁴See esp. Explanation of Provisions, Section C.1 *in fine* on page 1043 of the *General Explanation of the Revenue Provisions of the Tax Reform Act 1984* contained in Exhibit EC-6.

⁹⁵See e.g.: *The Making of an Export Subsidy: DISCs and FSCs in compliance with the GATT* by Leif Weizman published in the "World Competition" Law Review Vol. 12 1989 N.3 page 57 at p. 81; *DISCs and FSCs: Providers of Economic Incentives for Wholly-owned Domestic Exporters* by Caplan and Chametzky in

These legal authors share the view of the European Communities that the FSC scheme violates the WTO rules⁹⁶.

4.177 The European Communities, among others, never accepted the FSC legislation as compatible with the GATT and continuously contested it. It addressed a démarche to the United States Trade Representative on 8 November 1983.⁹⁷ The US Congress was perfectly aware of this when it adopted the FSC legislation in the Tax Reform Act of 1984.⁹⁸ The European Communities formally reserved its rights in the GATT Council⁹⁹ and formal consultations under Article XXII GATT were held between the European Communities and the United States on the FSC legislation on 26 March 1985 in which Australia, Canada, Finland, Japan, New Zealand, Sweden and Switzerland participated (see further below).

4.178 An good summary of the FSC legislation is contained in the document Exhibit EC-3 produced by the Office of the Chief Counsel for International Commerce of the US Department of Commerce which is designed to provide US exporters with “an overview of the FSC tax incentive” for “export-related income”. The following account is largely based on it though reference will also be made to the legislation in Exhibit EC-1 and other sources.

4.179 There are also two sets of FSC regulations which were published in the US Federal Register on 12 December 1984. One set of regulations, issued in question and answer form, contains other FSC general requirements as well as definitions and the other clarifies the “foreign presence” requirements. These regulations are designed to facilitate the operation of FSCs and have apparently been changed in 1998. The European Communities considers that it is the US primary legislation that creates the violations of the WTO Agreements and does not expect that it will be necessary to refer to these regulations.

Definition of a FSC

4.180 A FSC is a corporation created or organised in certain foreign countries or US possessions to obtain a US tax exemption on a portion of its earnings generated by the sale or lease of “export property”.¹⁰⁰ Export property is:

- any property;
- manufactured, grown, or extracted in the United States;
- by a person other than a FSC;
- sold, leased, or rented for use outside the United States; and
- with no more than 50 per cent of its fair market value attributable to imports.

Brooklyn Journal of International Law at page 12 and *Addressing Tax Revolutions the Lack Empirical Validity* by Westin in 1997 in chapter III. These articles are contained in Exhibit EC-7.

⁹⁶ See: *The Making of an Export Subsidy: DISCs and FSCs in compliance with the GATT* by Leif Weizman published in the "World Competition" Law Review Vol. 12 1989 N.3 page 57 (esp. Conclusion p. 81); *An Analysis of the GATT-Compatibility of The New Foreign Sales Corporation* by Ryan in the Santa Clara Law Review Vol. 26, page 705-706 and conclusion page 717; *Addressing Tax Revolutions the Lack Empirical Validity* by Westin in 1997 Tax Analysts at paragraph 31. These articles are contained in Exhibit EC-7.

⁹⁷ The contents are summarised in *DISCs and FSCs: Providers of Economic Incentives for Wholly-owned Domestic Exporters* by Caplan and Chametzky in Brooklyn Journal of International Law at pages 14 to 16.

⁹⁸ See Section B (Reasons for Change) *in fine* (page 1042) of the *General Explanation of the Revenue Provisions of the Tax Reform Act 1984* in Exhibit EC-6.

⁹⁹ C/M/180 page 5.

¹⁰⁰ Section 927(a) defines FSC export property as property held for sale or lease which: (1) had been manufactured, produced, grown, or extracted in the United States by a “person” other than the FSC; (2) was held primarily for sale, lease, or rental in the ordinary course of business for direct use, consumption, or disposition outside the US; and (3) had, at the time of sale, lease, or rental by the FSC, not more than 50 per cent of its fair market value attributable to articles imported into the US.

Formation Requirements

4.181 FSCs can be formed by manufacturers, export intermediaries, or groups of exporters, such as export trading companies. A FSC can function as a principal, buying and selling for its own account, or as a commission agent. It can be related to a manufacturing parent or can be an independent merchant or broker.

4.182 A FSC must first meet certain basic formation requirements¹⁰¹, the most notable of which is to be set up a US possession or a foreign country approved by the United States as having an exchange of information agreement.¹⁰² The vast majority of FSCs are set up in countries that do not tax them (but impose only minimal annual franchise taxes and licence fees).

4.183 In order to benefit from the scheme, a FSC must (unless it is a “small FSC”¹⁰³) meet several “foreign management” tests throughout the year. If it complies with those requirements, it is entitled to an exemption on qualified export transactions in which it performs the required “foreign economic processes”.

Foreign Management Requirements

4.184 Under the foreign management test a FSC will qualify for the exemption for a taxable year if it meets three basic requirements:

- all meetings of shareholders and directors are held outside the United States;
- the principal bank account is maintained outside the United States; and
- all dividends, legal and accounting fees, officers' salaries, and directors' fees are disbursed from a foreign bank account.

Foreign Economic Process Requirements

4.185 There are two foreign economic process requirements:

- the FSC must participate in the sales process; and
- the FSC must have a minimum percentage of foreign direct costs.

4.186 The FSC, or its agent, must comply with both of these requirements to earn income exempt from tax from any export transaction or group of transactions.

Participation in the Sales Process

4.187 The first foreign economic process requirement is that the FSC, or its agent, must participate, outside the United States, in any of the following in export transactions:

- solicitation (other than advertising),
- negotiation, or
- contracting.

4.188 As a general rule, the FSC must participate in only one of these three activities to obtain the FSC tax exemption. However, if the FSC seeks to use special administrative pricing rules (see below), then the FSC, or its agent, must perform all of the activities attributed to such sale, to the extent that they are performed. However, only the single qualifying activity must take place outside the United States.

¹⁰¹ Section 922 IRC.

¹⁰² Section 927(e)(3) IRC.

¹⁰³ Section 922(b) IRC.

Foreign Direct Costs

4.189 The second foreign economic process requirement is that specific percentages of the transaction costs must be "foreign direct costs," incurred by the FSC for activities it, or its agent, performs outside the United States. "Direct costs" for this purpose are: materials consumed in the activity, labour costs directly associated with the activity, and incremental costs of facilities or services incidentally related to the FSC activity. The activities tested are grouped in the following five categories:

- advertising and sales promotion;
- processing customer orders and arranging for delivery of the export property;
- transportation;
- assembling and transmission of a final invoice or statement of account and the receipt of payment; and
- assumption of credit risk.

4.190 A FSC meets the foreign direct cost test if its foreign direct costs are either 50 per cent or more of total direct costs for these five activities, or are 85 per cent or more of direct costs incurred in each of any two of the five activities listed above.

The Significance of the Foreign Management and Foreign Economic Process Requirements

4.191 The existence of the foreign management and foreign economic process requirements, limited as they are, are fundamental to providing a fig leaf of justification to the FSC scheme. In reality however they are a sham.

4.192 The foreign management requirements can be dealt with easily with meetings being held by telephone and service companies in the countries of incorporation dealing with the paperwork.

4.193 Although an FSC must incur the costs of the "foreign economic processes", it need not perform these activities itself. An agent may perform these activities, and any person may serve as an agent, irrespective of whether the agent is related (such as a parent or affiliate) or unrelated (such as a bank, trust company, export trading company, or accounting firm in the foreign jurisdiction).

4.194 Indeed software packages and service companies exist which facilitate the paperwork of running a FSC. The running costs are estimated to be as low as US\$2000 per year.¹⁰⁴

4.195 The sham character of FSCs is described in detail in "Fantasy Islands". The authors point out that in spite of some 3,600 FSCs formally established in the US Virgin Islands, none of these corporations are visible. One of the largest FSC companies just employ seven people. They explain that in reality the real work is still performed in the United States.

4.196 The "burden" of running FSCs is further reduced by the existence of special provisions for "small FSCs." A small FSC is generally the same as a FSC, except that the tax exemption for a small FSC is limited to the income generated by \$5 million or less in gross export revenues it does not have to meet foreign management or foreign economic process requirements. If a small FSC wants to use the administrative pricing rules it must undertake the contracting, economic process, and management activities. However, none of the activities are required to be done offshore. Small FSCs account for 48 per cent of all FSCs.

4.197 In addition many US States, regional authorities, trade associations, or private businesses sponsor "shared FSCs" for their companies, members or customers. A "shared FSC" is a FSC which

¹⁰⁴ Source: Article from the South Florida Business Journal of 24 February 1997 entitled Foreign Sales Corporations: *A Middleman that Offers Tax Savings* by David Wallace.

is "shared" by 25 or fewer unrelated exporter "shareholders", so as to reduce the costs while obtaining the full tax benefit of a FSC. Each exporter-shareholder owns a separate class of stock and each runs its own business as usual. The US Department of Commerce grants written Export Trade Certificates to shared FSCs that allow US exporters to engage in joint export conduct with other US companies. Certified exporters are virtually immune from all federal and state government antitrust action.¹⁰⁵

The Location of FSCs

4.198 The artificiality of the FSC scheme is further evidenced by the fact that most FSCs are set up in US possessions and of the remainder most are in location which specifically exempt them from tax.

4.199 According to US Treasury data¹⁰⁶, US possessions host 74 per cent of all FSCs. 66 per cent of all FSCs are located in the US Virgin Islands.

4.200 The situation of FSCs in US possessions is particularly worthy of note as an illustration of how lacking in "foreign" character FSCs really are.

4.201 The main location for FSCs is the US Virgin Islands. This is an organised, unincorporated territory of the United States, administered by the Office of Territorial and International Affairs in the US Department of Interior. It elects a member to the US House of Representatives.

4.202 The tax legislation of the US Virgin Islands is contained in the US IRC. Section 932 of the IRC provides that the United States will be treated as including the Virgin Islands for purposes of determining the US tax liability of US citizens or residents with Virgin Islands income.

4.203 According to the Naval Appropriations Act of 12 July 1921, "the income tax laws now in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States."

4.204 A Virgin Islands tax publication of July 1992 states that "the 1984 Tax Equity and Fiscal Responsibility Act (...) make the Virgin Islands a highly attractive location for US exporters desiring to form FSCs. US exporters can earn tax-exempt income by using V.I. FSCs to perform some sales activities outside the United States *that a US company might otherwise perform*" (emphasis added).¹⁰⁷

4.205 Another important location for FSCs is Barbados. Apparently¹⁰⁸, the Parliament of Barbados enacted the Foreign Sales Act of 1984 which exempts FSCs from all taxes on income arising from its operations except for income from investments made in Barbados. An FSC may engage in foreign trade transactions from within Barbados only if it has obtained a licence to do so and only subsidiaries of US corporations may obtain such a licence. The licence for a FSC is US\$1,000. The licence fee for a small FSC is US\$500.

The US Tax Benefits of a FSC

4.206 A portion of the "foreign trade income" is deemed to be "foreign source income not effectively connected with a trade or business in the United States" and is therefore not taxed in the United States; this is referred to as the "exempt foreign trade income".¹⁰⁹ The remaining portion is taxable to the FSC. Dividends paid by the FSC out of exempt and non-exempt income to the shareholder (ordinarily, the "related supplier") generally qualify for a full dividends received

¹⁰⁵ This immunity is granted through an Export Trade Certificate from the US Department of Commerce under the Export Trading Act of 1982.

¹⁰⁶ See Table 6.1 on page 20 of the Treasury Report for 1992-1993 in Exhibit EC-5.

¹⁰⁷ See Exhibit EC-18.

¹⁰⁸ See Exhibit EC-17. The source of this information is <http://www.ao-group.com/foreign.htm> and <http://www.fgfs.com/provibar.htm>

¹⁰⁹ See Section 923(a) IRC.

deduction.¹¹⁰ Foreign trade income is gross income¹¹¹ earned from the sale, lease, or rental of export property.

4.207 A minimum of 30 per cent of a corporate held FSC's foreign trade income is exempt from US tax. However, if the FSC buys from a related supplier and qualifies for the use of the special administrative pricing rules, the rate of exemption rises to approximately 65 per cent.

4.208 Special rules apply for agricultural cooperatives. All of the Foreign Trading Income of a FSC owned by a related qualified cooperative from the sale of agricultural or horticultural products will be treated as exempt foreign trading income.¹¹²

The Administrative Pricing Rules

4.209 Since FSCs are generally controlled subsidiaries of their parents the prices of transactions between them (and therefore the allocation between them of the profit on the transaction) would normally be required to be at arms length and controlled pursuant to Section 482 IRC. FSCs and their parents are however allowed to ignore this rule and apply special "administrative pricing" formulae between them.¹¹³

4.210 This derogation is examined in more detail from a tax point of view below. For present purposes it is merely necessary to describe how they function and how important they are for the FSC scheme.

4.211 The first administrative pricing rule apportions 23 per cent of the total foreign trade income from an export transaction to the FSC and the remaining 77 per cent to its related supplier. This rule further provides that 15/23 (approximately 65 per cent) of the FSC's foreign trade income is exempt from US tax. Thus, this rule provides an exemption for 15 per cent (23% x 15/23) of the total foreign trade income earned in the transaction.

4.212 The second administrative pricing rule allows the FSC to take 1.83 per cent of the total gross receipts from the export transaction as foreign trade income, not to exceed 46 per cent of the total amount of foreign trade income. This rule further provides that 15/23 (approximately 65 per cent) of the FSC's foreign trade income is exempt from US tax. Thus, this rule provides an exemption for up to 30 per cent (46% x 15/23) of the total foreign trade income earned in the transaction.

4.213 In general, the first rule produces greater tax savings for transactions with profit margins above 8 per cent, while the second rule produces greater tax savings for transactions with profit margins below 8 per cent. Additionally, a FSC may group transactions together by contract, customer, or product line to maximise its tax savings.

The Advantages of the Administrative Pricing Rules

4.214 The tax benefits achieved through FSCs are reported to be increasing through the use of computers and software packages. Exhibit EC-8 is an article from "Tax Notes International" entitled *A FSCful of Dollars: Maximizing FSC Benefits through Transaction Level Pricing*¹¹⁴ which

¹¹⁰ Section 926(a) and 245(c) IRC.

¹¹¹ "Foreign trading gross receipts" are defined in Section 924(a) IRC to represent: (1) the sale, exchange, or other disposition of export property (see above); (2) the lease or rental of export property for use by the lessee outside the US; (3) services which are related and subsidiary to activities described in (1) or (2); (4) engineering or architectural services for construction projects located (or proposed for location) outside the US; and (5) the performance of managerial services for an unrelated FSC or DISC. These receipts are earned by, or allocated to, the FSC as a result of applying intercompany pricing rules. Excluded is passive income.

¹¹² See Section 923(a)(4) IRC.

¹¹³ See Sections 925(a) (1) and (2).

¹¹⁴ Pages 197 to 203, 15 July 1996.

demonstrates how the flexibility built into the administrative pricing rules and in particular the scope for applying them to different groups of transactions can be used to greatly increase benefits.

Eligibility for Administrative Pricing

4.215 The administrative pricing rules are exclusively available for FSC-related transactions. They are available on a transaction-by-transaction basis and can produce results that are quite different from the results produced by the arm's-length pricing rule of Section 482.

4.216 A FSC may use administrative pricing rules, with respect to a sale when the FSC or its agent performs, to the extent they are performed, all of the activities attributed to such sale under:

- the "participation in the sales process" prong of the foreign economic process requirement; and
- the "direct cost" prong of the foreign economic process requirement.

4.217 The FSC, or its agent, must comply with both of the two foreign economic process requirements to earn FSC income exempt from tax on any export transaction. However, the FSC does not need to perform all of these activities outside of the United States in order to obtain the benefits of the administrative pricing rules.

4.218 Similarly, a small FSC need not perform any economic process activities abroad to qualify as a FSC. However, to the extent economic process activities are performed, the small FSC or its agent must perform these activities to qualify for administrative pricing.

Importance of the Administrative Pricing Rules

4.219 The administrative pricing rules are extremely advantageous since the amount of profit that would be attributed to the FSC under the generally-applicable Section 482 IRC rules would be very low in light of the limited role played by the FSC. Their attractiveness is increased by the fact that they can be applied *ex post* and transaction by transaction. The result is that the vast majority of FSC transactions use this method.

4.220 According to Joseph J. Guttentag, International Tax Counsel, Department of the Treasury in his Testimony to the Committee on Finance to the US Senate on July 21 1995 (Exhibit EC-2), "virtually every FSC, whether a commission FSC or a buy-sell FSC) that deals with a related party determines its foreign trade income under one of the two administrative pricing rules".¹¹⁵

Assessment of FSC Scheme from a Tax Perspective

Introduction

4.221 It is useful to briefly consider the FSC scheme from a tax law perspective. The purpose of the FSC scheme is to provide certain exemptions from the otherwise applicable tax rules of the US IRC to the profits arising out of the export of US goods. The basic exemptions comprised in the scheme are contained in the following provisions:

First, the "foreign trade income" of FSCs is excluded from the controlled foreign corporations provisions of Subpart F of the IRC, which would otherwise require such income to be taxed in the United States as income of the parent (Sections 951(e) and 954(d) and (e) IRC).

¹¹⁵ See the last paragraph on page 11 of the testimony.

Second, the “exempt foreign trade income” of the FSC is treated as “foreign source income which is not effectively connected with the conduct of a trade or business within the United States” and thus exempted from US tax which would otherwise be due (Section 921(a) IRC). The terms of Section 921(a) effectively exempts this income from the charge to tax in Sections 882(a)(1) IRC for income of a foreign corporation which is “effectively connected with the conduct of a trade or business within the United States” and the rules in Section 864 IRC which would otherwise make the income US source income.

Third the parent of the FSC is accorded a 100 per cent dividends received deduction (i.e. exemption from US tax) for the dividends received from the FSC from “earnings or profits attributable to foreign trade income” (Section 245(c) IRC). Section 926(a) IRC provides that distributions from FSCs to their parents shall be treated as first coming out of earnings and profits attributable to foreign trade income and thus maximises this exemption.

4.222 However, the main economic benefit for exporters from the FSC scheme derives from the availability of administrative pricing rules contained in Section 925 IRC. These were originally included in the DISC legislation and were carried over into the FSC scheme so as to maintain the same level of benefits. (In fact the level of benefits was increased due to the change from a system of tax deferral to a system of tax exemption). The importance of these provisions requires some explanation.

Transfer Pricing

4.223 It is widely recognised by tax authorities that special rules are needed to deal with the transfer of profits from one taxpayer to another and from one jurisdiction to another through transfer pricing. An international consensus has built up about how to deal with these issues and is set out in the OECD’s “*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*” (“the Guidelines”) contained in Exhibit EC-11.

4.224 The administrative pricing rules of the FSC scheme are a major departure from the principles applied by developed countries to deal with the problem of transfer pricing between related companies as reflected in the Guidelines.

4.225 This governing principle set out in the Guidelines is the arm’s length principle.¹¹⁶ This provides for prices practised between associated enterprises to be adjusted so as to reflect the prices that would have been practised between independent enterprises.¹¹⁷

4.226 The Guidelines state that “... the arm’s length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises”. They go on to state that “In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable”.¹¹⁸

4.227 The Guidelines acknowledge that the existence of alternative methods of deriving an arm’s length price may be appropriate, provided an attempt is made to ensure that the conclusion drawn on any given case from use of alternative methods is consistent with the arm’s length principle.

4.228 Moreover, the alternatives the Guidelines envisage are alternative *methods* to reach an arm’s length price, not alternative *formulae* designed to allocate income/profit returns. The Guidelines draw a clear distinction between application, as part of an authorised transfer pricing method, of formulae developed after careful analysis of the particular facts and circumstances of the case and a method

¹¹⁶ See the first sentence of paragraph 1.1 in Chapter 1 of the Guidelines in Exhibit EC-11.

¹¹⁷ See paragraph 1.6 of the Guidelines in Exhibit EC-11.

¹¹⁸ See paragraph 1.15 of the Guidelines in Exhibit EC-11.

which uses formulae predetermined for all taxpayers and which does not constitute proper application of the arm's length principle.

Section 482 of the IRC and the derogation in Section 925 of the IRC

4.229 The US has adopted the arm's length principle for dealing with transfer pricing between associated enterprises and this is set out in Section 482 IRC with rules for how the arm's length principle should be applied. It provides for a full range of techniques to be employed based on the latest understanding of the arm's length principle as set out in the OECD's Guidelines.

4.230 In particular it should be noted that Section 482 IRC and the regulations adopted under it allows for alternative methods to be employed, but this adoption is subject to approval of the US tax authorities (the IRS), and is not at the taxpayer's free choice. *By definition* the result achieved through its application must be the arm's length price applicable to the transaction concerned.

4.231 Section 925 IRC however allows the taxpayer to choose to adopt one of two alternative fixed formula methods instead of the outcome that would be achieved under Section 482 (subject to meeting relevant FSC conditions). The ability of taxpayers to be able to *choose* an alternative outcome – which is not subject to IRS approval as being consistent with the arm's length principle given the facts and circumstances of the case – means that an outcome which differs from the arm's length outcome is possible.

4.232 Indeed, Section 925 IRC provides that the transfer price shall be in an amount which allows the FSC to derive taxable income “which does not exceed *the greatest of*” the amount resulting from each of the administrative pricing rules and Section 482 (emphasis added). The emphasised words reveal the intent of the legislation to allow the most advantageous result for the taxpayer to be used.

4.233 In fact the result achieved by Section 482 creates a “cap” on effective US tax liability, rather than as a “floor” a suggested by US representatives when trying to justify the FSC scheme.

4.234 Accordingly, the availability of special administrative pricing rules under Section 925 IRC is a clear derogation from the arm's length principle in Section 482 IRC.

The formulae do not approximate to the normal return on the economic activity of FSCs

4.235 The only explanation for the special administrative pricing rules of Section 925 IRC is that they are designed to provide the same level of tax exemption as was previously available under the DISC scheme. They have no basis in the economic activity conducted by FSCs.

4.236 FSCs cover a wide range of economic activity, from agricultural products to a full range of manufacturing enterprises (including food, chemicals, electrical machinery and transportation products). Over the life-cycle, each of these industries will generate very different gross receipts, and very different taxable incomes. It seems unlikely that (say) an agricultural export agent would expect to earn a normal income which represents the same share of total receipts as (say) an export agent handling the export of freight locomotives. The same can be said in relation to combined taxable income. The special administrative pricing rules of Section 925 IRC cannot deliver a sufficiently close approximation to arm's length in such a wide variety of cases over time.

4.237 The availability of a choice between the two formulaic methods on a transaction by transaction basis is also at odds with the manner in which pricing terms would be struck between export agent and independent suppliers. It is inconceivable that the agent/distributor would be offered a choice by an independent manufacturer and certainly not one which it could apply on a transaction by transaction basis. As a matter of arithmetic, the profit split formula will become beneficial for the

FSC once the overall profit margin for the FSC and supplier reaches 8 per cent.¹¹⁹ Even if a margin of 1.83 per cent for the FSC alone were to represent a reasonable approximation of an arm's length result for the economic functions performed when overall profit margins were below 8 per cent, it is difficult to see why the FSC should be able to opt for an ever increasing margin through the use of the alternative formula once overall margins increased beyond 8 per cent.

4.238 In addition to these general arguments, use of standard industry data of this kind is rejected by the OECD Guidelines which state that "... in no event can unadjusted industry average returns themselves establish arm's length conditions". In this context it is notable that the formulae are intended to span more than one industrial sector, which makes this rejection all the more pertinent. Moreover, the Guidelines also reject the use of transactional profit methods which might overtax or undertax enterprises because their profits are less than or greater than the average.¹²⁰

Section 925 produces results which understate US taxation compared with application of the arm's length standard

4.239 As shown above the alternatives to the definitive arm's length standard of Section 482 provided in Section 925 IRC exist for no other purpose than to produce a more favourable result for the US taxpayer.

4.240 This effect is maximised by the fact that Section 925 also permits the taxpayer to choose, on a transaction by transaction basis, between the three alternative pricing methods.

4.241 The examples given in the Article from Tax Notes International entitled "*A FSCful of Dollars: Maximizing FSC Benefits through Transaction Level Pricing*" in Exhibit EC-8¹²¹ serves further to illustrate the point. These examples show that the two formulae give widely disparate results one often being twice the other. Even if the arm's length result lay exactly between the two methods the taxpayer would have considerable scope for departing from arm's length because a free choice of method is available.

4.242 Moreover, if the proposition that the formulae could never produce an outcome yielding less tax than if Section 482 were applied were to hold true, then there should be no circumstances in which the formulae should produce lower transfer prices. Indeed, the alternative formulae ought to produce the same outcome (or one which is sufficiently close to be able to ignore the difference as being within the range of tolerance). The examples clearly demonstrate that this cannot be the case.

Section 925 of the IRC Is Not Justified as A "Safe Harbour"

4.243 Given the options allowed by Section 925, it is clear that companies will adopt the formulaic methods if they result in less US tax being payable than if Section 482 were applied. But it was also suggested that companies might use these methods – and risk paying more US tax than would otherwise be necessary under Section 482 – simply for administrative convenience.

4.244 Apart from the fact that this would mean that such companies would be failing in their fiduciary duty to their shareholders, the incorrectness of this statement is demonstrated by the Article in Tax Notes International referred to above which shows how companies are applying computer software to obtain maximum benefit from the differences between the methods.

¹¹⁹ For the mathematically-minded this is because $1.83\% \times \text{FTGR}$ equals 23% FTI when profit margin is 8%. (FTI equals FTGR x profit margin (p). $1.83\% \times \text{FTGR} = 23\% \times (\text{p} \times \text{FTGR})$. Therefore, $\text{p} = 1.83/23 = 0.0795652173913 = 8\%$ (approx).)

¹²⁰ See paragraph 3.4 of the Guidelines in Exhibit EC-11.

¹²¹ Pages 198 to 202.

4.245 The United States has suggested that its special administrative pricing rules are merely a “safe harbour,¹²²” as provided for in the OECD Guidelines.

4.246 The OECD Guidelines are critical of “safe harbours.¹²³” The Guidelines conclude that “safe harbours are generally not compatible with the enforcement of transfer prices consistent with the arm’s length principle¹²⁴” and that: “special statutory derogations for categories of taxpayers in the determination of transfer pricing are not generally considered advisable, and consequently the use of safe harbours is not recommended¹²⁵”.

4.247 The OECD guidelines concede that safe harbours might be an appropriate way to relieve compliance burdens on small companies. But this is not the purpose of FSCs. The administrative pricing rules in the FSC scheme are not just available to small companies: they are available to all, regardless of size.

Conclusion

4.248 The FSC legislation allows companies to compute their transfer prices *ex post facto* - a procedure that is totally at odds with what would happen at arm's length. At arm's length, parties to transactions generally agree the terms on which they will deal before the transactions take place.

4.249 The special administrative pricing rules are an essential part of the FSC scheme. They are designed to enable taxpayers to maximise the profits accruing in the FSC, and thus the benefits of the scheme. **They are therefore not really "pricing" methods at all, but a mechanism for shifting profits from one company to another.** Pricing decisions at arm's length are not driven by considerations of this kind, but by economic and commercial realities.

The economic effects of the FSC

Introduction

4.250 When the FSC legislation was originally adopted it was provided (Section 804(a) Tax Reform Act 1984) that the US Department of the Treasury would produce [periodic] reports on the operation and effect of the legislation, just as had been done for the DISC scheme before it. In fact only two exist, that for the period 1 January 1985 to 30 June 1988 (Exhibit EC-4), published in January 1993, at and that for 1 July 1992 to 30 June 1993, published in November 1997 (Exhibit EC-5).

4.251 Much of the data on the economic effects of the FSC scheme given below is based on this rather inadequate data. For more recent data it is necessary to go to unofficial sources and a few of these are also enclosed as exhibits.

4.252 One source which has already been mentioned is the entitled *A FSCful of Dollars: Maximizing FSC Benefits through Transaction Level Pricing* Article in “Tax Notes International” pages 197 to 203, 15 July 1996.

4.253 Another source to which the European Communities will refer is an Article from the South Florida Business Journal of 24 February 1997 contained in Exhibit EC-9.¹²⁶

The Economic Importance of the FSC Scheme

¹²² Section IV.E paragraphs 4.94 to 4.123 of the OECD Guidelines in Exhibit EC-11.

¹²³ See esp. paragraphs 4.103(b), 4.104, 4.105, 4.106, 4.107, 4.120, final sentence, 4.121, 4.123 of the OECD Guidelines in Exhibit EC-11.

¹²⁴ Paragraph 4.121 of the OECD Guidelines in Exhibit EC-11.

¹²⁵ See final sentence of paragraph 4.123 of the OECD Guidelines in Exhibit EC-11.

¹²⁶ Available from the Internet on <http://www.amcity.com/southflorida>.

4.254 The number of active FSCs increased from 2,613 in 1987 to 3,073 in 1992.¹²⁷ According to the Article by David Wallace from the South Florida Business Journal of 24 February 1997, the number had reached 5000 by 1997. According to articles in the Economist¹²⁸ and the Journal of Commerce¹²⁹ there are about 6,000 FSCs today.

4.255 According to the Treasury Reports, the Foreign Trading Gross Receipts of FSCs doubled from US\$84,280 million in 1987 to \$152,263 million in 1992. Net Exempt Income increased over the same period from \$2,111 million to \$4,508 million.

4.256 The US Treasury has estimated the revenue cost of the FSC programme. This is estimated by increasing the taxable income of the US shareholders by the amount of exempt FSC income attributable to them and using a tax calculator to determine their new US tax liability. The revenue cost of the FSC programme was estimated to be US\$1,380 million in calendar year 1992. In its 1997 report, the Treasury estimated that, on the assumption that FSC exports grew at an annual average of 8 per cent, the revenue cost would increase steadily to \$2,080 million in 1997.¹³⁰ However, as noted above, other sources indicate that the total number of FSCs, has increased much more and The Economist claims that since 1993 the total benefit generated by FSCs has probably tripled (Article of March 1998).

4.257 Another indication that the importance of the FSC scheme is growing is the fact that it was expanded to cover computer software in 1997.¹³¹

A breakdown of FSC benefits to different sectors

4.258 Manufactured products account for the vast majority of FSC generated exports. Classified by the "gross receipts" of FSCs, all manufactured products accounted for \$136,287 million out of a total of \$152 billion in 1992. Non-manufactured products and services, including agriculture, accounted for \$15,747 million in 1992.¹³²

4.259 The largest exported product groups were in 1992:

	Gross receipts in \$ million
<u>Manufactured goods:</u>	
Non-electrical machinery:	29,758
Chemicals	29,285
Electrical machinery	21,121
Transportation equipment	18,125
Others	37,998
Subtotal:	136,287
<u>Non-manufactured products and services</u>	
Agricultural products	8,116
Other non-manufacturing	7,631
Subtotal	15,747
Total	152,034

¹²⁷ Based on a comparison of the two US Treasury reports on FSCs.

¹²⁸ 7 March 1998.

¹²⁹ 2 December 1997.

¹³⁰ See *The Operation and Effect of the Foreign Sales Corporation Legislation*, Department of the Treasury, November 1997 in Exhibit EC-5, at p.12-17. The estimates for future growth are contained in Table 5.1 on page 17.

¹³¹ By Section 1171(a) of Public Law 105-34 amending subsection (a)(2)(B) of Section 927 IRC.

¹³² See *Daniel S. Holik*, Foreign Sales Corporations, 1992, at p.121-128 EC Exhibit EC-12.

Trade effects of FSCs

4.260 The benefits accruing to US exporters through the FSC scheme allow them to price their goods more cheaply and market them more aggressively than would be the case in the absence of the FSC scheme. This according to the US Treasury report of 1997 report: “The FSC program encourages exports by reducing the tax rate on export income”¹³³ (page 10).

4.261 In its 1992 and 1997 reports, the Treasury has estimated the “export stimulus” of the FSC program. It depends on three factors:

- how great is the tax saving for exports?
- how responsive is the US export supply to a change in the export price (the elasticity of the US export supply¹³⁴)? and
- how responsive is the foreign demand for US exports to a change in their price (price elasticity of foreign demand for US exports)?

4.262 Chapter 4 of the report for the period from 1 July 1992 to 30 June 1993, the most recent available to the European Communities, states that “overall the FSC programme is estimated to have increased US exports by about US\$1.5 billion in 1992”. This is based on a sophisticated econometric model that even allows for the fact that the increased exports generated by the FSC scheme increase the exchange rate of the US dollar and thus tend to reduce exports in those sectors where FSCs cannot be used. Even allowing for the increased imports resulting from the same exchange rate effect the overall effect of the FSC scheme on the US balance of trade in goods was estimated to be US\$0.6 billion. The effect in each sector is set out in Table 4.1 on page 15 of Exhibit EC-5. Since then the use of FSCs has expanded and new sectors such as software have been included so that the overall benefit to the US balance of trade in goods must now be much larger. This overall advantage to US trade in goods is of course the consequence of a large number of beneficial effects at the level of individual export transactions.

4.263 The estimated overall annual export gain to US industry in 1987 and 1992 amounted to \$1.2 billion and \$1.5 billion, respectively. As a rough estimate, the total export stimulus created by FSCs, since they were created in 1985, may therefore amount to \$20 billion.

4.264 According to the US Treasury Report published in 1997, the sectors with the highest export gain were in 1992:

	US\$(million)
• Non-electrical machinery	700
• Electrical machinery	700
• Scientific instruments	170
• Lumber and wood	130
• Chemicals	100

The cost of setting up a FSC

4.265 There are only a few requirements for FSC action outside the United States. The actual incorporation and running of an FSC does not normally cost more than US\$2,000 per year.¹³⁵ Moreover, to reduce administrative costs up to 25 US corporations may jointly set up an FSC. Most

¹³³ Exhibit EC-5 at page 10.

¹³⁴ Export supply is generally believed to be highly price elastic, because output can be diverted away from domestic consumption toward export markets.

¹³⁵ See Article by David Wallace from the South Florida Business Journal of 24 February 1997 contained in Exhibit EC-9 quoting Robert Thornton of Export FSC International Ltd.

FSC exporters do not set up local operations but use FSC service providers. Most of the FSCs operate in jurisdictions that impose little or no tax.

A comparison of DISC and FSCs

4.266 It has already been noted above that the FSC scheme was designed to replace the DISC legislation of 1971 but to be functionally equivalent. The DISC legislation had been part of a package of “new economic policy”. Congress sought to generate additional exports, while keeping the loss of tax revenues as low as possible. DISCs were not taxed on their profits; the shareholders paid the tax on a pro rata basis when DISC income was repatriated to them. The income was then treated as foreign source income, entitling the shareholders to a tax credit against their tax liabilities. Resulting tax could be deferred indefinitely. This system encouraged exports by lowering the effective tax rate on export income.

4.267 Available figures show that, as was intended by Congress, DISC and FSC programmes provide roughly for the same amount of tax incentives. The Treasury’s report on the operation and the effect of DISCs during the period 1981-1983 estimates the revenue cost of the DISC programme as US \$1.5 and 1.24 billion for 1982 and 1983, respectively. This is within the same range as the \$1.3 billion FSC revenue cost calculated by the Treasury for 1992 (see above).

Legal Arguments

FSC scheme is a subsidy within the meaning of Article 1 of the SCM Agreement

Definition of subsidy

4.268 The notion of subsidy for the purposes of the SCM Agreement is defined in its Article 1.1. The relevant part for the purposes of the present dispute is as follows:

“1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as “government”), i.e. where:

...

(ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)¹³⁶;

...

and

(b) a benefit is thereby conferred.”

4.269 The European Communities will be identifying and objecting to two subsidies in the FSC scheme in the following legal analysis.

4.270 The first is the *tax exemptions* comprised in the FSC scheme. These are essentially:

- The exclusion of the “foreign trade income” of FSCs from the controlled foreign corporations provisions of Subpart F of the IRC (Sections 951(e) and 954(d) and (e))

¹³⁶ There is a footnote to sub-paragraph (ii) which provides that certain practices concerning taxes on goods (i.e. indirect taxes) shall not be deemed to be a subsidy, but this is not relevant to the present dispute.

IRC);

- The exemption from US tax which would otherwise be due on the “exempt foreign trade income” of the FSC (Section 921(a) IRC).
- The fact that the parent of the FSC is accorded a 100 per cent dividends received deduction (i.e. exemption from US tax) for the dividends received from the FSC from “earnings or profits attributable to foreign trade income” (Section 245(c) IRC in conjunction with Section 926(a)).

4.271 These exclusions, exemptions and deductions (hereafter referred to as the “tax exemptions”) complement each other and lead, as they are intended to lead, to less tax being paid than would be the case if the FSC scheme did not exist (or rather if it did not contain the tax exemptions).

4.272 The tax exemptions by themselves would be of relatively little economic significance if they were not compounded by the existence of the second of the subsidies which the European Communities identifies and objects to. That is availability for the calculation of the exempt foreign trade income of FSCs of *special administrative pricing rules* which derogate from the transfer pricing rules which would otherwise apply. These increase the non-taxed profits of FSCs and reduce the taxed profits of the parent companies and consequently decrease the tax burden on exports effected under the FSC scheme.

4.273 The European Communities makes this distinction between two aspects of the FSC scheme because each could exist in the absence of the other and it is important that both be held to be prohibited export subsidies so that both will have to be withdrawn.

4.274 When these two aspects of the FSC scheme are both being referred to in the remainder this submission they will be termed the “FSC subsidies”.

4.275 The European Communities will proceed to establish first that each of the FSC subsidies involves a financial contribution by the US Government within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement. It will then show that these confer a benefit within the meaning of Article 1.1(b) of the SCM Agreement before turning to examine their export contingency (which also establishes their specificity).

Financial Contribution by Government

4.276 Both aspects of the FSC scheme identified as subsidies above result in revenue forgone for the United States within the terms of Article 1.1(a)(ii) of the SCM Agreement.

The FSC tax exemptions

4.277 In order to show that revenue is forgone as a result of the *tax exemptions* it is necessary to compare the tax arising on a transaction qualifying under the FSC scheme with that which would arise if the FSC scheme did not exist or that arising on an equivalent transaction which does not qualify. There are a number of comparisons which can be made, such as the following:

If the FSC scheme did not exist or if the export transaction through a FSC were not to qualify under the scheme (for example because it involved the export of goods from *another territory* than the United States, or the local content conditions were not satisfied), no part of the FSC’s income from that transaction would be “exempt foreign trade income” and it would be subject to United States taxation. The existence of the FSC scheme, or the applicability thereof to the transactions, will therefore lead to revenue forgone.

If the FSC were to conduct an *import* transaction on behalf of its parent or sell the goods of its parent to a customer in the United States instead of conducting an export transaction, no part of the

FSC's income from those transactions would be "exempt foreign trade income" and it would be subject to United States taxation. The availability of the FSC scheme for the export transaction would lead to revenue forgone compared with the tax payable on the equivalent import or domestic transactions.

If a manufacturer were to sell the goods on the domestic market or to export the goods directly itself instead of passing through the FSC, no part of the profit would be exempted from tax and thus the tax paid would be higher. The use of the FSC therefore leads to revenue forgone.

4.278 There are some cases, as explained in the Testimony of Joseph J. Guttentag in Exhibit EC-2¹³⁷, where the tax position of the parent (excess unused foreign tax credits from other transactions) is such that it may be advantageous not to export through the FSC but to export directly.

4.279 The situation where it is advantageous to export directly rather than through an FSC will be exceptional. But in any event it does not prevent the FSC tax exemptions from constituting a subsidy in the majority of cases where they do lead to revenue forgone and are beneficial. Exporters have a choice, which they do not have for non-FSC qualifying transactions such as domestic transactions or for import transactions.

The Administrative Pricing Rules

4.280 The application of special administrative pricing rules to transactions of FSCs compounds the revenue forgone resulting from the tax exemptions and also gives rise to an additional financial contribution from government in the form of revenue forgone compared with the situation which would prevail if the normal transfer pricing rules of Section 482 of the IRC had to be applied.

4.281 An FSC has a choice between calculating its profits on the basis of the generally applicable transfer pricing rules contained in Section 482 of the IRC and the special "administrative pricing rules" contained in Section 925 of the IRC, if it satisfies the conditions set out in Section 925(c) IRC. The use of these rules, and in particular the fact they may be used *at the option* of the taxpayer, *ex post* and on a transaction by transaction basis when they give a more favourable result, have as a consequence lower tax revenues for the US Government than would be the case if these rules did not exist. Revenue is therefore forgone.

4.282 The amount of the revenue forgone as a result of the application of the administrative pricing rules is the difference between the extra tax that would be collected if Section 482 IRC were applicable in the same way as for all other transactions between related companies compared with the tax that is in fact collected with the special administrative pricing rules in existence. (Most FSCs use exclusively the administrative pricing rules).¹³⁸

4.283 The US Government has itself calculated the effect of the FSC scheme on US tax revenues. According to the Treasury Report published in 1997, "the revenue cost of the FSC programme is estimated to be \$1,380 million for calendar year 1992."¹³⁹ It furthermore estimated that it would increase to over US\$2,000 million in 1997. This estimate is based on the US Government's normal methodology and assumes that the profits of the FSCs would be normally taxed in the hands of the parents. It therefore corresponds to the revenue which is forgone as a result of the existence of FSCs.

4.284 The above estimate is based on data of five years ago. In view of the great increase in the number of FSCs and the increasing sophistication with which they are being exploited to obtain

¹³⁷ See pages 11-12 in Exhibit EC-2.

¹³⁸ See Testimony of Joseph J. Guttentag in Exhibit EC-2, p. 11.

¹³⁹ Exhibit EC-5 at p. 16.

exemption from tax for profits from export sales.¹⁴⁰ The revenue actually forgone at present is probably much greater.

A benefit is conferred

4.285 In the present case, the existence of a benefit conferred in the form of a financial advantage to FSCs and their parents is evident, for both of the subsidies identified above (the tax exemptions comprised in the FSC scheme *per se* and application of the special administrative pricing rules), since the revenue which the United States is forgoing is equal to the sum of money which does not have to be paid in taxes by FSCs and their parents. This sum of money remains the property of the FSCs and their parents and benefits them.

4.286 Since FSCs are an artificial tax device, it may be argued that they would not exist in the absence of the tax exemptions and that this reduces the benefit. However, the fact that a benefit exists despite these costs is evident from the fact that FSCs are not obligatory and therefore are only used when they do give rise to a benefit.

4.287 The existence of the special administrative pricing rules also give rise to an additional benefit. The use of these rules will reduce costs since the rules are more certain and involve less discussion and negotiation with the tax authorities. There is therefore an additional benefit arising out of the increased certainty (the so-called “safe harbour” effect).

4.288 The benefit conferred by the FSC subsidies leads to a price advantage for the exported goods and thus leads to an overall increase in the export of United States goods.

Specificity

4.289 Article 1.2 of the SCM Agreement provides that only subsidies which are specific are subject to Parts II, III, and V of the SCM Agreement. Article 2 of the SCM Agreement defines specificity and Article 2.3 provides that any subsidy falling under Article 3 is deemed to be specific. The applicability of Article 3 is examined below.

Conclusion

4.290 If the FSC subsidies fall within Article 3 of the SCM Agreement (which will be shown below), they constitute subsidies subject to the SCM Agreement within the meaning of Articles 1 and 2 of the SCM Agreement.

The FSC subsidies are contingent in law upon export performance contrary to Article 3.1(a) of the SCM Agreement

4.291 In this section, the European Communities will demonstrate that the FSC subsidies (both the tax exemptions comprised in the FSC scheme *per se* and that arising from the application of the administrative pricing rules), are contingent in law upon export performance contrary to Article 3.1(a) of the SCM Agreement. The European Communities will first demonstrate that the FSC subsidy falls squarely under Article 3.1(a). It will then demonstrate that it also falls under item (e) of Annex I to the SCM Agreement.

Article 3.1(a) of the SCM Agreement

4.292 Article 3.1(a) is entitled “Prohibitions” and provides in relevant part as follows:

¹⁴⁰ See the Article from “Tax Notes International” entitled “A FSCful of Dollars: Maximizing FSC Benefits through Transaction Level Pricing” in Exhibit EC-8.

“Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

- (a) subsidies contingent, in law or in fact¹⁴¹, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I¹⁴²;

4.293 Article 3.1 of the SCM Agreement starts with the words “except as provided in the Agreement on Agriculture”. It will be demonstrated in Section C below that the AA does not provide any relevant exception for FSCs exporting products falling under that Agreement but that on the contrary, the FSC scheme violates the provisions of the AA.

4.294 The FSC subsidy which arises from the tax exemptions comprised in the FSC scheme *per se* results from the forgoing of tax revenues which would otherwise accrue on:

- the “exempt foreign trade income” of the FSC as defined in Section 921(a) IRC; and
- the dividends received by the parent from the FSC from “earnings or profits attributable to foreign trade income” of the FSC within the meaning of Section 245 (c) IRC in conjunction with Section 926 IRC.

4.295 The FSC subsidy which arises from the application of the administrative pricing rules results from the increase in the “exempt foreign trade income” of the FSC and corresponding reduction in the direct profit of the parent from the transaction compared with the situation that would prevail if the normal transfer pricing rules of Section 482 of the IRC were applied to the transaction.

4.296 Both the FSC tax exemptions *per se* and the increase in the amount of those tax exemptions arising out of the application of the administrative pricing rules, depend on the existence and amount of “exempt foreign trade income” (the amount of the FSC’s income that does not bear tax). This can only be produced by the export of United States goods. The revenue forgone and the benefit increase with each export transaction relating to United States goods and do not increase if non-qualifying (e.g. domestic or import) transactions are conducted. Neither the tax exemptions nor the advantages arising from the use of the special administrative pricing rules are available in respect of domestic transactions.

4.297 “Exempt foreign trade income” as defined in Section 923(a)(1) depends on “foreign trade income” as defined in Section 923(b) which depends on “foreign trading gross receipts” as defined in Section 924(a) IRC and these derive from the “gross receipts of any FSC which are from the sale, exchange, or other disposition of export property” or the “lease or rental of export property for use by the lessee outside the United States”¹⁴³.

4.298 “Export property” is defined in Section 927(a) IRC as being property:

“(A) manufactured, produced, grown, or extracted in the United States by a person other than a FSC,

¹⁴¹This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

¹⁴²Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement.

¹⁴³Receipts from certain services connected with export transactions can also give rise to foreign trading gross receipts under Section 924 (a), but these are not relevant for this case.

(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct use, consumption, or disposition outside the United States, and

(C) not more than 50 per cent of the fair market value of which is attributable to articles imported into the United States.”

4.299 Consequently, only revenue derived from the export of United States goods qualifies for the tax exemptions and the use of the special administrative pricing rules. It is difficult to imagine a clearer case of *de jure* export contingency.

Item (e) of Annex I to the SCM Agreement

4.300 Article 3.1(a) of the SCM Agreement expressly provides that the subsidies contingent upon export performance illustrated in Annex I to the SCM Agreement are included in the prohibition.

4.301 Item (e) of the illustrative list deals with direct tax measures such as the FSC scheme. It deems to be a prohibited export subsidy:

“The full or partial exemption remission, or deferral specifically related to exports, of direct taxes¹⁴⁴ or social welfare charges paid or payable by industrial or commercial enterprises.¹⁴⁵”

4.302 The tax exemptions comprised in the FSC scheme have all the features required by the text of item (e). They are:

- exemptions
- specifically related to exports
- of direct taxes
- payable by industrial or commercial enterprises.

¹⁴⁴ For the purpose of this Agreement:

- The term "direct taxes" shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property;
- The term "import charges" shall mean tariffs, duties, and other fiscal charges not elsewhere enumerated in this note that are levied on imports;
- The term "indirect taxes" shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges;
- "Prior-stage" indirect taxes 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;
- "Remission" of taxes includes the refund or rebate of taxes;
- "Remission or drawback" includes the full or partial exemption or deferral of import charges.

¹⁴⁵ The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence.

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

4.303 As explained above, the FSC scheme exempts part of the FSCs foreign trade income from United States tax, and exempts the dividends arising out of that income from tax in the hands of the parent. The subsidy arising out of the application of the special administrative pricing rules increases the exemption and is thus in itself also an exemption. In addition the fact that this is to be considered an exemption (or perhaps a remission) of direct taxes is confirmed by footnote 59 to item (e) which states that “the Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length.” As explained, the FSC special administrative pricing rules do not comply with the arms length principle and are a derogation from it designed to shift profits from export sales into a tax exemption.

4.304 Both the tax exemptions *per se* and the special administrative pricing rules are “specifically related to exports” since they are conditional upon exportation of United States goods and limited in scope to the extent of such exportation.

4.305 The exemptions and the special administrative pricing rules all relate to direct taxes, that is to say income tax.

4.306 The taxes involved are those payable by FSCs, which are commercial enterprises exporting United States goods, and their parents, which are either industrial or commercial enterprises.

4.307 Accordingly, the FSC subsidies also fall within item (e) of the illustrative list and this confirms the clear terms of the prohibition in Article 3.1(a) of the SCM Agreement.

Conclusion

4.308 The FSC scheme is a clear prohibited subsidy within the meaning of Article 3.1(a) of the SCM Agreement and item (e) of the Illustrative list in Annex I to the SCM Agreement.

The **United States** responds in its First Submission as follows:

Factual Background

4.309 This dispute involves an attempt by the European Communities to reopen issues that the GATT resolved long ago, and to call into question well-established tax principles that guide almost all WTO Members in exercising their tax sovereignty, including members of the European Communities. In particular, implicit in the European Communities' claims is a request that this Panel reject the fundamental principle that income attributable to foreign economic processes need not be taxed. The last time this issue was raised, the GATT found itself ensnared in a decade-long dispute that impaired the GATT's ability to achieve its mission of reducing trade barriers, underscoring that a trade-based organization is not the most appropriate body to establish fundamental, international norms of taxation.

4.310 The FSC regime, which was designed to conform to GATT principles, incorporates salient features of territorial and other common tax systems, including those of European Communities member States. If the FSC confers an illegal export subsidy, so too do the tax systems of many European countries that are based on territoriality or that incorporate territoriality principles. Indeed, the European Communities' assertions have a familiar ring, because these same issues were debated in the GATT in the 1970s and early 1980s in the context of the *Tax Legislation Cases*. The reports in the *Tax Legislation Cases* ruled that the US Domestic International Sales Corporation (“DISC”) provisions and the income tax regimes of France, Belgium and the Netherlands had some attributes of export subsidies that were impermissible under GATT 1947. The parties agreed to the adoption of all four panel reports only after negotiating a set of principles that, in an unusual step, were reflected in a decision of the GATT Council (the “1981 Council Decision”). That decision, in effect, permitted France, Belgium, and the Netherlands to maintain their export-favoring tax systems without basic change, and provided a clear-cut territoriality test that served as a guideline for the United States to

conform its tax system to GATT subsidy disciplines. In 1984, in order to achieve a resolution of the DISC controversy, the US Congress replaced the DISC with the FSC. Congress carefully designed the FSC so as to comply with all applicable trade rules. Now, years after the fact, and in the absence of any alteration in the applicable rules, the European Communities challenges the FSC, even though its structure is based on territorial and related principles of taxation that many European Communities members themselves employ.

4.311 Accordingly, a full understanding of the present dispute requires a detailed review of the US and European tax systems, as well as the history of the *Tax Legislation Cases*, because the FSC was born from the embers of that dispute, and, indeed, was part of the solution to that controversy.

Tax Systems and the GATT and WTO

National Tax Systems Vary in Their Territorial Reach

4.312 The taxation systems of sovereign nations are diverse. The US tax system is different from the tax regimes of the European Communities countries, and the tax regimes of the European Communities countries differ markedly among themselves. There are two generally recognized grounds for any nation to tax income: jurisdiction over the recipient of the income based on the residence of the taxpayer, and jurisdiction over the activity that produces the income (*i.e.*, the source of the income).¹⁴⁶ Under the residence principle, a country taxes the worldwide income of persons subject to its jurisdiction (the worldwide system of taxation). Under the source principle, a country taxes income earned within its borders (the territorial system of taxation). Most countries tax under a mix of both principles.¹⁴⁷

4.313 Because sovereign nations apply different tax regimes, one country's tax on residence income may be duplicated by another country's tax on the same income based on source. Most countries have developed principles to accommodate these competing claims in order to avoid or mitigate double taxation. Countries that apply a territorial system avoid double taxation by exempting (*i.e.*, not taxing) income earned outside of the country's territorial borders (the exemption approach), whether earned by a foreign subsidiary or a foreign branch of a domestic corporation. In the case of a foreign corporation, this is accomplished by exempting the income earned by the foreign corporation and by exempting the income when transferred to the shareholder as a dividend. Countries that tax on a worldwide basis generally mitigate double taxation by allowing a tax credit against the resident country tax for income taxes paid by the taxpayer to a foreign country on income subject to taxation by that country (the foreign tax credit approach). In some cases, a combination of exemption and foreign tax credit methods are used, as applicable, to different categories of income.

The US Tax System

4.314 The US tax system generally operates on a worldwide basis. The United States taxes all of the income of US residents, as well as the income of nonresidents arising within US borders. The United States imposes income taxes on, among other taxable persons, all US corporations. Because the United States defines the residence of corporations for tax purposes purely on the basis of place of incorporation, a US corporation is defined as one that is organised under the laws of one of the 50 states within the United States, or the District of Columbia.¹⁴⁸ The US system taxes all income earned by US corporations, regardless of where that income has been earned or whether it was earned by a foreign branch office.

¹⁴⁶ Edward H. Gardner, *Taxes on Capital Income: A Survey*, in George Kopits, ed., *Tax Harmonization in the European Communities: Policy Issues and Analysis*, IMF Occasional Paper No. 94 (Washington, D.C. 1992), p. 52 (copy attached as US Exhibit 5).

¹⁴⁷ *Id.*

¹⁴⁸ Section 7701(a)(4) of the IRC (copy attached as US Exhibit 12).

4.315 On the other hand, the United States generally exempts from direct taxation all income of foreign corporations that has been earned outside the United States. Foreign corporations are defined as all corporations that do not fit the criteria of US corporations; *i.e.*, corporations organized outside the 50 states and the District of Columbia.¹⁴⁹ This definition includes corporations organized in US possessions.

4.316 The exemption of foreign corporations from direct US income tax on their foreign-source income applies even to foreign subsidiaries of US corporations. The United States generally taxes income of such subsidiaries only at the time it is transferred to the US parent company in the form of dividends. The period of exemption between the earning of such income by the subsidiary and the transfer to the US parent company is termed “deferral” under the US tax system.

4.317 Because of the potential for tax avoidance, the United States has adopted a series of “anti-deferral” regimes that constitute targeted exceptions to the general norm of deferral and that respond to specific concerns. One of these regimes is Subpart F of the Internal Revenue Code, which limits the benefits of deferral for certain types of income earned by certain controlled foreign subsidiaries of US companies.¹⁵⁰

European Tax Systems

4.318 In contrast to the United States, many European countries impose income taxes, at least in part, on a territorial basis. To the extent that European governments tax income on a territorial basis, only income arising from economic activity conducted within the territory of the taxing jurisdiction is subject to tax. Under these territorial tax systems, the home country generally does not tax income from economic activity conducted outside the territory of the taxing jurisdiction, regardless of whether such activity is conducted by a domestic or foreign corporation.¹⁵¹ Such a tax exemption for income from offshore economic activity can include income derived from the sale of goods exported from the home country, and, in some circumstances, whether or not any foreign tax is imposed.

4.319 Accordingly, as opposed to a worldwide system, such as that of the United States, many European tax systems provide more favorable treatment for exporters of goods and services. This is because whenever activities related to an export transaction occur outside of the territory of the taxing jurisdiction, income from such activities is not taxed under territorial or territorial-type systems.

Neither the GATT Nor the WTO Requires That Members Adopt a Particular Tax System

4.320 There is no rule of international law that requires nations to conform to a single tax system. A country can have a worldwide system, a territorial system, or a system that incorporates elements of both. In recognition of principles of tax sovereignty, a country using the worldwide system is free to incorporate elements of a territorial system (or *vice versa*), so that a foreign subsidiary, or particular kinds of foreign subsidiaries, such as a FSC, are taxed in a manner similar to foreign corporations under a territorial system (exemption of income plus an exemption for dividends) or are taxed like a foreign branch might be taxed under a territorial system (exemption).

4.321 The WTO never was intended (and is not well equipped) to establish international tax norms, especially when there is such diversity in accepted tax practices. The WTO certainly should not penalize a country using a worldwide system for incorporating elements of a territorial system in order to obtain comparable tax treatment. However, that is *precisely* what the European Communities is asking the Panel to do.

The DISC

¹⁴⁹ Section 7701(a)(4) and (9) of the IRC (copy attached as US Exhibit 12).

¹⁵⁰ Section 951 of the IRC. *See* Exhibit EC-1.

¹⁵¹ In the case of a foreign corporation, this is accomplished by exempting income earned by the foreign corporation and exempting profits from tax when distributed back to the parent corporation as a dividend.

4.322 In 1971, the United States established a system of tax deferral for corporations known as DISCs and for their shareholders to correct the inherent advantage enjoyed by European exporters, as compared to US exporters; *i.e.*, the fact that under European territorial systems, income earned offshore by European exporters was (and continues to be) exempt from taxation.

4.323 A DISC was a *domestic* subsidiary of a US company engaged in exporting, and the DISC regime had very strict qualifying rules requiring that they participate almost exclusively in export transactions. The income of a DISC was not taxed directly by the United States, and DISCs were not required to file tax returns separate from their parent company's tax returns. Instead, DISC income was taxed when it was paid as a dividend to the US parent company. Each year, the DISC was deemed to have paid a portion of its income from export transactions as a dividend to the parent company, thereby subjecting the parent to taxation on that income. US income tax on the remainder of the DISC's income could be deferred without an interest charge until the income was actually paid to the parent company (or certain other events occurred).

The Tax Legislation Cases

4.324 In February 1972, the requested GATT 1947 dispute settlement consultations regarding the DISC, alleging that the DISC constituted an export subsidy under Article XVI of GATT 1947. The United States responded by requesting similar consultations with France, Belgium and the Netherlands, alleging, in effect, that if the DISC was a subsidy, then the income tax laws of those countries resulted in at least the same tax subsidy to their exporters as the DISC allegedly provided to US exporters. The United States noted that these countries followed the territorial principle of taxation or otherwise did not tax income earned from foreign activities in export sales. As a result, the United States argued, those countries did not tax export sales income of foreign branches or foreign sales subsidiaries of domestic manufacturing firms – a more favourable treatment than DISC, which merely provided for a deferral of tax.

4.325 The United States and the European Communities requested the establishment of panels concerning their respective claims, and four panels, each with the same membership, were established.¹⁵² The panel issued its reports in the four cases on 2 November 1976¹⁵³, finding that both the DISC and the European tax systems had characteristics of an export subsidy.¹⁵⁴

4.326 With respect to the European practices, the panel found that basic features of a territorial tax system may themselves constitute an illegal subsidy, even though "the practices may have been an incidental consequence of . . . taxation principles rather than a specific policy intention [to favor exports]."¹⁵⁵ The panel found that the "application of the territoriality principle," in the case of Belgium and France, and the "application of the world-wide principle by the Netherlands, in conjunction with the qualified exemption in respect of foreign income," in each case:

allowed some part of the export activities belonging to an economic process originating in the country, to be outside the scope of [the applicable country's] taxes. In this way [the country]

¹⁵² In light of the identical membership, the United States will use the singular term "panel."

¹⁵³ *Tax Legislation - United States Tax Legislation (DISC)*, L/4422, BISD 23S/98, Report of the panel adopted 7-8 December 1981; *Tax Legislation - Income Tax Practice Maintained By France*, L/4423, BISD 23S/114, Report of the panel adopted 7-8 December 1981; *Tax Legislation - Income Tax Practice Maintained By Belgium*, L/4424, BISD 23S/127, Report of the panel adopted 7-8 December 1981; *Tax Legislation - Income Tax Practice Maintained By The Netherlands*, L/4425, BISD 23S/137, Report of the panel adopted 7-8 December 1981.

¹⁵⁴ Specifically, the panel concluded that "the DISC legislation in some cases had effects which were not in accordance with the United States obligations under Article XVI:4 [of GATT]." BISD 23S/98, paragraph 74. The panel also noted that "the deferral did not attract the interest component of the tax normally levied for late or deferred payment and therefore . . . to this extent, the DISC legislation constituted a partial exemption which was covered by . . . the illustrative list." *Id.*, at paragraph 71.

¹⁵⁵ See, e.g., BISD 23S/137, paragraph 35.

has foregone revenue from this source and created a possibility of pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries.¹⁵⁶

4.327 The panel's rulings against the European tax practices were based on three propositions: (1) that income generated by the economic processes of a foreign branch or subsidiary properly may be viewed as "originating in" the country in which the parent company engages in export activities; (2) that foregoing tax revenue on income attributable to these foreign economic processes creates the possibility of a pecuniary benefit to exports from low tax rates in the foreign country in which those processes occur; and (3) that a subsidy on exports may arise if this benefit is not also available with respect to income attributable to domestic activities. As discussed below, the GATT Council essentially rejected these propositions.

The 1981 Council Decision

4.328 France, Belgium, and the Netherlands refused to accept the findings against them, essentially claiming that the GATT rules never had been intended to prohibit particular tax systems or to require the taxation of foreign source income.¹⁵⁷ For its part, the United States refused to accept the DISC finding unless the Council adopted the panel rulings on the European tax practices. The parties finally agreed to the adoption of all four reports subject to an understanding that was reflected in a decision of the Council and that essentially reversed the rationale of the panel reports. That decision provided as follows:

The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign income.¹⁵⁸

4.329 Following adoption of the reports, the Chairman of the Council noted that the Council's decision did "not mean that the parties adhering to Article XVI:4 are forbidden from taxing the profits on transactions beyond their borders, it only means that *they are not required to do so*."¹⁵⁹

4.330 Thus, the 1981 Council Decision set forth three basic legal rules that permitted the exemption of certain export-related income from tax without running afoul of GATT anti-subsidy rules:

- foreign economic processes need not be taxed by the exporting country;
- arm's-length pricing should be observed; and
- measures can be adopted to avoid double taxation of foreign income.¹⁶⁰

¹⁵⁶ BISD 23S/114, paragraph 47; BISD 23S/127, paragraph 34; and BISD 23S/137, paragraph 34.

¹⁵⁷ These three countries stated their positions in the following memoranda: GATT Doc. Nos. C/97/Rev. 1 (21 March 1977) and C/97/Add. 1 (21 July 1977) (France); GATT Doc. Nos. C/98 (15 March 1977) and C/98/Add. 1 (21 November 1977) (Belgium); and GATT Doc. No. C/99 (15 March 1977) (the Netherlands).

¹⁵⁸ *Tax Legislation*, BISD 28S/114 (December 7-8, 1981). The United States agreed to adoption of the DISC report without conceding that the DISC violated the GATT.

¹⁵⁹ *Id.* (Emphasis added).

4.331 The 1981 Council Decision effectively overruled the panel's decisions with respect to France, Belgium, and the Netherlands, and established a clear-cut territorial test for determining whether a particular income tax measure constitutes an export subsidy; namely, that income attributable to activities taking place outside the territory of the taxing country need not be taxed, and that a decision not to tax such income does not give rise to an export subsidy. This test permitted France, Belgium and the Netherlands to retain their export-favoring territorial-type systems, while at the same time providing the United States with clear rules for how it might modify its tax laws so as to provide, in a GATT-consistent manner, the same treatment provided by European governments to their exporters. The rules contained in the 1981 Council Decision built upon the rules contained in the Subsidies Code, and those rules were not altered during the Uruguay Round negotiations that resulted in the SCM Agreement.

Overview of the FSC

Enactment of the FSC

4.332 Although the initial US view was that the 1981 Council Decision validated the DISC¹⁶¹, in order to resolve the DISC dispute, in October 1982, the United States made a commitment to the GATT Council to propose legislation that would address concerns of other GATT Contracting Parties. In March 1983, the US Administration approved the general outlines of a proposal to replace the DISC with a territorial-type system of taxation for US exports designed to comply with GATT subsidy rules. As with the DISC, the goal of the FSC legislation was to redress, to some extent, the imbalance accorded US exporters as the result of differing approaches between the European system of territorial taxation and the US worldwide system of taxation.

4.333 In 1984, Congress enacted the Deficit Reduction Act of 1984, Title VIII of which replaced the DISC with the FSC.¹⁶² In the accompanying legislative materials, Congress expressed its intention that the FSC legislation be GATT-consistent:

Under GATT rules, a country need not tax income from economic processes occurring outside its territory. Accordingly, Congress believed that certain income attributable to economic activities occurring outside the United States should be exempt from US tax in order to afford US exporters treatment comparable to what exporters customarily obtain under territorial systems of taxation.¹⁶³

¹⁶⁰ The last two rules were drawn virtually *verbatim* from Footnote 2 to Item (e) of the Illustrative List of Export Subsidies annexed to the Tokyo Round Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade ("Subsidies Code"), which entered into force on 1 January 1980. The Subsidies Code Illustrative List represented the results of further agreements to update the 1960 Illustrative List that the panel had relied on in each of the reports in the *Tax Legislation Cases*. See BISD 23S/98, paragraph 28; BISD 23S/114, paragraph 50; BISD 23S/127, paragraph 37; and BISD 23S/137, paragraph 37. The three European countries each cited the Subsidies Code Illustrative List, as well as a mutual recognition that economic activities taking place outside of the territory of the country of origin need not be taxed by that country, as bases for the inclusion of the principles memorialized in the 1981 Council Decision. See GATT Doc. Nos. C/114 (8 December 1980), C/115 (8 December 1980), and C/116 (8 December 1980).

¹⁶¹ See Staff Comm. on Taxation, 98th Cong., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 1041 (1985) ("*General Explanation*") (Exhibit EC-6).

¹⁶² Pub. L. No. 98-369, Sections 801-805, 98 Stat. 985, 985-1003 (1984). The FSC provisions are contained in sections 921-927 of the Internal Revenue Code (Exhibit EC-1).

¹⁶³ *General Explanation*, at 1042. Contrary to the European Communities' assertion (First EC Submission, paragraph 20), the FSC was not designed to be the "functional equivalent" of the DISC, but rather was designed to cure the alleged defects in the DISC by instituting an entirely different system that would be compatible with all applicable GATT standards. In this regard, US courts have recognized that the FSC regime is less favorable to companies than was the DISC regime. See, e.g., *McCoy Enterprises v. Commissioner*, 64 T.C.M. (CCH) 1449 (1992) (copy attached as US Exhibit 16).

4.334 Thus, in designing the FSC, Congress was seeking to devise a method by which it could exempt a portion of the income from foreign economic processes occurring in export transactions. To understand and properly analyse the FSC, it is necessary to keep this overriding purpose in mind.

Description of the FSC

4.335 The *General Explanation* provides the following useful overview of the FSC provisions:

The Act provides that a portion of the export income of an eligible foreign sales corporation (FSC) will be exempt from Federal income tax. It also allows a domestic corporation a 100-per cent dividends-received deduction for dividends distributed from the FSC out of earnings attributable to certain foreign trade income. Thus, there is no corporate level tax imposed on a portion of the income from exports.¹⁶⁴

4.336 Thus, a portion of the “foreign trade income” of a FSC is exempted from US tax by treating it as foreign source income not effectively connected with a US trade or business.¹⁶⁵ This treatment corresponds to the exemption of income attributable to a foreign branch or foreign subsidiary of a French, Belgian, or Dutch corporation under a territorial-type system. In addition, shareholders of a FSC are eligible for a 100 per cent dividends-received deduction from distributions made out of the earnings and profits attributable to the foreign trade income of a FSC. This treatment corresponds to the “participation exemption” typically provided by territorial-type tax systems, such as those of France, Belgium, and the Netherlands.

4.337 The *General Explanation* further explains that an exemption from tax is permitted under GATT rules:

only if the economic processes which give rise to the income take place outside the United States. In light of these rules, the Act provides that a FSC must have a foreign presence, it must have economic substance, and that activities that relate to its export income must be performed by the FSC outside the US customs territory. Furthermore, the income of the FSC must be determined according to transfer prices specified in the Act: either actual prices for sales between unrelated, independent parties or, if the sales are between related parties, formula prices which are intended to comply with GATT's requirement of arm's-length prices.¹⁶⁶

4.338 It is evident that the FSC differs significantly from the DISC in very fundamental respects that were intended to conform to the principles articulated in the 1981 Council Decision and, now, the SCM Agreement. Unlike a DISC, which is a US corporation, a FSC must be incorporated outside the US customs territory in a jurisdiction that meets US requirements for exchange of information on tax matters.¹⁶⁷ In contrast to a DISC, a FSC must have a foreign office and maintain a set of permanent books of account at that office, thereby rendering the FSC equivalent to a foreign branch office or a permanent establishment.¹⁶⁸ Unlike a DISC, which was not a taxable entity, a FSC files a separate tax

¹⁶⁴ *General Explanation*, at 1042. A detailed description of the FSC is set forth in Appendix A to this submission.

¹⁶⁵ Such income is generally exempt from tax under section 882 of the Internal Revenue Code. See Exhibit EC-1.

¹⁶⁶ *General Explanation*, at 1042-1043.

¹⁶⁷ The following EC countries are a qualified situs for a FSC: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, the Netherlands, and Sweden. Notice 84-15, 1984-2 C.B. 474 (copy attached as US Exhibit 6). The Netherlands and Belgium, in particular, have actively recruited FSCs.

¹⁶⁸ The *General Explanation*, page 1044, states that “to satisfy [the requirement of having an office and books of account outside the United States], Congress intended that the office conduct activities comparable to those of a ‘permanent establishment’ under income tax treaty concepts.” “Permanent establishment” is an international term used to describe a foreign branch office that may be subject to tax in the source (host) country under tax treaty principles. It is not necessary here to discuss the specific, technical requirements for a

return and pays taxes, including estimated taxes, on a substantial portion of its income.¹⁶⁹ Moreover, by statute a FSC is required to be legally and financially responsible for certain crucial economic processes occurring outside the United States. Only if a FSC meets these requirements will the FSC provisions exempt from taxation income attributable to those foreign economic processes, as permitted by the 1981 Council Decision and the SCM Agreement. These requirements are discussed in more detail below.

FSCs Are Legitimate, Operating Foreign Corporations

4.339 Congress mandated that a FSC be a foreign corporation organized outside the customs territory of the United States.¹⁷⁰ As noted above, under US tax law, a foreign corporation is any corporation organized under the laws of a jurisdiction outside the fifty states and the District of Columbia. The European Communities assertion that FSCs are shams and not real foreign corporations is, therefore, factually incorrect.¹⁷¹

4.340 Indeed, in enacting the FSC provisions, Congress added requirements that are more stringent than those usually imposed in US tax law for recognition of a foreign corporation. Although the United States normally does not impose management and control requirements, which are central concepts for recognizing the legitimacy of separate entities under many tax systems, a FSC is required by statute to have a board of directors that includes at least one individual who is not a resident of the United States.¹⁷² In addition, the meetings of a FSC's board of directors and shareholders must occur outside the United States.¹⁷³ Moreover, a FSC's principal bank account must be maintained in a qualifying foreign country, and all dividends, legal and accounting fees, salaries of officers, and directors fees must be disbursed out of bank accounts held outside the United States.¹⁷⁴

4.341 By statute, a FSC must have attributes comparable to a "permanent establishment" or foreign branch office.¹⁷⁵ All FSCs incur real administrative costs, including – at a minimum – the costs of corporate registration and accounting, legal, and management fees.¹⁷⁶ A FSC must file its own tax returns and pay its own taxes to the US federal government and any other applicable taxing jurisdiction.¹⁷⁷ Indeed, a number of US judicial decisions have confirmed the status of FSCs as valid foreign corporations for taxing purposes.¹⁷⁸

permanent establishment, because Congress did not intend that a FSC would have to satisfy all of the requirements for a permanent establishment.

¹⁶⁹ A FSC is required to pay an underpayment penalty with respect to estimated taxes even when the FSC and its related supplier have made an overpayment of taxes. Because the FSC and its related supplier are two separate taxpayers, there is no netting of estimated tax payments between the two. In this manner, the separate status of the FSC is respected.

¹⁷⁰ Senate Print No. 98-169, at 636 ("*Senate Print*") (Copy attached as US Exhibit 11).

¹⁷¹ First EC Submission, paragraphs 35, 39, 42.

¹⁷² Section 922(a)(1)(E) of the IRC.

¹⁷³ Section 924(c)(1) of the IRC.

¹⁷⁴ Section 924(c)(3) of the IRC.

¹⁷⁵ *Senate Print*, at 637.

¹⁷⁶ The European Communities suggestion that FSCs are shams because their initial start-up costs are relatively low is misleading. In fact, most corporations cost relatively little to organize. The European Communities fails to acknowledge that the costs of actually operating a FSC are substantial.

¹⁷⁷ Note that any corporation incorporated in a US possession is generally considered a foreign corporation under US tax law. *See* Section 7701(a)(4) and (9) of the IRC. In fact, the US Virgin Islands, where many FSCs are organized, has collected over \$68 million in taxes from FSCs located within its jurisdiction. Although the US Virgin Islands is a US possession, it is outside the customs territory of the United States and is a taxing jurisdiction separate from the United States, like many possessions and territories of EC member States.

¹⁷⁸ From time to time, certain US states have attempted to impose taxes on a FSC's foreign income by relying on the theory that FSCs are sham corporations that should be taxed as though they were domestic operations of their parent companies. Those theories have been rebuffed by state courts and administrative agencies that have held FSCs to be valid foreign corporations over which those states could not assert their tax jurisdiction. *See, e.g., SLI International Corporation v. Crystal*, 236 Conn. 156 (February 27, 1996) (copy

4.342 Corporate meetings of a FSC must comply with the requirements of the jurisdiction in which it is located. If the jurisdiction of incorporation of a FSC mandates that corporate meetings occur physically in that location, such meetings must take place there.¹⁷⁹ The FSC rules requiring compliance with such mandates are enforced by the United States through regular audits of FSC tax returns by the US Internal Revenue Service.

A FSC Is Required to Be Responsible for All Distributor Functions and to Perform a Significant Portion of Them Outside the United States

4.343 A FSC must either itself perform or pay for specific economic processes related to the relevant export transaction. By statute, in order to qualify for the partial tax exemption, a FSC that uses administrative pricing rules must perform, contract, or pay for *all* of the distribution activities attributable to the export transaction.¹⁸⁰ These include the solicitation (other than advertising), negotiation, or making of the contract for the relevant FSC export transaction. At least one of these three important activities must be performed outside the United States. Additionally, the FSC must take responsibility for all of the following distribution activities:

- (a) Advertising and sales promotion;
- (b) Processing of customer orders and arranging for delivery;
- (c) Transportation of goods involved in the transaction to the customer;
- (d) Determination and transmittal of final invoice or statement of account, and receipt of payment; and,
- (e) Assumption of credit risk.¹⁸¹

4.344 In addition, the FSC must incur outside the United States at least 50 per cent of the total direct cost of the five activities listed above, or 85 per cent of the total direct costs associated with two of the five activities.¹⁸²

4.345 Because the purpose of the FSC rules is to attribute to the FSC those activities that take place outside of US territory, the FSC statute requires that the FSC be responsible for these activities. The rules do not require that the FSC perform all of these activities itself through its own employees. Instead, it is permissible for them to be performed by an agent under contract with the FSC. The FSC must pay for these activities, however. These rules reflect that Congress designed the FSC to replicate the results of a territorial exemption, and that it did so by requiring the FSC to take economic responsibility for *all* foreign economic activity in the transaction, regardless of who performs it.

4.346 Congress designed the FSC to isolate the foreign economic activity taking place outside US territory, whether the export transaction involves a sale, a lease, or a provision of services. If a sale is

attached as US Exhibit 13) (holding that a corporation meeting the federal requirements of a FSC has a valid business and economic purpose and reflects an arm's length relationship from its parent and other subsidiaries); see also *Kimberly-Clark Corporation v. Wisconsin Department of Revenue*, 1994 Wisc. Tax LEXIS 13 (Wisconsin Tax Appeals Commission, April 12, 1994) ("*Kimberly-Clark*") (copy attached as US Exhibit 14). Also, case law in the United States has held consistently that an entity incorporated for the purposes of obtaining a tax or other advantage is to be treated as a separate business entity. For example, in *Hospital Corp. of America v. Commissioner*, 81 T.C. 520 (1983) (copy attached as US Exhibit 15), the US Tax Court respected the Cayman Islands corporation at issue as a separate entity and allocated income to it in accordance with the economic activities performed outside the United States.

¹⁷⁹ See, e.g., *Kimberly-Clark*; and *Advisory Opinion - Petition No. C880726A*, 1989 N.Y. Tax LEXIS 123 (State of New York - Commissioner of Taxation and Finance, January 31, 1989) (copy attached as US Exhibit 17).

¹⁸⁰ Section 925(c) of the IRC.

¹⁸¹ Section 924(d) and (e) of the IRC.

¹⁸² Section 924(d) of the IRC.

involved, the US parent company must produce the product or service that is the subject of the transactions; FSCs are not permitted to do so. The US parent company may choose to sell the qualifying product to the FSC, which will then resell that product to the customer. Alternatively, the US parent may also sell directly to the customer, with the FSC acting as a commission agent, never taking title to the qualifying product. If a lease or service is involved, then the FSC still must perform or pay for the required intermediary functions that are necessary to complete the transaction. In any of these cases, the FSC is statutorily required to be legally and financially responsible for the functions that a distributor would perform, while the US parent retains responsibility for the producer's functions. The FSC's share of income, based on the functions for which it is responsible, is calculated using the applicable transfer pricing rules. The purpose, again, is to isolate and attribute to the FSC the income that is fairly attributable to economic activities occurring outside of US territory. A portion of that income will be exempted if the FSC has complied with all of the legal requirements.

4.347 With respect to the functions for which the FSC is responsible, the FSC statute requires that income be allocated to FSCs under one of three methods. One of these methods uses the prices actually charged between the FSC and the "related supplier" (*i.e.*, the US parent), subject to the standard US transfer pricing rules in Section 482 of the Internal Revenue Code.¹⁸³ The other two methods are administrative pricing rules, allocating to the FSC either 1.83 per cent of the qualified gross receipts from transactions using that method, or 23 per cent of the combined taxable income ("CTI") of the FSC and its related supplier attributable to transactions using that method.¹⁸⁴ The CTI allocation method requires a calculation of all costs incurred by both the FSC and its parent that are related to the transactions involved; those costs are subtracted from the gross receipts to find the total CTI. Of that amount, 23 per cent is allocated to the FSC as distributor and 77 per cent to the US producer. A FSC may use the administrative pricing rules only for transactions in which it performs or pays for *all* of the distributor functions mentioned above.¹⁸⁵ The US Congress stated specifically that these pricing rules "are intended to comply with GATT's requirements of arm's length prices" and "to approximate arm's length pricing."¹⁸⁶

4.348 Finally, the FSC is designed to prevent double taxation of export income earned outside the United States by exempting a portion of the FSC's income from taxation. Income thus exempted is not eligible for double taxation relief using the foreign tax credit mechanism.¹⁸⁷

4.349 Thus, through this combination of requirements and transfer pricing rules, the FSC emulates the type of tax treatment received by a foreign sales subsidiary of a manufacturing company in a territorial-type system. Like those systems, the FSC exempts from tax income earned outside the territory of the home country.¹⁸⁸

4.350 Finally, it must be noted that the European Communities grossly exaggerates the size and effect of the tax reduction provided by the FSC. In the First EC Submission, paragraph 100, the European Communities accurately reports from the 1997 US Treasury report (Exhibit EC-5) that the FSC resulted in a revenue reduction of \$1,380 million for calendar year 1992. However, the European Communities withholds from the Panel data that put this figure in perspective. Specifically, the \$1,380 million "expenditure" for all FSCs corresponds to gross receipts for the same time period of \$152,263 million.¹⁸⁹ Putting these figures together in *ad valorem* terms, the resulting figure is 0.93

¹⁸³ Exhibit EC-1.

¹⁸⁴ Section 925(a) of the IRC.

¹⁸⁵ Section 925(c) of the IRC.

¹⁸⁶ *General Explanation*, at 1042-43, 1054.

¹⁸⁷ Section 901(h) and Section 906(b)(5) of the IRC.

¹⁸⁸ As in a territorial system, the FSC provides shareholders with an exemption for dividends received by the parent with respect to foreign income.

¹⁸⁹ Exhibit EC-5, Table 6-4, p. 23

per cent *ad valorem*.¹⁹⁰ In other words, even assuming for purposes of argument that the FSC is a subsidy, any “benefit” it provides is less than 1 per cent *ad valorem*. Similarly, while the European Communities accurately cites Treasury’s estimate that the FSC increased US exports by about \$1.5 billion in 1992¹⁹¹, the European Communities omits the fact that this estimated increase amounted to a percentage increase in exports of only 0.3 per cent.¹⁹²

The FSC Is Not an Export Subsidy

Introduction

4.351 The European Communities makes two basic arguments in support of its claim that the FSC regime constitutes a prohibited export subsidy in violation of Article 3.1(a) of the SCM Agreement. First, the European Communities contends that FSC tax exemption itself is a prohibited export subsidy. Second, the European Communities alleges that the FSC administrative pricing rules provide an additional export subsidy because they allegedly decrease the tax burden that otherwise would be imposed, presumably by allocating too much income to the FSC. The first is an incorrect proposition as a matter of law; the second is both legally flawed and wholly unsupported by facts.

4.352 The United States first responds to the European Communities' first argument – that the FSC partial tax exemption is an export subsidy. This position is untenable, as a matter of law, because it ignores the specific provision of the SCM Agreement that contains the controlling legal standard applicable to its claim – Footnote 59 and the GATT subsidy principles it embodies. Footnote 59 confirms that income generated from economic activity outside the territory of the taxing authority need not be taxed, and that a decision not to tax such income is not a prohibited subsidy. This principle, which dates back to the GATT’s original ban on export subsidies and which is articulated in the authoritative 1981 decision of the GATT Council, makes clear that such a tax exemption does not violate Article 3.1(a).¹⁹³ The FSC was expressly designed to exempt income derived from foreign economic activities. Because it does so, it is entirely consistent with WTO standards and principles.

4.353 Then the United States addresses the European Communities' second claim – that FSC administrative pricing rules separately confer a prohibited subsidy by improperly shifting, or misallocating, income.

4.354 First, as a legal matter, the European Communities misconstrues the governing provision of the SCM Agreement and builds its entire argument on that erroneous premise. Footnote 59, the applicable provision of the SCM Agreement, provides that WTO Members may allocate income from export transactions in order to distinguish income derived from economic activities outside their territory from income derived from economic activities within their territory. Footnote 59 clearly provides that in making such allocations, Members are free to use administrative or other practices. Accordingly, Members have considerable discretion in deciding what administrative practices to apply, so long as the overall allocation of income approximates arm’s length results and does not result in a “significant saving” of direct taxes in export transactions.

¹⁹⁰ In fact, assuming *arguendo* that the FSC administrative pricing rules confer a subsidy, this figure overstates the size of the “benefit.” The 0.93 per cent figure includes data for FSCs that use the section 482 method of allocating profits, a method that the European Communities has conceded does not constitute a subsidy. Thus, any alleged “benefit” conferred by the FSC administrative pricing rules would be some fraction of 0.93 per cent.

¹⁹¹ First EC Submission, paragraph 106.

¹⁹² Exhibit EC-5, p. 14. The European Communities also omits the following Treasury conclusion: “In several industries the FSC benefits were so small relative to the total value of exports that the adverse effect of the exchange rate is estimated to exceed the benefit from the FSC program. For these industries, the FSC program has a small *adverse* effect on exports.” *Id.* (Emphasis added).

¹⁹³ For these same reasons, the exemption from direct taxes of foreign-source income is not a subsidy at all. To the extent that the FSC tax exemption is not a subsidy within the meaning of SCM Agreement Article 1, it does not constitute a prohibited subsidy under Article 3.1(a) or any other provision of the SCM Agreement.

4.355 The European Communities misstates this standard and, instead, assumes that a prohibited subsidy exists, by definition, because the FSC does not perform enough activities itself to earn the income allocated to it under the administrative pricing rules, or because the use of an administrative pricing rule may, in particular transactions, produce results different from the result that Section 482 might yield in the same transaction. This *ipso facto* argument ignores the fact that the purpose of footnote 59 is to discipline the allocation of income so as not to overstate income attributable to foreign economic activities, and thereby confer a subsidy by exempting income generated from activities occurring within the taxing authority's territory. By alleging simply that in particular transactions administrative rules yield prices that are different from those that would result were those rules not available, the European Communities misses both the point of footnote 59 and the point of what the FSC provisions, including its administrative pricing rules, are intended to do.

4.356 In fact, the results produced by the FSC – of which the administrative pricing rules are but one part – do properly allocate to FSCs the income that is attributable to economic activities occurring outside United States territory. When the US Congress designed the FSC, it was explicit in its intention to implement the 1981 Council Decision which confirmed that GATT Contracting Parties could exempt from tax the income properly allocable to foreign economic processes. By doing so, Congress sought to replicate features of a territorial tax system. Because the United States system is residence-based, Congress achieved this result by using a *bona fide* foreign entity, the FSC, and by (1) requiring the FSC to perform or contract and pay for all of the distribution activities attributable to exports, a significant portion of which are required to be performed outside the United States; and (2) crediting the FSC with the actual foreign economic processes in an export transaction, whether performed by the FSC directly or through an agent, including a related supplier under contract.

4.357 To ensure that the foreign activities of the FSCs and their related suppliers justify the limited tax exemption granted by the FSC, the Congress imposed a variety of requirements to operate in conjunction with the statutory administrative pricing rules. Specifically, the FSC statute:

- Requires that FSCs be foreign corporate entities;
- Requires that FSCs be managed abroad and engage in prescribed activities outside of the United States;
- Attributes all distribution and sales activities (which includes all foreign economic processes) to the FSC (even when performed abroad by the FSC's United States parent);
- Limits the percentage of income or profit that may be allocated to the FSC; and
- Further deems that, for purposes of the FSC tax exemption, only a fraction of the income attributable to the FSC qualifies for the tax exemption.

4.358 The effect of these provisions, operating together, is to approximate – or even understate – the income attributable to foreign economic activities. Moreover, in no event do the FSC rules result in a “significant saving” of taxes due on income attributable to economic activities occurring *within* the United States.

4.359 Thus, the FSC provisions fully comport with the standards set forth in Footnote 59. In particular, the effect of the FSC is to exempt income generated by foreign economic activities. The result, as intended, replicates the results of a territorial system, and is entirely consistent with the standards set out in the SCM Agreement.

4.360 The European Communities' arguments do not address whether the FSC exemption relates to foreign economic activity, and the First European Communities submission offers no factual evidence whatsoever indicating that it does not. Instead, the European Communities invokes an erroneous legal

standard and asserts that, by definition, the FSC does not meet it. As a result, the European Communities has failed to make a *prima facie* case. It has fallen even further short of meeting its burden of showing a “significant saving” of direct taxes within the meaning of footnote 59.

Under Controlling WTO Provisions, a Decision to Exempt Income Attributable to Foreign Economic Processes from Tax Is Not a Prohibited Export Subsidy

4.361 Implicit in the European Communities' first argument is an extraordinary proposition; namely, that WTO rules *mandate* that Members tax income attributable to foreign economic processes.¹⁹⁴ The relevant provisions of the SCM Agreement, properly interpreted, refute the European Communities' argument, however, and make clear that the FSC's exemption from taxation of certain income from export transactions is not prohibited *per se*. Indeed, if the WTO rules were as the European Communities claims they are, then the income tax systems of EC members would be in violation of the SCM Agreement.

Footnote 59 Embodies the Principle That WTO Members Need Not Tax Income Attributable to Foreign Economic Processes

4.362 Article 3.1(a) of the SCM Agreement provides in relevant part that “the following subsidies, within the meaning of Article 1, shall be prohibited: (a) subsidies contingent in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I.” Annex I (the “Illustrative List of Export Subsidies”), in turn, gives specific meaning to the provision to which it is attached. The Illustrative List, which consists of 12 paragraphs, identifies practices that do or do not come within the prohibition of Article 3.1(a). Footnote 5 to Article 3.1(a) makes clear that practices identified by the Illustrative List as *not* constituting an export subsidy are not prohibited under Article 3.1(a).

4.363 Thus, if the Illustrative List treats a measure as an export subsidy, it is prohibited. Conversely, if the List treats a measure as not being an export subsidy, it is not prohibited. No further analysis is needed to divine the meaning of Article 3.1(a) with respect to measures addressed by the Illustrative List.

4.364 The European Communities has cited paragraph (e) of the Illustrative List in support of its argument that the FSC is a prohibited export subsidy. Paragraph (e) states the general rule that “the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes” is an export subsidy. However, footnote 59 to paragraph (e) qualifies the scope of that paragraph and

¹⁹⁴ The European Communities defines the tax exemption at issue in this case to include three parts:

The exclusion of the “foreign trade income” of FSCs from the controlled foreign corporations provisions of subpart F of the Internal Revenue Code (Sections 951(e) and 954(d)-(e) of the IRC).

The exemption from US tax which would otherwise be due on the “exempt foreign trade income” of the FSC (Section 921(a) of the IRC).

The fact that the parent of the FSC is accorded a 100 per cent dividends-received deduction (*i.e.*, exemption from US tax) for the dividends received from the FSC's “earnings or profits attributable to foreign trade income.” (Section 245(c) of the IRC in conjunction with Section 926(a) of the IRC).

First European Communities Submission, paragraph 125. The United States also includes these three components (inapplicability of subpart F, exemption of a portion of foreign trade income, and the dividends-received deduction) in its definition of “exemption” as used in this submission. However, the United States disagrees with the European Communities' characterization of the second component as an exemption from tax “which would otherwise be due.” As discussed below, because there is no WTO requirement that the United States tax income attributable to foreign economic processes, the partial exemption of such income from tax cannot be considered as the foregoing of revenue which is “otherwise due”.

makes clear that exempting income attributable to foreign economic processes from direct taxation is not a prohibited export subsidy.¹⁹⁵

4.365 Footnote 59, among other things, spells out general rules for allocating income to economic activities outside the territory of the taxing authority. According to footnote 59, where profits are allocated between related parties, they must be allocated in accordance with the arm's length principle: "The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length." Footnote 59 further provides that WTO Members may "draw the attention of another WTO Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions."

4.366 The necessary predicate of footnote 59 is that income from foreign economic processes may be exempted from direct taxes. Were that not the case, the arm's length principle would be irrelevant. The arm's length principle prevents income from being inappropriately shifted between parties or functions. In the context of export transactions, the principle focuses on ensuring that income properly attributable to economic processes *within* the taxing jurisdiction is not shifted to another jurisdiction. If the SCM Agreement were interpreted as requiring that income attributable to both foreign and domestic economic processes be taxed by the domestic taxing authority, the shifting of income between related parties would be irrelevant (because no tax advantage would be gained), and the relevant portions of the footnote would be rendered devoid of meaning.¹⁹⁶ Therefore, implicit in footnote 59 is the longstanding principle that income attributable to foreign economic processes need not be taxed.

The Principle Underlying Footnote 59 Is Well-Established

4.367 The principle underlying footnote 59 – that income attributable to foreign economic processes need not be taxed – is well-established and reflects the long-held views of GATT Contracting Parties and WTO Members, particularly European Members. Not only have Members relied on this principle, but it has been a central element of proposals that various countries have made during the development and evolution of the Illustrative List. This history, summarised below, confirms that WTO Members, like GATT Contracting Parties before them, never intended that a decision to exempt income attributable to foreign economic processes from taxation should be considered an export subsidy.

4.368 The original ban against export subsidies was contained in Article XVI:4 of GATT 1947. As originally crafted, Article XVI did not address export subsidies. Because Article XVI was lacking in this and a number of other important respects, the Contracting Parties decided to renegotiate and

¹⁹⁵ In this regard, the Appellate Body has stated that, where the issues before a panel implicate two provisions, the panel should examine the more specific provision first. *European Communities - Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/AB/R, Report of the Appellate Body adopted 25 September 1997, paragraph 204. The Appellate Body's reasoning in this regard derives from the interpretive principle of *generalia specialibus*, which holds that "a matter governed by a specific provision, dealing with it as such, is thereby taken out of the scope of the general provision dealing with the category of subject to which that matter belongs, and which otherwise might govern it as part of that category." Gerald Fitzmaurice, *The Law and Procedure of the International Court of Justice 1951-4: Treaty Interpretation and Other Treaty Points*, 1957 British Y.B. Int'l L. 236 (copy attached as US Exhibit 7). Accordingly, the United States addresses first item (e) and footnote 59, the provisions of the SCM Agreement that most specifically address a tax measure such as the FSC.

¹⁹⁶ Such an outcome, of course, is impermissible under public international law. "An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility." *United States – Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R, Report of the Appellate Body adopted 29 April 1996, at 23 ("*Reformulated Gasoline*"); see also *Japan – Taxes on Alcoholic Beverages*, WT/DS8/AB/R, Report of the Appellate Body adopted on 4 October 1996, at 11 ("*Alcoholic Beverages*") (same).

amend the provision. The current part B of Article XVI, which addresses export subsidies, was added in 1955 and generally came into effect for those parties accepting its obligations in 1957.¹⁹⁷ The revision added a new paragraph 4, which provides that “as from 1 January 1958 or the earliest practical date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product”¹⁹⁸

4.369 On 19 November 1960, a number of GATT Contracting Parties agreed to a declaration that gave effect to Article XVI:4 for the first time.¹⁹⁹ Accompanying that declaration was a report of a working party that included what would become the first Illustrative List of Export Subsidies.²⁰⁰ The list, which was proposed by France, explained that “these practices generally are to be considered subsidies in the sense of Article XVI:4”²⁰¹ Paragraph (c) of the list – which is the precursor to paragraph (e) in Annex I to the SCM Agreement – stated that “[t]he remission, calculated in relation to exports, of direct taxes . . . on industrial or commercial enterprises” should be considered to be an export subsidy.²⁰²

4.370 It is clear that paragraph (c) was not intended to prohibit Contracting Parties from exempting income attributable to foreign economic processes from taxation. This can be seen from the fact that all of the European parties to the *Tax Legislation Cases* – France, Belgium, and the Netherlands – agreed to the declaration.²⁰³ Each of the three European governments at the time either had territorial tax systems or systems that contained features of a territorial system. Each government considered sales income from export transactions to be foreign and thus exempt from taxation, and each argued in the *Tax Legislation Cases* that it was simply impossible to believe that GATT Article XVI:4 prohibited the exemption from tax of income attributable to foreign economic processes relating to exports from their territories.²⁰⁴

4.371 In 1979, Article XVI was further refined by the adoption of the Subsidies Code.²⁰⁵ Article 9 of the Subsidies Code, which banned export subsidies on non-primary products, referred to an Annex and stated that “[t]he practices listed in points (a) to (l) in the Annex are illustrative of export subsidies.”²⁰⁶ Entitled the “Illustrative List of Export Subsidies,” the Annex was a modified version of the 1960 Illustrative List.²⁰⁷

4.372 Paragraph (e) of the 1979 Illustrative List was a revised version of paragraph (c) of the 1960 list. Paragraph (e) provided that “the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes” is an export subsidy, language that is identical to what later became paragraph (e) in Annex I of the SCM Agreement.

4.373 Paragraph (e) also contained a footnote 2, which had essentially the same language as footnote 59 of the SCM Agreement. Footnote 2 stated in pertinent part:

The signatories reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises

¹⁹⁷ BISD 3S/222, 224-27 (1955); *Protocol Amending the Preamble and Parts II and III of the GATT, 1955* (Agreement No. 33 in App. C), GATT Doc. L/717 (1957).

¹⁹⁸ *Id.*

¹⁹⁹ BISD 9S/32.

²⁰⁰ BISD 9S/185.

²⁰¹ *Id.*, at 187.

²⁰² *Id.*, at 186.

²⁰³ BISD 9S/33; see also J. Jackson, *World Trade and the Law of GATT*, Section 15.3, page 374, note 24 (1969) (US Exhibit 8).

²⁰⁴ See BISD 23S/114, paragraph 20 (France); BISD 23S/127, paragraph 21 (Belgium); BISD 23S/137, paragraph 21 (Netherlands).

²⁰⁵ BISD 26S/56.

²⁰⁶ *Id.*, at 68-69.

²⁰⁷ *Id.*, at 80-83.

acting at arm's length. Any signatory may draw the attention of another signatory to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the signatories shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of signatories under the General Agreement, including the right of consultation created in the preceding sentence.

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

4.374 Footnote 2 reflected the then ongoing concerns of the disputing parties regarding the panel's conclusions in the *Tax Legislation Cases*. On the one hand, footnote 2 recognized the principle that if income attributable to foreign economic processes were exempted from direct taxation, the attribution or allocation of such income must be made on the basis of the arm's length principle, a major concern being raised at the time by the United States.²⁰⁸ On the other hand, it recognized that countries could design their tax systems so as to avoid the double taxation of income, a primary feature of the European territorial systems of taxation then under attack.²⁰⁹ In short, footnote 2 was inserted into the Subsidies Code to acknowledge and confirm that GATT Contracting Parties were not obligated to tax income attributable to foreign economic activities and that an exemption of such income from taxation would not constitute an export subsidy, provided that income was properly allocated between domestic and foreign activities where related parties were involved in export transactions.

4.375 In 1981, two years after the Subsidies Code was adopted, the GATT Council, in adopting the reports in the *Tax Legislation Cases*, explicitly articulated and reiterated these principles. The Council's decision states:

The Council adopts these reports on the understanding that with respect to these cases, and in general, *economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement.*²¹⁰

4.376 The decision also states:

It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign income.²¹¹

4.377 The 1981 Council Decision echoed footnote 2 of the Subsidies Code. It expressly articulated what was implicit in footnote 2; namely, the general principle that "economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export

²⁰⁸ BISD 23S/114, paragraph 26.

²⁰⁹ See, e.g., BISD 23S/114, paragraph 20 ("the representative of France stated that the territoriality principle . . . was part of a concept which respected the fiscal sovereignty of States and which enabled double taxation to be avoided"). Of course, the avoidance of double taxation is also a principle recognized by the US tax system in, for example, its use of foreign tax credits.

²¹⁰ BISD 28S/114 (emphasis added).

²¹¹ *Ibid.*

activities in terms of Article XVI:4 of the General Agreement.” It also made clear, however, that in allocating income to foreign economic activities, “arm’s length pricing must be observed,” and it reiterated that applicable GATT articles “do not prohibit the adoption of measures to avoid double taxation of foreign source income.” By unambiguously confirming that the exemption of income attributable to foreign economic processes from taxation does not constitute a prohibited export subsidy, the Council Decision effectively reversed certain findings made by the panel in the *Tax Legislation Cases*.

4.378 This history culminates in paragraph (e) and footnote 59 of the SCM Agreement. By incorporating the same language that was used in the Subsidies Code, the drafters of the Agreement brought the history of the GATT’s treatment of the exemption from direct taxation of income attributable to foreign economic processes forward into the WTO.²¹² The language of footnote 59, when read in light of a history that dates back to the inception of GATT Article XVI:4, reflects a consistent understanding among the GATT Contracting Parties and WTO Members that the exemption from direct taxation of income attributable to foreign economic processes *per se* does not constitute an export subsidy.

The Principle Articulated in the 1981 Council Decision Is Controlling Here

4.379 The 1981 Council Decision not only informs the interpretation of the SCM Agreement and reflects a long-held GATT principle, it also warrants separate weight in its own right. As the Appellate Body has explained, “Article XVI:1 of the WTO Agreement and paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the WTO Agreements bring the legal history and experience under the GATT 1947 into the new realm of the WTO in a way that ensures continuity and consistency in a smooth transition from the GATT 1947 system.”²¹³ Article XVI:1 of the WTO Agreement states that “[e]xcept as otherwise provided under this Agreement or the Multilateral Trade Agreements, the WTO shall be guided by the decisions, procedures and customary practices followed by the CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947.”

4.380 The 1981 Council Decision provides the most explicit statement of the principle that income attributable to foreign economic processes need not be taxed. Because it contains reasoning that the GATT Council specifically endorsed, it is akin to an authoritative interpretation of a WTO agreement by the Ministerial Conference or General Council which, under Article IX:2 of the WTO Agreement, “have the exclusive authority to adopt interpretations of this Agreement and of the Multilateral Trade Agreements.”²¹⁴ In light of the fact that the GATT Council made a specific pronouncement of legal principles, its statement constitutes a “subsequent practice” within the meaning of Article 31(3)(b) of the *Vienna Convention on the Law of Treaties* (“VCLT”) with respect to GATT Article XVI:4, as amended by the Subsidies Code. At minimum, the decision merits more weight than Council decisions that merely adopt a panel report.²¹⁵

²¹² With the exception of certain conforming changes and the elimination of certain transitional provisions, item (e) and footnote 59 of the SCM Agreement are identical to item (e) and footnote 2 of the Subsidies Code. This is not surprising, because although other items of the Illustrative List were discussed and modified during the Uruguay Round negotiations, item (e) was not a subject of negotiation.

²¹³ *Alcoholic Beverages*, at 13.

²¹⁴ See also Article 3.9 of the DSU, which provides that “[t]he provisions of this Understanding are without prejudice to the rights of Members to seek authoritative interpretation of provisions of a covered agreement through decision-making under the WTO Agreement or a covered agreement which is a Plurilateral Trade Agreement.”

²¹⁵ The Appellate Body has stated that a decision of the Contracting Parties to adopt a panel report, without more, does not necessarily reflect that the Contracting Parties “intended that their decision would constitute a definitive interpretation of the relevant provisions of GATT 1947,” nor “constitute agreement by the Contracting Parties on the legal reasoning in that report.” *Alcoholic Beverages*, at 12-13. Nevertheless, a decision by the Contracting Parties to adopt a report is part “of the GATT *acquis*” and it “creates legitimate

4.381 There can be no doubt that the GATT Council intended its decision to have broader application than the specific cases then before it. In articulating its decision, the Council stated: “The Council adopts these reports on the understanding that with respect to these cases, *and in general*, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement.” (Emphasis added.) The Council made explicit that it was establishing a principle to be applied not only in the cases at hand, but also in future cases.

4.382 It is clear that the first European Communities argument – that the FSC tax exemption, in and of itself, constitutes a prohibited export subsidy – is incorrect.²¹⁶ The European Communities' position is directly contradicted by the controlling standard discussed above. As noted by the Chairman of the GATT Council, the principle spelled out in the 1981 Council Decision “does not mean that the parties adhering to Article XVI:4 are forbidden from taxing profits on transactions beyond their borders, it only means that *they are not required to do so*.”²¹⁷ How or to what extent WTO Members choose not to impose a tax on such activities is irrelevant. Members can apply the territorial principle, limiting their tax jurisdiction at the water's edge. Alternatively, Members using a worldwide system can adopt exemption, deferral, or credit regimes (or any combination of the three) to accomplish this same goal. However it is done, the exemption of some or all of the income generated from foreign economic activities, through whatever means, is not an export subsidy.

The FSC Administrative Pricing Rules Do Not Constitute an Export Subsidy

4.383 The European Communities' second assertion – that the FSC administrative pricing rules create an export subsidy in violation of the arm's length principle established by footnote 59 – is based upon a fundamental misinterpretation of both the footnote and the FSC regime's replication of territorial tax concepts. As such, the European Communities' second claim is wholly unsupported by relevant facts.²¹⁸

4.384 Footnote 59 is designed to ensure that attributions or allocations of income to foreign economic activities are appropriate and do not confer a subsidy by over-allocating income so that income attributable to *domestic* economic activities escapes taxation. Under footnote 59, administrative practices to allocate income must satisfy the arm's length principle, and must not allow a “significant saving” of direct taxes. The FSC rules were intended to, and do, meet this standard by establishing a territorial exemption for income attributable to distributor functions performed outside the United States, whether by the FSC directly or by related manufacturers or third parties under contract to, and paid by, the FSC.

4.385 The European Communities errs by focusing solely on how administrative pricing rules may apply in a particular transaction and by insisting on analysing FSCs as separate corporate entities, rather than as a method for allocating income to foreign economic activities in accordance with the standard of footnote 59. By failing to present any evidence relevant to the actual standard contained

expectations among WTO Members, and, therefore, should be taken into account whenever relevant to any dispute.” *Id.*

²¹⁶ See First European Communities Submission, paragraphs 151, 158.

²¹⁷ *Tax Legislation*, BISD 28S/114 (emphasis added).

²¹⁸ First European Communities Submission, paragraph 158. The European Communities does not challenge the results of the FSC pricing rules that rely on section 482 of the Internal Revenue Code. Section 925(a)(3) of the IRC. Instead, the focus of the European Communities' criticism is directed at the administrative pricing rules as alternatives to section 482. See First European Communities Submission, paragraphs 150, 158. In that regard, however, it should be recognized that a certain percentage of FSC transactions do not use the administrative pricing rules, but instead use the standard “non-administrative” transfer pricing rules. Although that percentage may be relatively small overall, it is much higher in some industry sectors than others. In the aircraft industry, for instance, counting both categories of aircraft sales and aircraft leases, the 1992 data show that section 482 transfer pricing accounted for some 23 per cent of the total exempt FSC income earned by US aircraft manufacturers that year. See Exhibit EC-12, at 128.

in footnote 59, the European Communities has not made even a *prima facie* case for its subsidy allegation, and, under established principles of WTO dispute settlement, the United States is not obligated to present a rebuttal.²¹⁹ The United States nonetheless does so below.

The Arm's Length Standard of Footnote 59 Tests Whether Income Is Properly Allocated to Foreign Economic Processes

4.386 The European Communities argues that the FSC administrative pricing rules are *per se* export subsidies because they allegedly do not approximate “the normal return on the economic activity of FSCs,” they derogate from “normal transfer pricing rules of Section 482 IRC,” and they do not comply with the arm’s length principle, as established by the OECD Guidelines.²²⁰ Even if these assertions were true, none of them establishes that the FSC administrative pricing rules are an export subsidy because the European Communities relies on the wrong legal standard. What matters for purposes of footnote 59 of the SCM Agreement is not whether the FSC administrative pricing rules might produce determinations of tax liability that are different from what would be determined through the application of Section 482 or the OECD Guidelines. Instead, the proper question is whether the FSC rules properly allocate income between foreign and domestic economic processes.

4.387 In evaluating the European Communities' argument regarding the FSC administrative pricing rules, several aspects of footnote 59 are important. First, as discussed above, footnote 59 embodies the fundamental GATT rule that income derived from foreign economic processes need not be taxed. Second, it imposes discipline on how that rule is applied. Some standard is necessary to ensure that only income attributable to foreign processes involved in export transactions is exempt from taxation. Otherwise, by misallocating income that is attributable to domestic activities, a Member could abuse the right conferred by footnote 59. Thus, in the context of this case, the arm’s length principle of footnote 59 requires only that the FSC administrative pricing rules properly allocate income in export transactions. The purpose of the arm’s length principle in footnote 59 is not, as the European Communities asserts, to arrive at an actual price in individual export transactions (as would be the goal, for example, of an analogous determination for customs valuation or antidumping purposes).²²¹ Instead, its purpose is to ensure that income is properly allocated between activities performed in the United States (which are taxed by the United States) and activities performed outside the country (which WTO rules permit the United States to exempt from tax).

4.388 Third, footnote 59 expressly allows WTO Members to use administrative pricing methods to allocate income between domestic and foreign economic processes. The text states that “any Member may draw the attention of another Member to *administrative or other practices* which may contravene” the arm’s length principle established in the footnote’s previous sentence. (Emphasis added). The clear implication of this language is that Members may rely on administrative practices to allocate income, as long as they do not “contravene” the arm’s length principle contained in footnote 59 and cause a significant saving of direct taxes.²²² Footnote 59 does not further dictate the form or substance of the practices by which Members may allocate income. That determination is left to individual Members.

4.389 Moreover, footnote 59 makes clear that administrative practices that approximate arm’s length results on an overall basis are permissible. Under footnote 59, only an administrative or other practice that “result[s] in a significant saving of direct taxes in export transactions” can be considered

²¹⁹ Below, the United States discusses burden of proof principles as they apply to this case.

²²⁰ First European Communities Submission, paragraphs 67-72, 93, 150, 158.

²²¹ In this regard, based on a computer search of the entire text of the WTO Agreements, footnote 59 appears to be the only provision in any of the WTO agreements that uses the term “arm’s length”. Moreover, it uses the term in the context of “tax purposes.”

²²² Given the express language of footnote 59, which is the applicable standard, the European Communities' assertion that the FSC administrative pricing rules are not the type of “safe harbour” allowed by the OECD Guidelines, even if it were true, is irrelevant. See First European Communities Submission, paragraphs 87-91.

to be a potential export subsidy. The structure of the third sentence of footnote 59 – the plural form of the words “taxes” and “transactions”, together with the singular for “saving” – indicates that allocations of income to foreign economic processes must comply with the arm’s length principle of footnote 59 on average or in the aggregate. If they do, then the objective of imposing the appropriate level of tax is met.

4.390 Administrative rules or practices are used for reasons of administrative convenience for both administrators and users of the system. Administrative rules avoid the burden of challenging or defending allocations on a transaction-by-transaction basis. If such practices are used, however, the resulting overall allocations of income from domestic and foreign economic processes must satisfy the arm’s length principle and not produce any “significant,” impermissible tax saving.²²³

4.391 Finally, footnote 59 states that “prices . . . in transactions between exporting enterprises and foreign buyers . . . *should for tax purposes* be the prices which would be charged between independent enterprises at arm’s length.” (Emphasis added). Because parties dealing at arm’s length can agree on a variety of prices, it is accepted in the tax area that the application of the arm’s length principle produces a range or zone of prices.²²⁴ Prices falling within this range meet the standard of “arm’s length,” and allocations of income consistent with this range are, for purposes of footnote 59, at “arm’s length.”

4.392 In its effort to establish that the FSC administrative pricing rules violate the arm’s length principle of footnote 59, the European Communities invokes the OECD Guidelines and Section 482 of the Internal Revenue Code. As a matter of law and treaty interpretation, neither the OECD Guidelines nor US law governs this dispute. Nothing in footnote 59, the 1981 Council Decision, or any other provision of the SCM Agreement provides that the OECD Guidelines or Section 482 establishes a standard applicable to all WTO Members. Indeed, were the Panel to declare the OECD Guidelines as the applicable benchmark for measuring compliance with the arm’s length principle of footnote 59, it would be imposing OECD norms on the 100-plus WTO Members that have not acceded to those Guidelines. Such an action by the Panel would clearly exceed its authority under the DSU.²²⁵

4.393 Moreover, both the Guidelines and Section 482 are concerned with allocating profits between related entities in individual transactions for tax administration purposes.²²⁶ The standard of

²²³ The European Communities contends that the very fact that the FSC administrative pricing rules reduce transfer pricing compliance costs constitutes an export subsidy. First European Communities Submission, paragraph 142. This surprising and sweeping contention would create disincentives for more efficient tax administration, because it suggests that steps taken to reduce administrative burdens for both administrators and taxpayers could constitute a subsidy under the SCM Agreement. Indeed, individual US taxpayers who elect to take the “standard deduction” in lieu of the more labour-intensive (but potentially tax saving) itemized deductions would be surprised to learn that by doing so, they receive a subsidy.

²²⁴ The European Communities concedes this point when it refers to the OECD Guidelines and section 482. *See* OECD Guidelines, paragraph 1.45 (“transfer pricing is not an exact science”). This concept is also embodied in the US section 482 rules. *See* Treas. Reg. 1.482-1(e)(1), which establishes the standard of an “arm’s length range” (US Exhibit 9).

²²⁵ *Cf.*, *European Communities - Measures Affecting Importation of Certain Poultry Products*, WT/DS69/AB/R, Report of the Appellate Body adopted 23 July 1998, paragraphs 79-81 (Oilseeds Agreement was not a “covered agreement” and, as such, did not contain the relevant obligations of the European Communities under the WTO Agreement). In this regard, even if the drafters had intended OECD Guidelines to govern the application of footnote 59, it could not have been the 1995 Guidelines, because those Guidelines did not yet exist when the *WTO Agreement* entered into force on 1 January 1995.

²²⁶ *See* OECD Guidelines, paragraph 1.6 (rules designed to allocate profits, and thereby taxable income, of the related companies that have entered transactions with one another or together); and Treas. Reg. 1-482-1(b)(1) (US Exhibit 9). In this regard, the United States notes that the FSC administrative pricing rules are more restrictive than section 482 in an important and unique respect. The regulations implementing section 482 contemplate flexibility in allocations based on an evaluation of all relevant facts and circumstances. By contrast, the FSC administrative pricing rules apply *only* if threshold foreign economic process requirements are satisfied.

footnote 59 has a different purpose – that any administrative practices used by Members when allocating income between domestic and foreign economic processes not confer a subsidy to exporters by systematically over-allocating income to foreign economic processes in such a way as to create a “significant saving” of taxes on income attributable to *domestic* economic processes.²²⁷

4.394 To prevail on its claim that the FSC administrative pricing rules fail to comply with the arm’s length principle of footnote 59, the European Communities must demonstrate, at a minimum that: (1) the allocations of income between domestic and foreign economic processes that the FSC rules produce fall outside the range of comparable allocations between independent enterprises acting at arm’s length; and (2) such a misallocation results in a significant saving of direct taxes in export transactions. Under the controlling WTO principles, this is the standard that must be met, and whether the FSC meets this standard should be the Panel’s sole inquiry.

4.395 By arguing simply that allocations between related entities in particular transactions may not coincide with the result that would be reached under Section 482, the European Communities fails to satisfy its burden as the complaining party to establish a *prima facie* case under the applicable legal standard. By focusing on a separate company, transactional pricing analysis, the European Communities misconstrues entirely the economic objective and import of the FSC regime. Its failure to do so is fatal to its claim.

The United States Designed the FSC to Replicate the Territorial Exemption Authorised by Footnote 59 and Thereby to Conform with the Arm's Length Principle of that Footnote

4.396 The European Communities' failure to establish a *prima facie* case regarding the FSC administrative pricing rules is not surprising. This is because the express purpose of the US Congress

²²⁷ In addition, several of the European Communities' assertions regarding the compliance of several aspects of the FSC administrative pricing rules with those benchmarks are simply inaccurate. For example, the European Communities asserts that the FSC pricing rules must be improper simply because they permit grouping of transactions and *ex post facto* determinations with respect to the pricing method chosen. *See, e.g.*, First European Communities Submission, paragraphs 63, 136. Indeed, the European Communities states that US transfer pricing rules under section 482 would not normally allow any choice of method by a corporation. *See* First European Communities Submission, paragraph 74. These assertions reflect a fundamental lack of understanding of the US transfer pricing rules applicable for tax purposes. It is not generally necessary that transfer prices be fixed for individual transactions at the time those transactions are executed. The US tax regulations issued under section 482 provide that companies may re-compute transfer prices at any time up to the point when the tax return for the relevant year is filed. *See* Treas. Reg. 1.482-1(a)(3) (US Exhibit 9). Moreover, if a company finds that its original transfer price needs to be adjusted in a way that results in higher taxable income, it may re-compute that price on an amended tax return at any time before the Internal Revenue Service contacts it about the price as originally reported. *Id.*; Treas. Reg. 1.6662-6(a)(2) (US Exhibit 10).

Furthermore, under the section 482 regulations, companies also may group the results of transactions for transfer pricing purposes, “evaluating the arm’s-length results by applying the appropriate method to the overall results for product lines or other groupings.” Treas. Reg. 1.482-1(f)(2)(iv) (US Exhibit 9). This authorization to group transactions for transfer pricing purposes is similar to the grouping by product line that is permitted under the FSC transfer pricing rules. *See* Section 927(d)(3).

Finally, the OECD Guidelines and US rules address another objection that the European Communities makes to the FSC administrative pricing rules – that those rules permit companies to choose a transfer pricing method when normal practice allegedly would not do so. *See* First European Communities Submission, paragraph 75. Both the Guidelines and the regulations under section 482 discuss at length various methods that may be accepted for the purpose of establishing an acceptable transfer price, and those lists are not exhaustive. Tax administrators have recognized that, for different industries, different types of businesses, and different conditions of business, different methods will be most appropriate. The choice of methods under the FSC transfer pricing rules reflects this recognition. More generally, the US rules under section 482 state explicitly that it is the result, not the method, that matters for transfer pricing purposes; so long as the taxpayer has reached an arm’s length result, it does not matter how that result was reached. *See* Treas. Reg. 1.482-1(f)(2)(v) (US Exhibit 9). For purposes of satisfying the arm’s length standard applicable to this dispute, it is also the result that matters, not the method. Footnote 59 requires that tax provisions reach arm’s length results in the aggregate in order to prevent any significant saving of direct taxes on export transactions. The FSC administrative pricing rules are completely consistent with this approach.

in creating the FSC was to allocate income in export transactions so as to exempt income attributable to foreign, but not domestic, economic activities from tax, in accordance with existing GATT rules. As the staff of the Joint Committee on Taxation explained,

Under GATT rules, a country need not tax income from economic processes occurring outside its territory. Accordingly, Congress believed that certain income attributable to economic activities occurring outside the United States should be exempt from US tax in order to afford United States exporters treatment comparable to what exporters customarily obtain under territorial systems of taxation.²²⁸

4.397 The Committee staff further stated:

[u]nder the GATT rules, an exemption from tax on export income is permitted *only if the economic processes which give rise to the income take place outside the United States*. In light of these rules, the Act provides that . . . the income of the FSC must be determined according to transfer prices specified in the Act . . . [including] formula prices *which are intended to comply with GATT's requirement of arm's-length prices*.²²⁹

4.398 Thus, the FSC rules, including the administrative pricing rules, were specifically designed to achieve the type of allocation required by footnote 59. The FSC rules are the administrative practice²³⁰ through which Congress sought to ensure that only income properly attributable to economic processes occurring outside the United States is eligible for the exemption from tax provided by the FSC.

4.399 To implement the objective of exempting from tax that income which is attributable to foreign economic activities, and thereby provide the same treatment to United States exporters that exporters receive under territorial systems, Congress fashioned rules that are compatible with the basic principles and structure of the US tax system. To replicate the effect of a territorial system within the US system, Congress, for reasons discussed below, required the formation of a foreign corporation, the FSC. Congress required the FSC to be responsible for all distributor functions, including all of the foreign economic activities in an applicable export transaction, regardless of whether or not the FSC actually performs those activities directly or contracts for their performance through a related supplier or another agent. Only a portion of the income from those foreign activities credited to the FSC is exempted from tax; the balance is taxed by the United States as being attributable to distribution activities occurring within the United States. By failing to discuss this purpose or structure, the First European Communities Submission does not even address whether the FSC complies with the standard of footnote 59.

The Structure of the FSC Is Dictated by Congress' Decision to Work Within the US Tax System

4.400 Because the US tax system is a worldwide system, rather than a territorial system, the United States generally taxes the foreign activities of United States corporations, but exempts from tax (subject to certain anti-avoidance rules) income from foreign economic processes earned by foreign corporations, including foreign subsidiaries of United States corporations. By contrast, under a tax system with "territorial" features, income from extraterritorial processes associated with exports can be exempted whether it is earned through the activities of a foreign corporation or the foreign ("branch") activities of a domestic corporation.

²²⁸ *General Explanation*, at 1042.

²²⁹ *Id.* at 1042-43 (emphasis added).

²³⁰ *Senate Print*, at 649 (FSC administrative pricing rules designed as an administrative convenience to both tax administrators and taxpayers) (US Exhibit 11).

4.401 By requiring that the FSC be a foreign corporation, Congress, acting within the confines of traditional US taxation principles, created a means for providing a partial exemption for all extraterritorial activities associated with export transactions, whether carried out by the FSC itself or whether attributed to the FSC. The FSC provisions rely on a foreign corporation as the means for achieving an exemption for foreign economic activities because that is the most appropriate method for doing so under the US world-wide taxation system.

4.402 To ensure a significant level of foreign economic activity, a FSC is required to: (1) be incorporated outside of the United States; (2) maintain an office with a permanent set of books in a qualified jurisdiction outside the United States; (3) satisfy certain “foreign presence” criteria that give it attributes comparable to a branch office or “permanent establishment” of the US parent company; and (4) as a condition of the application of the administrative pricing rules, take legal and financial responsibility for all of the functions traditionally carried out by a distributor with respect to export transactions (whether performed by the FSC, the US parent, a third party, or any combination of the these). The FSC is then credited with essentially all of the distributor/sales functions in the transaction performed outside of the United States, whether done by the FSC directly or by another party under contract to the FSC.²³¹

4.403 The First European Communities Submission does not acknowledge this design. The European Communities' argument is focused largely, and erroneously, on the assertion that a FSC does not directly perform enough economic activity using its own in-house resources to justify the share of the profits allocated to it under the administrative pricing rules. However, the FSC rules were not designed to force the FSC to perform all of the foreign economic activities itself; rather, they were designed to attribute to the FSC that income which is derived from foreign economic processes, regardless of the manner in which those processes are performed. So long as the FSC rules, in the end, exempt only income attributable to foreign economic processes of export transactions, the standard of footnote 59 is satisfied and the corporate forms are irrelevant.

4.404 In addition, in its attack on the more lenient rules for “small FSCs,” the European Communities argues that because a small FSC is exempt from the foreign management and foreign economic processes tests, small FSCs should not be entitled to a partial tax exemption. However, a small FSC is required to have foreign incorporation, a foreign office, and, in order to use the administrative pricing rules, must perform (or have performed on its behalf), all eight economic activities that are essential to the export sales function.²³² Thus, small FSCs do not have to satisfy the activities described in Sections 924(d) and 924(e) of the Internal Revenue Code. However, this treatment is justified as a means of reducing the burdens on small businesses, especially in light of the fact that small FSCs receive a partial tax exemption with respect to a maximum of \$5 million of foreign trading gross receipts.²³³

4.405 Finally, the FSC rules have been vigorously enforced by the US Internal Revenue Service. Like all other corporations, FSCs are required to submit tax returns and pay taxes, including estimated taxes. FSCs are routinely subjected to audits, adjustments of tax due, and penalties for taxes not paid when due. Moreover, in auditing a FSC return, examining agents check carefully to ensure that all

²³¹ Looking at the FSC and its US parent company together is fully consistent with a territorial tax system, which allows an exemption for foreign economic processes carried out through a foreign branch of a domestic corporation. Therefore, Congress spoke explicitly of “viewing the FSC and any related supplier as a single entity which sells to the purchaser.” *Id.*

²³² Sections 924(d)-(e) and 925(c) of the IRC.

²³³ The European Communities has conceded that what it calls “safe harbours” might be an appropriate way to relieve compliance burdens on small companies. First European Communities Submission, paragraph 91. In that regard, there are a number of provisions of the Internal Revenue Code that treat small businesses more favorably with respect to taxation and compliance requirements. If desired, the United States would be prepared to provide the Panel with a list of these provisions.

In addition, while the European Communities cites the fact that small FSCs account for 48 per cent of all FSCs, it ignores the fact that their economic impact is negligible, given that small FSCs account for only 2.3 per cent of all FSC income.

foreign presence, foreign management, and foreign economic process requirements are complied with, and that the computation of the partial tax exemption is accurate. Finally, the FSC rules have been enforced through court proceedings.²³⁴

Congress Limited the Tax Exemption Available Through the FSC

4.406 As an additional safeguard to ensure that the tax exemption received by a FSC extends only to income attributable to foreign economic activity, as required by footnote 59, Congress chose to exempt from tax less income than the United States was entitled to exempt under GATT rules. Although this decision was driven to a large extent by the fiscal policy of preventing a larger revenue loss, it nevertheless is the case that only a fraction of the income allocated to the FSC under the administrative pricing rules is eligible for the tax exemption. For example, under the CTI method most commonly used by FSCs, of the 23 per cent of the combined taxable income of the FSC and its related supplier that may be allocated to the FSC, only 15 per cent of the combined taxable income of the FSC and its related supplier attributable to foreign trade gross receipts is exempt from federal income tax ($0.23 \times 15/23 = 0.15$). This figure is a conservative approximation of the amount of foreign economic activity for which the FSC is responsible.

The European Communities Has Failed to Establish that the Allocations to FSCs Under the Administrative Pricing Rules Do Not Yield Results Within the Range of the Arm's Length Results Required by Footnote 59

4.407 The factual and historical record just discussed makes it clear that the US Congress was attempting specifically to comply with the income allocation principle that later was set forth in footnote 59. The only possible remaining question is whether the FSC rules failed to achieve that purpose.

4.408 Notwithstanding the existence of publicly available data that would help answer this question, the European Communities has failed to offer any evidence on this point, relying instead on conjecture rather than facts. Because the European Communities has not presented *any* evidence, let alone evidence sufficient to establish a *prima facie* case, the United States has no evidentiary showing to rebut.

4.409 However, the European Communities' allegations could be tested in a variety of ways. The points of reference under the FSC rules would be, of course, the allocations allowable under the FSC administrative pricing rules. The more commonly used of the two administrative pricing alternatives is the CTI method. Under this method, 23 per cent of the combined taxable income of the FSC and its related manufacturer-supplier is allocated to the FSC. Of the 23 per cent of total income, only 15 per cent (or 15/23) of the total is eligible for the FSC tax exemption. Accordingly, the tax exemption available under the CTI method is 15 per cent of the total combined income of the FSC and its manufacturer-supplier. Thus, in assessing whether the result under the CTI method conforms to footnote 59, the question would be whether, in the case of unrelated manufacturers and distributors, the distributors earn in the range of 15 per cent or more of the combined total income of the distributors and unrelated manufacturers.

4.410 The other administrative pricing alternative is the gross receipts method, under which 1.83 per cent of qualified gross receipts is allocated to the FSC. Here, the question would be whether the gross receipts of distributors that are unrelated to their manufacturer-suppliers are in the range of the 1.83 per cent prescribed by the FSC rules.

4.411 With these points of reference in mind, the European Communities could have attempted to show that the FSC administrative pricing rules rely on faulty assumptions regarding the profit attributable to distributors in export transactions. Because the FSC rules require FSCs to be

²³⁴ See, e.g., *Naporano v. United States*, 834 F. Supp. 694 (D. N.J. 1993) (US Exhibit 18); and *Union Carbide Corp. v. Commissioner of Internal Revenue*, 110 T.C. No. 28 (1998) (US Exhibit 19).

responsible for the distributor functions in export transactions, their function is analogous to the function of independent distributors.

4.412 The European Communities could have used publicly available Statistics of Income data published annually by the US Internal Revenue Service to determine the relative profit shares realized by independent distributors and unrelated manufacturers. This aggregate, public data then could have been used as a basis for comparing empirical performance with the 23 per cent of combined taxable income that the CTI method allocates to FSCs. These data would allow such comparisons to be done on an industry-by-industry basis.

4.413 The European Communities could have performed a similar empirical analysis using publicly available data derived from corporate financial statements filed annually by US corporations with the US Securities and Exchange Commission. These data would support an analysis not only of how profits split between distributors and unrelated manufacturers, but also of the allocation made under the FSC gross receipts allocation method.

4.414 Such comparisons with empirical taxpayer and corporate data would be one basis for evaluating the reasonableness of the FSC administrative pricing rules, and for determining whether those rules result in an over-allocation of income to foreign economic processes.

4.415 Because individual taxpayer information is not publicly available, the data on which such analyses could be made is, of course, aggregate data. However, aggregate data is an entirely appropriate basis for assessing the results that the FSC rules seek to achieve. Not only does footnote 59 anticipate that Members may employ administrative practices (the reasonableness of which can be confirmed only by average, or aggregate, data), but also the ultimate test under footnote 59 – that, in the end, administrative practices for allocating income must not result in a “significant saving of direct taxes in export transactions” – suggests that an aggregate test is appropriate.²³⁵

4.416 However, notwithstanding the existence of seemingly relevant data, and notwithstanding that it is the burden of the European Communities, as the complainant in this case, to make an initial factual showing that the FSC administrative pricing rules violate the standard set forth in footnote 59, thus far, the European Communities has failed to offer *any* evidence that the FSC administrative pricing rules create tax exemptions for anything other than income attributable to economic activity occurring outside of United States territory. That standard is the only standard required by the SCM Agreement.²³⁶

4.417 To meet its burden of proof, the European Communities must come forward with evidence showing that the FSC administrative pricing rules generally allow income generated from economic activities occurring in the United States to escape taxation and that this results in a “significant saving of direct taxes in export transactions.” The mere assertion that the FSC, as a separate entity, does not itself perform all of the foreign economic processes involved in an export transaction is not enough.

²³⁵ Footnote 59 also provides that any Member that believes that another Member’s administrative or other practices contravene the arm’s length principle may draw that issue to the attention of the other Member. Because taxpayer information is generally confidential, aggregate data would be the logical basis for a Member’s making such an assertion. This suggests that the drafters of footnote 59 contemplated the use of aggregate data on this issue.

²³⁶ The European Communities’ superficial conclusions about the operation, purpose, and effect of FSCs may be attributable in part to the secondary literature on which the European Communities’ case has relied so heavily. Written by authors who appear not to have a complete understanding of both the trade and tax origins of the FSC provisions, some of the articles are marketing efforts that exaggerate the tax reductions available through FSCs. Others, drawn from the popular press, superficially portray FSCs, along with a host of other governmental programmes and institutions, in a flamboyant, not an analytical, manner. That such sources provide the evidentiary support for the European Communities’ claims speaks to more than just the burden of proof.

Even if the FSC Administrative Pricing Rules Were Considered to Contravene the Arm's Length Principle in Footnote 59, Those Rules Do Not Result in a Significant Saving of Direct Taxes in Export Transactions

4.418 The United States has demonstrated that the FSC administrative pricing rules do not contravene the arm's length principle of footnote 59. However, even assuming *arguendo* that those rules did depart from the arm's length principle, they still would be consistent with footnote 59, because the rules do not generate a significant saving of direct taxes in export transactions within the meaning of the footnote.

4.419 Nowhere does the European Communities address footnote 59's requirement that, in order to create a prohibited export subsidy, any derogation by administrative or other practices from the arm's length principle must create a "significant saving of direct taxes in export transactions." This requirement, which is joined to the arm's length principle with the conjunctive "and" in the footnote's text, is an essential element that the European Communities must prove in order to support its allegation.

4.420 Because the European Communities failed to address this standard or to provide any evidence relating to it (other than a general discussion of the aggregate tax reduction reportedly enjoyed by FSCs), the European Communities has failed to make a *prima facie* case with regard to its export subsidy claims. Therefore, in the absence of additional evidence, neither the Panel nor the United States is required to address the issue further.²³⁷ Nevertheless, the United States will do so.

4.421 Although no GATT or WTO panel has yet attempted to quantify "significant saving" under footnote 59 specifically, the text of the SCM Agreement itself provides helpful guidance in construing that term. Consistent with the generally accepted principle that subsidies should have distortive trade effects in order to warrant a remedy under the SCM Agreement, the Agreement has more than one provision setting a threshold above which subsidies must rise to warrant a remedy.

4.422 One such threshold is the *de minimis* standard found in Article 11.9 for purposes of the countervailing duty remedy. Under Article 11.9, a Member contemplating countervailing measures against subsidized imports must find that the amount of the benefit conferred by subsidies are more than *de minimis*. Otherwise, a countervailing duty investigation must be immediately terminated.

4.423 "*De minimis*" is a defined term. Article 11.9 provides that any subsidy shall be considered *de minimis* if it is less than 1 per cent *ad valorem*.²³⁸ Annex IV to the SCM Agreement prescribes how *ad valorem* subsidy rates are to be calculated for certain subsidy disputes. The overall value of the subsidy benefit is expressed as a percentage of the total value of the recipient firm's sales during the period in which the subsidy is granted. This method is used by the United States for purposes of its own countervailing duty law, and the United States understands that the European Communities also employs this method for purposes of its countervailing duty law.

4.424 For tax-related subsidies, the calculation rules in Annex IV are explicit. Specifically, footnote 64 states that "in the case of tax-related subsidies the value of the product shall be calculated as to total value of the firm's sales in the fiscal year in which the tax-related measure was earned." Here, too, the United States uses the same method under its countervailing duty law, and the United States believes that the European Communities does also under its countervailing duty law. Under this method, a subsidy with a value of less than 1 per cent of sales value (effectively a percentage of gross receipts) would be considered *de minimis* for purposes of Article 11.9.

4.425 This definition of *de minimis* is, of course, found in the very same agreement that excludes direct tax subsidies that do not produce a "significant saving" of direct taxes in export transactions.

²³⁷ See *European Communities - Measures Affecting Meat and Meat Products (Hormones)*, WT/DS26/AB/R, Report of the Appellate Body adopted 13 February 1998, at paragraph 98.

²³⁸ Articles 27.10 and 27.11 establish higher *de minimis* thresholds for developing country Members.

Principles of construction of international agreements, as articulated in WTO jurisprudence, indicate that these terms should be construed rationally and harmoniously within the context of the SCM Agreement.²³⁹ The same considerations that led the drafters to make *de minimis* subsidies non-actionable under Part V of the SCM Agreement underlie the requirement that a tax measure result in a “significant saving of direct taxes in export transactions” in order to constitute a prohibited export subsidy. The plain meaning of the two terms indicates that *de minimis* is the lower threshold and that anything that is *de minimis* falls well below “significant.” It would be anomalous, as well as a distortion of the language of the SCM Agreement, for the “benefits” of a tax measure to be “*de minimis*” but at the same time “significant.”

4.426 The most recent report by the Treasury Department to the US Congress on the operation of the FSC, dated November 1997, aggregates the maximum tax savings that may be attributed to the FSC.²⁴⁰ Using the same type of calculation as that set out in Annex IV of the SCM Agreement and used by the United States and the European Communities for countervailing duty purposes, the report shows that the aggregate tax savings under the FSC for all products and services in the year covered by the report was 0.93 per cent *ad valorem*. This is below the 1 per cent *de minimis* level of Article 11.9.

4.427 Moreover, this calculation overstates any possible subsidy attributable to the FSC administrative pricing rules, because the calculation includes all tax savings conferred under the FSC provisions during the year measured. Thus, the 0.93 per cent figure includes tax savings available under the Section 482 allocation method, a method that the European Communities has conceded does not contravene the arm’s length principle of footnote 59. Because the exemption from taxation of income derived from foreign economic processes is permissible as long as the arm’s length principle is observed in allocating income, and because the European Communities has conceded that the Section 482 method conforms to the arm’s length principle, any potential “subsidy” that might be conferred through the application of the FSC administrative pricing rules (an amount for which the European Communities has offered no evidence) would be only a fraction of 0.93 per cent *ad valorem*, a figure that is already *de minimis*.

4.428 In sum, any “benefit” conferred by the FSC administrative pricing rules is indisputably *de minimis* under the rules of the SCM Agreement. By an even wider margin, those “benefits” do not result in any “significant saving of direct taxes in export transactions” under footnote 59. The European Communities has not presented any evidence otherwise. Instead, its own evidence (in the form of Exhibit EC-5) establishes that any “benefit” conferred by the FSC administrative pricing rules falls below all of the thresholds set forth in the SCM Agreement.

The FSC Is Not a "Subsidy" Under the SCM Agreement

4.429 In the preceding section, the United States addressed the status of the FSC under the provisions of the SCM Agreement that most specifically address an income tax measure like the FSC. The United States responded to the European Communities’ claim that the FSC constitutes an export subsidy under Article 3.1(a) of the SCM Agreement by discussing the controlling legal standard found in footnote 59 and the related 1981 Council Decision. The same legal principles apply, however, to the question of whether a Member’s decision not to tax income attributable to economic processes located outside of its territory is a “subsidy” at all, as that term is defined in Article 1 of the SCM Agreement.

²³⁹ See, e.g., *Reformulated Gasoline*, at 16-17 (citing Article 31 of the *VCLT* for the proposition that GATT 1994 articles “should be read in context and in such manner as to give effect to the purposes and object of the General Agreement . . . [and] the context of [the relevant article] includes the provisions of the test of the General Agreement”); and *Alcoholic Beverages*, at 11 (“Provisions of [GATT 1994 and other “covered agreements”] are to be given their ordinary meaning in their context”).

²⁴⁰ Exhibit EC-5.

4.430 For a measure to be a prohibited or actionable subsidy, it must first come within the definition of a “subsidy” set forth in Article 1. With respect to Article 1, the European Communities alleges that the FSC amounts to “a financial contribution by a government” because, under the FSC, “government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits).”²⁴¹ What the European Communities fails to do, however, is to explain why potential tax revenues from income attributable to foreign economic processes are revenues that are “otherwise due.”

4.431 The conclusive answer to the question that the European Communities declines to discuss is provided by the controlling legal principles articulated in footnote 59 and the 1981 Council Decision. The broad principles expressed in footnote 59 and the 1981 Council Decision necessarily bear on Article 1, and they must be interpreted in harmony with each other.²⁴² Indeed, it is clear from the language of footnote 59 and the 1981 Council Decision that the principle they embody must apply to the interpretation of Article 1.

4.432 As explicitly stated in the 1981 Council Decision, “economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country *need not be subject to taxation by the exporting country . . .*” (emphasis added). As explained by the Chairman of the GATT Council at the time the Decision was adopted, this statement “does not mean that the parties adhering to Article XVI:4 are forbidden from taxing the profits on transactions beyond their borders, it only means that *they are not required to do so*” (emphasis added).²⁴³

4.433 Thus, where the applicable WTO rules provide that a category of income need not be taxed, taxes on that income cannot be considered as “otherwise due.” Any other reading of this provision would be inconsistent with the ordinary meaning of both footnote 59 and of Article 1.1(a)(1)(ii).

4.434 The circular reasoning upon which the European Communities bases its argument shows nothing other than that if income that is exempt from tax were not exempt from tax, there would be additional government revenue.²⁴⁴ While this proposition is not, on its face, incorrect, it does not address the controlling legal question of whether the hypothetical government revenue was “otherwise due.” In this case, WTO principles provide that the United States is not required to tax income attributable to foreign economic processes. The fact that the provision through which the United States chooses to exercise its right not to tax such income is often referred to as an “exemption” does not mean that taxes would be “otherwise due” any more than a decision to adopt a territorial tax system and “exempt” income arising from activities outside the territory from tax means that such a decision is an Article 1 “subsidy”.

4.435 Returning to the definition of “subsidy” in Article 1.1 of the SCM Agreement, the FSC does not cause the US Government to forego revenue that is “otherwise due.” As a result, the FSC does not constitute a “financial contribution by a government” and, thus, is not a “subsidy” for purposes of Article 1.1(a). Consequently, the FSC cannot be a prohibited export subsidy within the meaning of Article 3.1(a), because Article 3.1(a) requires that export subsidies must first be “subsidies . . . within the meaning of Article 1”.

4.436 That the FSC is not a “subsidy” within the meaning of Article 1 has far-reaching implications in this case. Not only does it dispose of the European Communities' Article 3.1(a) claim, it also forecloses the European Communities' claim that the FSC is a prohibited import substitution subsidy within the meaning of Article 3.1(b). Article 3.1(b) requires as a threshold matter that a challenged measure be a subsidy under Article 1. Moreover, it also defeats the European Communities' claim that the FSC violates the export subsidy provisions of the AA, because those provisions must be construed in light of the subsidy definitions of Article XVI of GATT 1994 and the SCM Agreement.

²⁴¹ First European Communities Submission, paragraphs 123-130.

²⁴² *VCLT*, art. 31(1).

²⁴³ *Tax Legislation*, BISD 28S/114.

²⁴⁴ First European Communities Submission, paragraph 132.

Accordingly, this definitional issue under Article 1 of the SCM Agreement is dispositive of all of the European Communities' claims.

The European Communities Has Failed to Make a Prima Facie Case that the FSC Violates WTO Rules

4.437 Finally, the United States notes that, as the complaining party, it is the European Communities, not the United States, that bears the burden of proof in this case.²⁴⁵ As a result, the European Communities is obligated to establish a *prima facie* case with respect to each of the elements necessary to demonstrate the violations alleged. Establishing a *prima facie* case requires presenting both sufficient legal arguments and, where factual issues are in dispute, adequate supporting evidence. The Appellate Body has made this clear, stating that a panel should begin “its analysis of each legal provision by examining whether the [complaining party] has presented evidence and legal arguments sufficient to demonstrate that the . . . measures were inconsistent with the obligations assumed by the [responding party] under each article of the [applicable] agreement addressed by the Panel.”²⁴⁶

4.438 To establish a *prima facie* case, the European Communities must provide a quantum of evidence sufficient to establish a presumption that the FSC violates a provision of a WTO agreement.²⁴⁷ In this regard, the Appellate Body has stated that “we find it difficult, indeed, to see how any system of judicial settlement could work if it incorporated the proposition that the mere assertion of a claim might amount to proof . . . [T]he party who asserts a fact . . . is responsible for providing proof thereof.”²⁴⁸

4.439 Absent such a showing, the United States, as the responding party, need not rebut the allegations. The Appellate Body has explained that “[o]nly after such a *prima facie* determination has been made by the Panel may the onus be shifted to the [responding party] to bring forward evidence and arguments to disprove the complaining party’s claim.”²⁴⁹

The European Communities Has Failed to Establish a Prima Facie Case that the FSC Tax Exemption Is Per se a Prohibited Subsidy Under Article 3.1(a)

4.440 The European Communities first alleges that the tax exemption conferred by the FSC constitutes a *per se* prohibited export subsidy under Article 3.1(a) of the SCM Agreement. This argument is a legal, not a factual, argument.

4.441 With respect to this argument, the European Communities has failed to make a *prima facie* case principally because, first, it has failed to invoke the correct legal standard. The European Communities has ignored the fact that footnote 59 and the 1981 Council Decision qualify paragraph (e) of Annex I by providing that the exemption from tax of income attributable to foreign economic processes (including income arising out of export transactions) does not constitute an export subsidy. Because the FSC does just that, the European Communities' argument is insufficient on its face to support the contention that the FSC tax exemption is *per se* prohibited by Article 3.1(a).

²⁴⁵ The United States arguments reflected in paragraphs 4.437-4.439 apply with respect to all of the claims of the European Communities.

²⁴⁶ *EC – Measures Affecting Meat and Meat Products (Hormones)*, WT/DS26/AB/R, WT/DS48/AB/R, Report of the Appellate Body adopted 16 January 1998, at paragraph 109; *see also*, *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India (Shirts and Blouses)*, WT/DS33/AB/R, Report of the Appellate Body adopted on 25 April 1997, at 16 (“a party claiming a violation of a provision of the WTO Agreement by another Member must assert and prove its claim”); and *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, Report of the Appellate Body adopted on 16 January 1998, at 27 (noting that the Panel had “properly requir[ed] the [complaining party] to establish a *prima facie* case” before proceeding to the next step of its evaluation of the claim at issue).

²⁴⁷ *Shirts and Blouses*, at 13.

²⁴⁸ *Id.*, at 14.

²⁴⁹ *Hormones*, at paragraph 109; *see also*, *Shirts and Blouses*, at 14.

4.442 Furthermore, as a threshold matter, Article 3.1(a) requires that a measure first must be a subsidy under Article 1. In this case, the question of whether the FSC is a subsidy turns on whether it involves the United States foregoing revenue “that is otherwise due.” The principle underlying footnote 59, however, indicates that no taxes need be levied on income attributable to foreign economic processes. Thus, revenue from such income is not due at all and cannot be said to be “foregone.” By arguing that government revenue is foregone simply because a tax exemption is conferred, the European Communities makes a conclusory assertion, not a legal argument tied to the actual text of the SCM Agreement.²⁵⁰

4.443 Indeed, in light of the established legal principle that income attributable to foreign economic processes need not be taxed, and in light of Congress’ clear purpose to take advantage of precisely that principle, the only export subsidy issue properly before the Panel is whether the FSC, in practice, exempts more income than this principle allows. This is the question raised by the second European Communities allegation.

The European Communities Has Failed to Meet Its Burden of Proof With Respect to Its Claim that the FSC Administrative Pricing Rules Constitute a Prohibited Subsidy Under Article 3.1(a)

4.444 The second major European Communities contention under Article 3.1(a) is that the FSC administrative pricing rules allegedly contravene the arm’s length principle of footnote 59. On this point, the European Communities has failed to make a *prima facie* case for three reasons. First, the European Communities misconstrues the applicable legal standard under Article 3.1(a), and, as a result, has failed to present any evidence relevant to that standard; namely, whether the FSC administrative pricing rules allocate income attributable to foreign economic processes to the FSC in accordance with the standard of footnote 59. Second, even under the mistaken theory on which the European Communities relies, the European Communities has failed to present facts sufficient to demonstrate that the FSC administrative pricing rules do not approximate arm’s length results. Third, the European Communities has failed to provide any evidence that the FSC administrative pricing rules result in a significant saving of direct taxes in export transactions.

The European Communities Has Relied on the Wrong Standard and Provided No Evidence to Prove Its Claim Under the Right Standard

4.445 The European Communities maintains that the FSC administrative pricing rules contravene the arm’s length principle of footnote 59 because they *may* produce results in individual transactions that would differ from those that would be obtained under Section 482. However, as demonstrated above, this point is irrelevant. What matters for purposes of footnote 59 is whether the FSC pricing rules properly allocate income attributable to foreign economic processes (or, conversely, whether the FSC pricing rules improperly allocate income attributable to *domestic* economic processes to the FSC). On this seminal question, the European Communities has provided *no* evidence.

4.446 In particular, the European Communities has presented no evidence even suggesting that the FSC administrative pricing rules have resulted in an exemption for income attributable to *domestic* economic processes. The European Communities has not shown that the overall tax exemption conferred by the FSC includes any income derived from economic activities occurring *within* the United States.

The European Communities Has Offered No Proof of a "Significant Saving" of Tax

²⁵⁰ For the same reasons, the European Communities has failed to make a *prima facie* case that the FSC tax exemption violates Article 3.1(b). Because the tax exemption does not result in foregone revenue that is “otherwise due,” it does not constitute a subsidy under Article 1. In addition, because the tax exemption is not an export subsidy under Annex I, it cannot, pursuant to footnote 5, be prohibited by Article 3.1(b).

4.447 Finally, even assuming *arguendo* that the FSC administrative pricing rules do allow for the exemption of direct taxes on income attributable to domestic economic processes, the European Communities has presented no evidence showing that the resulting tax saving from such exemption is “significant,” as is required under footnote 59.

4.448 In short, the European Communities must provide the Panel with evidence showing both that the FSC administrative pricing rules contravene the arm’s length principle of footnote 59 *and* that any such contravention results in a significant saving of taxes. In the absence of such evidence, the European Communities’ claim regarding the administrative pricing rules must be rejected.²⁵¹

The **European Communities** rebuts the United States’ response in its Oral Statement at the First Meeting of the Panel as follows:

Introduction

4.449 In discussing the more legal questions, the European Communities will follow the order of its First Written Submission and deal first with the export subsidy and local content subsidies under the SCM Agreement and then turn to the AA.

4.450 But first, the European Communities would just remind you that its First Written Submission identified and objected to *two subsidies* in the FSC scheme.

4.451 The first was the *tax exemptions* comprised in the FSC scheme. The second was the availability for the calculation of the foreign trade income of FSCs of *special administrative pricing rules* which derogate from the transfer pricing rules which would otherwise apply. Both are contingent in law on export of United States goods and on the use of United States rather than imported inputs in the manufacture of those goods.

4.452 The European Communities makes this distinction between two aspects of the FSC scheme because it is important that both be held to be prohibited subsidies so that both will have to be withdrawn.

Export Subsidies – SCM Agreement

Introduction

4.453 In its First Written Submission the European Communities demonstrated that the tax exemptions contained in the FSC scheme and the increased revenue forgone as a result of the application of its administrative pricing rules constitute prohibited export subsidies by following a *systematic* approach dictated by the *structure* of the SCM Agreement.

- It first showed that they resulted in revenue forgone and conferred a benefit within the meaning of Article 1.1 of the SCM Agreement;
- It then explained that by virtue of Article 2.3 of the SCM Agreement they would be specific if contrary to Article 3 of the SCM Agreement.

²⁵¹ For the same reasons, the European Communities has failed to make a *prima facie* case that the FSC administrative pricing rules violate Article 3.1(b). The European Communities’ assertion fails for the same reasons discussed in connection with its assertion regarding the FSC tax exemption: (1) because the administrative pricing rules do not result in foregone revenue that is “otherwise due,” those rules do not constitute a subsidy under Article 1; and (2) because the administrative pricing rules are consistent with footnote 59, they are not an export subsidy under Annex I, and, thus, under footnote 5 cannot be prohibited by Article 3.1(b).

- It then showed that the FSC subsidies were contingent in law upon export performance contrary to Article 3.1(a) SCM Agreement.

4.454 Although the above is in fact sufficient to show that the FSC subsidies are prohibited export subsidies under the SCM Agreement, the European Communities went on to show that this result is confirmed by Item (e) of the Illustrative List. It is important to stress that the Illustrative List contains a certain number of export subsidies which are *deemed* to be *included* in the prohibition in Article 3.1(a) of the SCM Agreement and of course that it is *illustrative*.

4.455 Item (e) specifically deals with export subsidies deriving from

“the full or partial exemption remission, or deferral specifically related to exports, of direct taxes ... paid or payable by industrial or commercial enterprises.”

And thus confirms that there is no implicit exception from the SCM Agreement for direct taxes.

4.456 Of course it is easy to show that the FSC subsidies come within Item (e) and this the European Communities did in its First Written Submission.

The US Arguments

4.457 The European Communities will now comment on the United States' arguments. Instead of applying the SCM Agreement to the FSC scheme by starting with Article 1 (the definition of a subsidy) and then applying Article 3.1 (the prohibition on export and local content subsidies) and Item (e) of the Illustrative List (which deals with exemptions from direct taxes) in the light of its footnote 59, the United States turns the whole system on its head and starts with footnote 59 which it has to twist and turn to extract what it would wish to be a "controlling legal standard".

4.458 Fundamental to the United States case is a clever concept which it calls the “controlling legal standard” or principle. By this it is not referring to Item (e). It is not even referring to the footnote to Item (e). It is referring to a principle which it wishes to read into the footnote and thus the SCM Agreement *but which does not in reality exist*.

4.459 The United States refers to the second sentence of footnote 59 which states that

“The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length.”

4.460 and claims²⁵² that:

“The *necessary predicate* of footnote 59 is that income from foreign economic processes may be exempted from direct taxes.”

4.461 The United States does not claim that footnote 59 says this. Footnote 59 does not mention “foreign economic processes” and does not exempt anything. The United States claim is that the principle it would wish the Panel to apply *underlies* footnote 59.

4.462 This is not true. The European Communities will examine in a moment the arguments the United States makes in support of its claim of an underlying principle or “necessary predicate,” which rely heavily on a distortion not only of texts but also of negotiating history. But first it is necessary to point out that the United States approach to interpretation is incorrect and contrary to the DSU.

²⁵² Paragraph 59 of the US First Written Submission.

The Correct Approach to Interpretation

4.463 The United States' claims can already be seen to be misguided from the fact that they derive from a wrong approach to interpretation.

4.464 Panels are directed by Article 3.2 DSU to interpret the WTO Agreements “in accordance with customary rules of interpretation of public international law”. As the Appellate Body has confirmed on a number of occasions these are codified in Articles 31 and 32 of the 1969 Vienna Convention on the Law of Treaties. Article 31.1 provides that

“a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”.

4.465 This means in particular that a treaty interpreter must respect the structure of the treaty and interpret the words that are there. He may not start by imagining a “necessary predicate” of a footnote to an Annex containing an Illustrative List and distort all the rest of the Agreement to fit in with what he wishes this footnote to mean. This is turning interpretation on its head.

4.466 In order to justify this approach, the United States makes a *lex specialis* argument.²⁵³

4.467 The United States refers to the Appellate Body’s advice to Panels in *Bananas*²⁵⁴ to examine more specific provisions first, which the United States says derives from the interpretative principle of *generalia specialibus non derogant*.

4.468 We can leave to one side the question of whether the Appellate Body was confirming the applicability of a principle of “*lex specialis*” or simply giving panels a lesson in “judicial economy”. (This principle is not mentioned in the Vienna Convention and its application to the WTO is not without difficulty in the light of the general interpretative note to Annex 1A of the WTO.) For present purposes it is sufficient to note that we are not concerned here with different agreements or even provisions – we are examining *a single legal norm*. That is the prohibition of export subsidies in Article 3.1(a), which expressly *includes* the export subsidies in the Illustrative List, which of course in turn *includes* Item (e) and its footnote. There is no scope here for *lex specialis*. The United States is seeking to persuade the Panel to do the opposite of what Article 31 of the Vienna Convention requires, that is to interpret footnote 59 *out of context*. Its context is *first* the text of Item (e) which expressly deems to be an export subsidy “the exemption of direct taxes payable by commercial enterprises if this is “specifically related to exports”, and second Article 3.1(a) itself which prohibits subsidies contingent in law or fact on export performance. The applicability of these provisions to the FSC subsidies could hardly be clearer.

4.469 The United States is also asking the Panel to disregard Article 31 of the Vienna Convention by interpreting not only Article 3.1(a) and Item (e) but also footnote 59 divorced from the ordinary meaning of the terms used. The terms of footnote 59 do not refer to “foreign economic processes” as being exempted from tax.

The other defects in the United States arguments

4.470 Do not imagine that this is the only weakness in the United States argument. Let us examine the other arguments the United States makes in support of the existence of its “controlling legal standard”. These are:

²⁵³ It is perhaps a recognition of its weakness that it is contained only in a footnote (footnote 68 to paragraph 89 of the US First Written Submission).

²⁵⁴ *European Communities - Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/AB/R, Report of the Appellate Body adopted 25 September 1997, paragraph 204.

- First that if there were no such principle, the arm's length principle (which is mentioned in footnote 59) would be irrelevant.²⁵⁵
- Second that this "controlling legal standard" is well-established in pre-existing GATT law. *The argument that, in the absence of the "controlling legal standard", the arm's length principle would be irrelevant*

4.471 The reference to arm's length prices in footnote 59 reads as follows:

"The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length."

4.472 This sentence is not irrelevant – it is stating that one of the ways in which an export subsidy can be given is by allowing an exporter to sell at an undervalue to a foreign related buyer. Of course this sentence assumes that the foreign related buyer may not be taxed at the same level as the exporter and this may lead to a lower total tax charge for the income arising from the export transaction. There may be all sorts of reasons for this factual circumstance. The quoted sentence does not say or even imply that the exporting country has the right to *exempt from tax* income from an export transaction which would otherwise bear tax. If it did, it would be directly contradicting both Item (e) and Article 3.1(a).

The argument that the "controlling legal standard" is well-established in pre-existing GATT law

4.473 The second United States argument – that the "controlling legal standard" is well-established in pre-existing GATT law is based on the Decision of the GATT 1947 Contracting Parties to adopt the Panel Reports in the *Tax Legislation Cases*²⁵⁶ and includes a claim that this is part of the negotiating history of footnote 59.

4.474 The European Communities has a number of comments to make on these claims.

- First the Understanding in the *Tax Legislation* cases is irrelevant to the present case which is based on the SCM Agreement, not Article XVI GATT.
- Second, the Understanding is not part of GATT 1994;
- Third, the Understanding in the *Tax Legislation* cases does not contain the claimed "controlling legal standard".

4.475 It ought not to be necessary to spend much time on GATT history and the Understanding in the *Tax Legislation* cases for the simple reason that this is related to Article XVI GATT 1947 and the present case is based on the SCM Agreement.

4.476 The European Communities does not wish to belittle the importance of these cases at the time or the quality of the work performed by the persons involved in the 1970s and 80s, but the world, and the WTO, have moved on since then. We now have a detailed SCM Agreement with a specific and strict prohibition of export subsidies, including those deriving from the exemption of direct taxes

²⁵⁵ Paragraph 91 of the US First Written Submission.

²⁵⁶ *United States - Tax Legislation (DISC)*, L/4422, BISD 23S/98; *Tax Legislation - Income Tax Practice Maintained By France*, L/4423, BISD 23S/114; *Tax Legislation - Income Tax Practice Maintained By Belgium*, L/4424, BISD 23S/127; *Tax Legislation - Income Tax Practice Maintained By The Netherlands*, L/4425, BISD 23S/137. All the reports were adopted on 7-8 December 1981 on the basis of an Understanding published in BISD 28S/114.

specifically related to exports – something which did not exist in 1973 when the *Tax Legislation* cases were brought. One could also add that there is now a superior system of dispute settlement in existence.

4.477 The United States further claims that the Understanding in the *Tax Legislation* cases is part of the negotiating history of the predecessor to footnote 59, footnote 2 to Item (e) to the Tokyo Round revision of the Illustrative List. This is false. One reason is that the Understanding was adopted in December 1981, more than two and a half years after the conclusion of the Tokyo Round SCM Agreement. The Understanding was proposed after conclusion of the Tokyo Round and was the subject of political compromise up to the last moment. Some elements of the Understanding repeat elements found in the Illustrative List but this is *not* the case with the reference to “foreign economic processes” on which the United States relies so heavily.

4.478 Another reason why this contention is incorrect is that, as US President Jimmy Carter stated in his Memorandum of 4 January 1979 notifying the US Congress that he intended to conclude the Tokyo Round Agreements (which the European Communities annexes to this statement as Exhibit EC-23), the Tokyo Round the SCM Agreement introduced a “flat prohibition of export subsidies” and “a definition of export subsidy which abolishes the existing dual pricing requirement”.²⁵⁷

4.479 The *Tax Legislation* reports are all based on the thesis that the legislation under review leads to dual pricing, that is lower prices for exports than for domestic sales. Since this requirement has been abolished and the current rules on export pricing are tighter, the *Tax Legislation* reports are no longer relevant.

4.480 The United States attempts to give current force and relevance to the Understanding by claiming that it is a decision of the GATT Contracting Parties which is carried over into the WTO by virtue of Article XVI:1 of the *WTO Agreement* and paragraph 1(b)(iv) of the introductory language to GATT 1994²⁵⁸, even claiming²⁵⁹ that this even makes the Understanding “subsequent practice” within the meaning of Article 31(3)(b) of the *Vienna Convention on the Law of Treaties*.

4.481 The Appellate Body has explained the status of such decisions in *Japan – Taxes on Alcoholic Beverages*²⁶⁰ and this entirely contradicts the position of the United States in the present case. The Appellate Body said the following:

“[W]e do not agree with the Panel's conclusion in paragraph 6.10 of the Panel Report that “panel reports adopted by the GATT CONTRACTING PARTIES and the WTO Dispute Settlement Body constitute subsequent practice in a specific case” as the phrase “subsequent practice” is used in Article 31 of the *Vienna Convention*. Further, we do not agree with the Panel's conclusion in the same paragraph of the Panel Report that adopted panel reports in themselves constitute “other decisions of the CONTRACTING PARTIES to GATT 1947” for the purposes of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the *WTO Agreement*.”

4.482 The 1981 Decision adopting the *Tax Legislation* reports may be unusual to the extent that it qualified those reports but this does not change its legal nature. Panel reports were always only proposals to the GATT CONTRACTING PARTIES which was the body which adopted recommendations for the resolution of disputes and so the GATT CONTRACTING PARTIES was

²⁵⁷ See page 1935 of the document in Exhibit EC-22

²⁵⁸ Paragraph 103 of the US First Written Submission.

²⁵⁹ Paragraph 104 of the US First Written Submission.

²⁶⁰ WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R of 4 October 1996 (AB-1996-2) at page 13.

doing no more than fulfilling its role. Therefore the United States is wrong to suggest that the 1981 Decision is “akin to an authoritative statement.”²⁶¹

4.483 In any event, the Understanding in the *Tax Legislation* cases does not contain the principle or “controlling legal standard” claimed by the United States. The relevant part states that:

“... economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement.”²⁶²

4.484 Please note that it says that economic processes (that is *all* economic processes, not just export activities) which are outside the territorial limits of the exporting country *need not* be subject to taxation by the exporting country. It does *not* say that a GATT Contracting Party may *specifically exempt* transactions relating to exported goods even where other economic processes, which may be considered outside the territorial limits of the exporting country, *are* subject to tax.

4.485 This is a fundamental weakness of the United States case. Even if one accepts all the United States legal construction seeking to make the 1981 Understanding relevant to this case (and the European Communities does not) the Understanding does not say what the United States would wish it to say. It never did say what the United States would wish it to say as the European Communities and seven other countries pointed out when they objected to the FSC and held formal consultations under Article XXII GATT 1947 on 26 March 1985.²⁶³

Conclusion

4.486 The conclusion is clear. The “controlling legal standard” that the United States is proposing does not exist. It is a figment of the United States imagination designed to defend the indefensible.

The Administrative Pricing Rules

4.487 The United States follows a similar approach to that it employs in respect of the first FSC subsidy when responding to the European Communities' arguments that the special administrative pricing rules which are available to FSCs also constitute a prohibited export subsidy. It constructs a legal standard that it would wish to prevail and then argues that the European Communities has not proved that these rules infringe the standard. The United States is wrong on all counts.

4.488 The reason why the special administrative pricing rules give rise to a prohibited export subsidy is that they result in revenue forgone, confer a benefit, and are only available in respect of export sales. Exporters have a choice that is available to no other taxpayers and in particular not to importers and domestic transactions. Just as for the first FSC subsidy, one does not need to consult the Illustrative List to come to this conclusion.

4.489 But, as before, the conclusion is confirmed by the Illustrative List. The Illustrative List confirms in the sentence of the footnote which I have already quoted twice that one of the ways (not the only way) an export subsidy can be given is through allowing the use of non-arm's length pricing.

4.490 The United States again attempts to read into the footnote conditions which are not there and which it wishes were there. It claims to read this footnote as allowing it to designate a certain category of economic processes as “foreign” – that is “distributor functions”²⁶⁴ – and to exempt them from tax – provided of course that they relate to the export of United States goods. It candidly admits that the

²⁶¹ Paragraph 104 of the US First Written Submission.

²⁶² BISD 28S/114.

²⁶³ See paragraphs 21 and 112 of the European Communities First Written Submission.

²⁶⁴ Paragraph 108 of the US First Written Submission.

administrative pricing rules will not correctly allocate profit between the persons involved (the FSC and its related supplier) but claims that the two companies should not really be regarded as separate²⁶⁵ and that allocating all “income attributable to distributor functions” to the FSC is just a convenient device for taking advantage of a pretended WTO right.

4.491 Of course, footnote 59 says no such thing. One only needs to look at it to see that it is referring to arm’s length pricing between related persons not the allocation of income between “economic processes.”

4.492 The United States position derives from its wishful importation into the SCM Agreement of the pretended “controlling legal standard” that what a Member arbitrarily deems to be a “foreign economic process” may be exempted from tax on any condition it pleases, including export contingency. The European Communities has refuted this contention above.

4.493 The indefensibility of the United States position is further evident from its admission that the FSC does not have to carry out these “foreign economic processes” itself, it may subcontract them back to its related supplier. According to the United States they remain “foreign economic processes” because the FSC is paying for them and is “legally and financially responsible²⁶⁶” for them.

4.494 The United States position becomes quite worrying, when it states that “Congress chose to exempt from tax less income than the United States was entitled to exempt under GATT rules²⁶⁷”

4.495 One must assume that according to the United States thesis, a country could legitimately take the view that the sale of goods to foreigners is 50 per cent or 100 per cent a “foreign economic process” and devise a scheme whereby the profit is siphoned off to an offshore “foreign sales corporation” and allowed to be remitted to the parent as a tax free dividend. The “foreign sales corporation” would take “legal and financial responsibility” for the production and export of the goods, but would of course be entitled to subcontract the production and export back to its parent. Why should a more determinedly export subsidizing Member than the United States stop at the modest incentives allowed by the FSC scheme and not completely exempt from tax the income from the sale of “export property”?

4.496 What is there “foreign” about economic activities relating to the export of United States goods which are all conducted in the United States? An FSC can subcontract all its activities back to its parent and this may make no difference to the amount of tax benefit.

The de minimis arguments

4.497 The United States brings a further argument in defence of the FSC scheme – that is that the subsidies it provides are *de minimis* and therefore escape prohibition.

4.498 This is based on the reference in the footnote 59 to a significant saving of direct taxes in export transactions. The sentence reads:

“Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions.”

4.499 The United States argument is misguided because the sentence only refers to the right to draw attention to such practices and the word “significant” is simply designed to avoid Members from invoking individual cases of minor importance.

²⁶⁵ Paragraph 109 of the US First Written Submission.

²⁶⁶ See e.g. paragraphs 52 and 126 of the US First Written Submission.

²⁶⁷ Paragraph 130 of the US First Written Submission.

4.500 The prohibition on export subsidies is absolute. There is no *de minimis* rule. The existence of a *de minimis* rule in countervailing duty cases is dictated by the different nature of this remedy and in particular the fact that countervailing duties can only be imposed where there is injury and injury is not likely where the price effect is less than 1 per cent. Also the *de minimis* rule in countervailing duty cases applies only to the imposition of duty on the product of an exporter. No subsidy *scheme* escapes countervailing duty because it amounts to less than 1 per cent of sales value.

4.501 In any event, the FSC subsidies are significant at US\$2 billion per year according to the United States own estimates. The success of the scheme demonstrates that it is of interest exporters. Companies are normally quite keen to take measures that add 1 per cent or so to their profit margins. This may after all increase their profits by 10 or 20 per cent and this is what matters to companies.

4.502 Even the *ad valorem* effect can of course, in some cases, be much more than the 0.93 per cent claimed by the United States, since this is only an average.

4.503 The FSC scheme is important since it applies throughout the United States economy. In this regard, the United States would have you believe that a 0.3 per cent increase in United States exports is insignificant. It is not. It is enormous and in any event much greater than trade effects the United States has complained of in the past.

Most FSCs are not foreign

4.504 It is not only because the economic activities of the FSC may be carried out in fact by the related supplier that they are not foreign. They would also not be foreign even if carried out by the FSC where the FSC is established in a United States territory or possession.

4.505 The European Communities pointed out that, according to US Treasury data²⁶⁸, United States possessions host 74 per cent of all FSCs. 66 per cent of all FSCs are located in the US Virgin Islands.

4.506 The main location for FSCs is the US Virgin Islands. This is an organised, unincorporated territory of the United States, administered by the Office of Territorial and International Affairs in the US Department of Interior. It elects a member to the US House of Representatives.

4.507 The tax legislation of the US Virgin Islands is contained in the US IRC. Section 932 of the IRC provides that the United States will be treated as including the Virgin Islands for purposes of determining the United States tax liability of United States citizens or residents with Virgin Islands income.

4.508 According to the Naval Appropriations Act of 12 July 1921, "the income tax laws now in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States."

4.509 A Virgin Islands tax publication of July 1992 states that "the 1984 Tax Equity and Fiscal Responsibility Act (...) make the Virgin Islands a highly attractive location for United States exporters desiring to form FSCs. United States exporters can earn tax-exempt income by using V.I. FSCs to perform some sales activities outside the United States *that a United States company might otherwise perform*" (emphasis added).²⁶⁹

4.510 The United States claim that the FSC havens which are United States territories and possessions are foreign is that they are not part of the United States customs territory. This is not the correct test. Even the 1981 Understanding on which the United States relies so heavily refers to "transactions involving exported goods . . . located outside the territorial limits of the exporting country." That is not the case of the United States territories and possessions. In addition these

²⁶⁸ See Table 6.1 on page 20 of the Treasury Report for 1992-1993 in Exhibit EC-5.

²⁶⁹ See Exhibit EC-18.

territories and possessions are not separate WTO Members but come under the responsibility of the United States. The fact that they are different customs territories is simply a matter of formal definition.

4.511 WTO Members are not obliged to collect customs duties or to have customs territories at all. The fact that a part of their territory is deemed outside their customs territories or to be a separate customs territory cannot exempt them from WTO obligations. Otherwise the scope for abuse is enormous. Parts of ports could be excluded from a customs territory and used to grant export subsidies.

Burden of Proof

4.512 The United States relies heavily on the allegation that the European Communities has not proved that the FSC scheme exempts from tax more than it is entitled to.

4.513 The first answer to this objection is that the FSC scheme is not entitled to exempt anything from tax if this is contingent on export performance or specifically related to export.

4.514 The second answer is that it is proved that the FSC scheme provides a benefit. The European Communities demonstrated by reference to the United States own documents how much revenue forgone is involved.

4.515 Even accepting *arguendo* the United States view that the availability of exemptions and favourable pricing rules is not in itself a benefit and a benefit compared with the situation that would prevail if what it describes as the “controlling legal standard” applied it can easily be demonstrated that the FSC scheme provides a benefit by offering taxpayers a choice.

4.516 Most FSCs use exclusively the administrative pricing rules²⁷⁰, which already demonstrates how advantageous they are. But in addition there are two rules and taxpayers can choose the one which gives the most favourable result transaction by transaction and *ex post*. If the special administrative pricing rules did provide an approximation to arm’s length pricing or even a “controlling legal standard” then why should there be two rules one of which can give twice the tax exemption of the other? If one of these tests gives the right result the other must give the wrong result. By giving taxpayers a choice there is clearly revenue forgone.

4.517 In addition, what administrative convenience is involved in giving taxpayers such a choice? In reality the only purpose of the special administrative pricing rules is to shelter a part of export profits from United States tax.

Footnote 5

4.518 The United States has referred to footnote 5 to the SCM Agreement to support its argument. This does not support its position since it only relates to measures which are considered not to be export subsidies in the Illustrative List. If it exempted subsidies not expressly prohibited by the Illustrative List, it would be transforming the Illustrative List into an *exhaustive list*, which would be contrary to the expressed intent.

Conclusion

4.519 The European Communities concludes that the FSC scheme is a clear prohibited subsidy within the meaning of Article 3.1(a) of the SCM Agreement and Item (e) of the Illustrative list in Annex I to the SCM Agreement.

The **United States** further responds in its Oral Statement at the First Meeting of the Panel as follows:

²⁷⁰ See Testimony of Joseph J. Guttentag in Exhibit EC-2, page 11 and discussion above.

4.520 At the outset, perhaps we should clarify what it is we are talking about in this dispute. What we have here is a situation where a WTO Member taxes income attributable to domestic economic processes involving the sale of goods, but does not tax foreign economic activities involving the sale of goods in export transactions. The European Communities claims that this type of situation involves an export subsidy.

4.521 What the United States has described to you is what happens in a typical territorial tax system. The FSC was specifically designed to emulate the features of a territorial system. The European Communities' position is that it is permissible for European Communities countries with territorial or territorial-type systems to decline to tax income arising out of foreign economic activities, but that it is impermissible for WTO Members with a different type of tax system, such as the United States, to do the same. However, the WTO rules must apply equally to all. Thus, if the FSC constitutes an export subsidy, then so, too, do the tax systems of those WTO Members with territorial tax systems or tax systems that incorporate this particular feature of a territorial system. In other words, if the Panel accepts the European Communities' legal theory, then the tax systems of most, perhaps even all, WTO Members – including European Communities member States – will be transformed overnight into prohibited export subsidies, and there will be an awful lot of activity under Article 4 of the SCM Agreement.

4.522 However, this should not be the outcome. As previously noted, the European Communities' claims should be dismissed for procedural reasons. However, putting aside procedural issues, the European Communities' case is fatally flawed on the merits because the European Communities ignores the controlling legal standard applicable to its claims. As a result, the European Communities has not supplied the Panel with sufficient evidence to meet its burden of presenting a *prima facie* case, and the Panel should reject the European Communities' claims.

The FSC tax exemption is not an export subsidy

4.523 The first task faced by the Panel in this case is to identify the controlling legal principle that serves as the analytical starting point. The pivotal GATT/WTO principle applicable here is that Members are not obliged to tax income attributable to foreign economic activity, and declining to tax such income does not give rise to an export subsidy.

4.524 This is the principle on which the GATT Council (and France, Belgium, the Netherlands, and the United States) resolved the *Tax Legislation Cases* in 1981. This is the principle on which Members, including the European Communities member States and the United States, have relied, and on which they continue to rely. This is the principle that applies equally to Members today. And this is the principle around which the FSC was designed. If the European Communities contests the continuing validity of this principle, and if the Panel accepts the European Communities' arguments, the implications of this case will be far-reaching, indeed.

4.525 Beginning with the FSC tax exemption, which the European Communities claims is a prohibited export subsidy in and of itself, the European Communities fundamentally misconstrues the relevant standard under the SCM Agreement. The European Communities does so because it fails to take into account the controlling provision of the SCM Agreement – footnote 59 in Annex I. Footnote 59 brings forward into the WTO the prior GATT standard regarding tax exemptions for income attributable to foreign economic activities. This standard was most clearly articulated in the 1981 Council Decision adopting the *Tax Legislation Cases*. Because the European Communities ignores footnote 59, it fails to recognize that footnote 59 qualifies the general rule contained in paragraph (e) of the Illustrative List of Export Subsidies regarding direct tax exemptions related to export transactions.

4.526 More specifically, the European Communities overlooks the threshold question of what types or sources of income must be taxed. Clearly, if, under WTO rules, a WTO Member is not obligated to

tax certain categories of income, then the exemption of such income from taxation cannot constitute a subsidy, let alone an export subsidy.

4.527 Footnote 59 indicates that one type of income that WTO Members are not required to tax is income derived from economic activities occurring outside their respective territories, even if those activities relate to export transactions. Because such income need not be taxed, its exemption from taxation does not constitute an export subsidy.

4.528 The reasons for allowing income attributable to foreign economic processes to go untaxed are not hard to fathom. This type of treatment of such income is common to most, perhaps all, WTO Members. Although they exempt such income from tax through different methods and to varying degrees, most countries do not tax most income of foreign companies operating abroad. Some members of the European Communities, for example, tax only economic processes occurring within their borders. Under these tax systems, even the income of domestic companies – including subsidiaries and branches of domestic companies – arising out of activities that they engage in abroad is not taxed. The effect of a territorial or territorial-type system is that foreign activities of domestic companies that are specifically related to export transactions are exempted from taxation, even though the same activities are taxed when conducted within a country's territory.

4.529 If exempting income arising out of foreign economic activities were deemed to constitute an export subsidy, then all of these classes of income would have to be taxed, and almost every tax system in the world would be in violation of WTO rules. It is unlikely that the drafters of the SCM Agreement intended such a result, and footnote 59 is evidence that they did not.

4.530 This reality of the tax systems of WTO Members is reflected in the history that led to the eventual inclusion of paragraph (e) and footnote 59 in the SCM Agreement. This history reveals that the GATT Contracting Parties and WTO Members never were of the view that nations must tax income derived from foreign economic processes. The United States has recounted this history in its First Submission, and need not repeat it here. Suffice it to say that paragraph (e) traces its origins to a proposal made by a nation that has long exempted income attributable to foreign economic processes from taxation and that never intended that such an exemption would be considered a prohibited subsidy.

4.531 This understanding among Contracting Parties regarding the treatment of income attributable to foreign economic processes is expressed most clearly in the 1981 Council Decision. The panel in the *Tax Legislation Cases* had just rejected this understanding by declaring that territorial tax systems and tax systems with territorial features inherently subsidize exports. The Council essentially reversed the panel, and expressly stated what had been understood all along: “economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement.” The lone qualification that the Council made with respect to exempting income attributable to foreign economic processes from taxation is that the allocation of income between related parties must reach a result consistent with the arm's length principle.

4.532 The GATT practice regarding the taxation of income attributable to foreign economic processes was carried over into footnote 59 of the SCM Agreement. The footnote uses essentially the same language as the GATT Council in stating that the arm's length principle applies to related parties in export transactions. The purpose of footnote 59 is manifest from its text – it qualifies the general rule stated in paragraph (e) by indicating that income attributable to foreign economic processes need not be taxed. If this were not the case, much of footnote 59 would have no meaning, an unacceptable result under customary rules of treaty interpretation.

4.533 To whatever extent footnote 59, or the SCM Agreement more broadly, can be said to be unclear on this point, past practice, which forms part of the context, should be dispositive. The 1981 Council Decision is not merely persuasive, as any decision of the GATT Contracting Parties to adopt

a panel report would be. Instead, the 1981 Council Decision is tantamount to an authoritative interpretation of GATT Article XVI:4, which must be read in harmony with the analogous provisions of the SCM Agreement. Unlike most decisions to adopt a panel report, which contain no statement of whether the Contracting Parties agreed or disagreed with the reasoning contained in the report, in its 1981 Decision, the Council made its views known. Those views should be respected here, because the fundamental issues before this Panel are essentially the same as those that were before the Council in 1981 – namely, the extent to which a failure to tax income attributable to foreign economic processes violates WTO subsidies disciplines.

4.534 If it is correct that Members are not required to tax income arising out of foreign economic activities – and that principle is indisputably correct – then the European Communities' first export subsidy claim (that the FSC tax exemption is prohibited *per se*) cannot stand. Just as territorial tax systems stop short of taxing foreign economic activity, the United States is free to do the same. This is precisely what the FSC is designed to do, as the explicit statements of the US Congress made clear when the FSC was enacted. Thus, the only possible legitimate objection that the European Communities could have to the FSC is that the FSC allegedly does not grant the WTO-permitted exemption accurately, not that income attributable to foreign economic activity cannot be exempted at all. In other words, this is a dispute about the details of implementation, not about principle.

4.535 Because the European Communities has failed to demonstrate – or even provide any evidence – that the FSC tax exemption covers anything other than income attributable to foreign economic activities, the European Communities has failed to make a *prima facie* case. The fact that the European Communities does not acknowledge the principle underlying the 1981 Council Decision and footnote 59 is not only striking, it is alarming. As stated previously, if the principle articulated by the Council in 1981 is no longer valid, then the tax systems of most WTO Members, including those of EC member States, *will* be the subject of future disputes and *will* be found to be export subsidies.

The FSC tax exemption is not a subsidy

4.536 For the reasons just discussed, the European Communities also is unable to show that the FSC tax exemption is a subsidy for purposes of Article 1 of the SCM Agreement. In order for the FSC tax exemption to constitute a subsidy, it must involve the United States foregoing “revenue that is otherwise due.” As previously explained, under WTO rules, WTO Members need not tax income attributable to foreign economic processes. Therefore, such income cannot be considered to be “due” at all. Because the FSC tax exemption does not involve a “financial contribution,” the FSC is outside the scope of Article 1.

The FSC administrative pricing rules do not constitute export subsidies

4.537 The European Communities' second major claim is that the FSC administrative pricing rules constitute separate export subsidies in and of themselves. As noted previously, this is an issue of detail, of implementation. It is not an issue of fundamental principle.

4.538 As an aside, the United States must note a certain oddity in the European Communities' position that the FSC administrative pricing rules can exist separately from the FSC tax exemption, and that the Panel must make findings with respect to both the tax exemption and the administrative pricing rules. If the European Communities is correct that income attributable to foreign economic processes may not be exempted from tax – and the United States reiterates that the European Communities is not correct – the administrative pricing rules are irrelevant. If such income must be taxed, then it really does not matter, for purposes of WTO subsidy rules, whether 0, 50, or 100 per cent of the income earned in an export transaction is attributed to those activities.

4.539 However, putting this point aside, the European Communities' attack on the FSC administrative pricing rules also lacks merit. Here, too, the main defect in the European Communities' position is that it relies on an incorrect legal standard. Instead of arguing that the FSC administrative pricing rules improperly allocate income from domestic, as opposed to

foreign, economic activities – as the European Communities must do to show a violation of Article 3.1(a) – the European Communities mistakenly asks the Panel to examine whether the administrative pricing rules achieve results that are different from those that might obtain under Section 482 of the US Internal Revenue Code. As explained in the First US Submission, however, Section 482 does not supply the definition of arm's length for purposes of the SCM Agreement. Instead, the fundamental question with respect to this European Communities claim is whether or not the FSC administrative pricing rules generate results that fall within an acceptable range of arm's length values for purposes of footnote 59, and, if they do not, whether they result in a significant saving of direct taxes in export transactions.

4.540 Having ignored the governing legal standard, the European Communities naturally has not presented any evidence on point. The European Communities not only has failed to prove that the FSC administrative pricing rules result in the exemption from tax of income attributable to *domestic* economic processes, but also has failed to show that any resulting tax saving on income attributable to *domestic* economic processes is “significant,” as footnote 59 requires. Unless and until the European Communities does so, it has not made a *prima facie* case that the FSC administrative pricing rules constitute an export subsidy.

4.541 The European Communities' misunderstanding of the governing legal standard is matched by its misunderstanding of how the FSC rules actually operate. The European Communities would have the Panel believe that what matters is whether the FSC itself, using its own in-house resources, performs certain activities in export transactions. The European Communities maintains that some FSCs do little and that under the FSC rules they receive a share of income that is disproportionately large. From this, the European Communities concludes that FSCs are “shams,” providing a way for US exporters to improperly shift a portion of fully-taxable income to partially-exempt FSC income.

4.542 The European Communities simply has it wrong. What matters about FSCs is *not* whether they perform through their own in-house resources sufficient activities by themselves to justify the allocation of income allocated to them under the administrative pricing rules. What matters under footnote 59 is whether income is allocated in such a way as to isolate the income attributable to foreign economic activities – the income which, under WTO rules, need not be taxed. The FSC rules make FSCs responsible for all sales and distribution functions in covered export transactions. This means that where a FSC has not performed such a function itself through its own in-house resources, it is required to pay the party who did. Thus, even if a FSC were not considered as performing the foreign economic processes carried out by its agents, it would be appropriate to attribute all sales and distribution activities to FSCs because these functions are the part of export transactions that typically occur abroad.

4.543 In this regard, it is important to bear in mind that not all income derived from the sales and distribution activities attributed to FSCs is exempt from income. Instead, the exempted amount (approximately 15 per cent, or 15/23's of 23 per cent) reflects (somewhat conservatively) the portion of the FSC export transaction that generally occurs outside of the United States.

4.544 The European Communities has provided the Panel with no basis on which it could conclude that the FSC tax exemption is not justified by economic processes conducted outside of the United States. The European Communities has not even asked the question. Instead, the European Communities merely asserts that no methodology akin to the FSC administrative pricing rules is acceptable. However, such an assertion is at odds with the text of footnote 59, which plainly contemplates that Members may use “administrative and other practices” so long as they do not contravene the arm's length principle and do not result in a “significant” saving of direct taxes in export transactions. Moreover, the European Communities' assertion that the mere availability of a choice of methods violates footnote 59 ignores the fact that it is the overall results of a method, rather than the label attached to a method, that matter.

4.545 The European Communities has to do more than merely point to the methodology underlying the FSC administrative pricing rules. It must show that those rules achieve impermissible results.

Notwithstanding the existence of publicly available information that the European Communities could have examined in an effort to determine whether the FSC rules do achieve impermissible results, the European Communities has presented no empirical evidence whatsoever. For that reason alone, its claim regarding the FSC administrative pricing rules should be rejected.

Observations Regarding the European Communities' Oral Statement

4.546 The United States now would like to comment briefly on some of the points made by the European Communities in its Oral Statement. First, regarding the European Communities' characterisation of the FSC and its relationship to Subpart F of the Internal Revenue Code, Subpart F is an exception to the normal rule of deferral. Thus, if one wants to use the term "exception," the FSC is an "exception to an "exception."

4.547 Regarding the European Communities' assertion that FSCs are "shams," the United States disagrees, and refers the Panel to our written submission on this point. Here, I just will reiterate that it is relatively inexpensive to establish a corporation, such as a FSC, but much more expensive to run one.

4.548 Regarding the European Communities' characterization of the FSC as a functional equivalent to the DISC, the FSC is quite different from the DISC. These differences are laid out in detail in our written submission, principal differences being that FSCs are subject to foreign presence, foreign management, and foreign economic process requirements to which DISCs were not subject.

4.549 Regarding the European Communities' accusation that the United States has failed to follow the treaty interpretation rules of the Vienna Convention, the United States believes that it is the European Communities that has failed to follow those rules. The United States has looked at the SCM Agreement in light of its text, context, object and purpose, while the European Communities has looked selectively at certain portions of the text alone.

4.550 With respect to the European Communities' reference to President Carter's notification of the Tokyo Round agreements, it does not establish anything regarding the status of the 1981 Council Decision, because the Council Decision did not reference the bi-level pricing issue to which President Carter's notification referred.

4.551 With respect to the European Communities' approach to footnote 59, it essentially reads it out of existence. The drafters must have intended that footnote 59 have some meaning, and the principle of effectiveness creates a presumption that they did.

4.552 Regarding the European Communities' reference to the fact that FSCs have a choice among transfer pricing methods, taxpayers have a choice under Section 482.

4.553 Finally, with respect to the European Communities' claim that the United States should have sought to exempt the FSC from subsidy disciplines during the Uruguay Round, in the view of the United States, the FSC did not constitute a subsidy under the rules existing prior to the conclusion of the Round, and there was no reason for the United States to "pay" to have clarified something that it already had – namely, rules under which the FSC was not considered to be a subsidy – and that it continues to have under the current rules.

The **European Communities** further rebuts the United States' response in its Second Submission as follows:

Introduction

4.554 The European Communities argued in its First Written Submission that:

- the tax exemptions contained in the FSC scheme and the increased revenue forgone as a result of the application of its administrative pricing rules constitute subsidies subject to the SCM Agreement within the meaning of Article 1 and 2 of the SCM Agreement; the subsidies are contingent in law upon export performance contrary to Article 3.1(a) of the SCM Agreement;

- the subsidies are contingent in law upon the use of domestic over imported goods contrary to Article 3.1(b) of the SCM Agreement; and
- as regards agricultural goods covered by the AA, the subsidies violate Articles 3 and 8 AA read in conjunction with Articles 9.1(d), 10.1 and 10.3 of the AA.

4.555 Although the character of the FSC subsidies as prohibited export subsidies is clear already from Articles 1, 2 and 3 of the SCM Agreement, the European Communities went on to show that this result is confirmed by Item (e) of the Illustrative List, which contains a certain number of export subsidies which are *deemed* to be *included* in the prohibition in Article 3.1(a) of the SCM Agreement.

4.556 In response, the US First Written Submission attempted to argue that the European Communities' approach was misguided because it neglected what the United States termed the "controlling legal standard" or principle, which it believed to be implicit in, or "predicated by", a footnote to the Illustrative List.

4.557 At the First Meeting of the Panel the United States also attempted to argue that the dispute between the European Communities and the United States related to "details of implementation" of its "controlling legal standard"²⁷¹ and stressing that the European Communities had to meet its burden of proof that the "controlling legal standard" was not met.

4.558 The European Communities demonstrated in its Statement to the First Meeting of the Panel that it was the United States approach which was misguided and indeed that it turned interpretation on its head, being contrary to the customary rules of interpretation of public international law codified in Articles 31 and 32 of the 1969 Vienna Convention on the Law of Treaties and thus with Article 3.2 DSU. It also stressed in response to the US Statement to the First Meeting of the Panel that the dispute was not at all about "details of implementation" but in the first instance about a fundamental difference of approach to the interpretation of the SCM Agreement.

4.559 The European Communities is of course prepared to develop these arguments if the Panel considers it necessary but anticipates from the United States reaction at the First Meeting of the Panel and its written questions addressed to the European Communities, that it will adopt different lines of argument in its Second Written Submission concentrating more on Article 1 of the SCM Agreement. In order to assist the Panel, the European Communities will make a first response to these alternative lines of argument and demonstrate that they also cannot justify the FSC subsidies.

4.560 The first argument the United States may make is that the 1981 Understanding on the basis of which the *DISC and Tax Legislation* panel reports were adopted lays down in some way overriding taxation principles that must be followed by WTO Members and that, if followed, prevent any violation of WTO Agreements arising. This will be examined below.

4.561 Next the United States may seek to argue that the FSC subsidies do not result in any "revenue forgone" that is "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement. This will be examined below.

4.562 The European Communities notes that the United States has not attempted to contest the export contingency of the FSC subsidies²⁷² nor indeed that they are specifically related to exports within the meaning of Item (e) of the Illustrative List²⁷³ and thus the European Communities has nothing to add for the present to its arguments in its First Written Submission and in its Statement to the First Meeting of the Panel.

²⁷¹ See e.g. paragraph 16 of the United States Statement to the First Meeting of the Panel.

²⁷² Demonstrated in paragraphs 146 to 154 of the European Communities' First Written Submission.

²⁷³ Demonstrated in paragraphs 155 to 132 of the European Communities' First Written Submission.

4.563 One issue to which the United States devoted more arguments is its defence of the FSC scheme's special administrative pricing rules where it argues that the European Communities would need to prove that they lead to a "significant saving of direct taxes in export transactions." The European Communities will be responding further to these arguments below.

The 1981 Understanding

Introduction

4.564 The 1981 Understanding is in the following terms:

"The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income."

"Following the adoption of these reports the Chairman noted that the Council's decision and understanding does not mean that the parties adhering to Article XVI:4 are forbidden from taxing the profits on transactions beyond their borders, it only means that they are not required to do so. He noted further that the decision does not modify the existing GATT rules in Article XVI:4 as they relate to the taxation of exported goods. He noted also that this decision does not affect and is not affected by the Agreement on the Interpretation and Application of Articles VI, XVI and XXIII. Finally, he noted that the adoption of these reports together with the understanding does not affect the rights and obligations of contracting parties under the General Agreement".²⁷⁴

4.565 The European Communities does not disagree in any way with the principles set out in the 1981 Understanding as it understands them but considers that it is not applicable to the present dispute or relevant as "negotiating history" or "subsequent practice." The European Communities also most definitely does not agree with the meaning the United States attempts to give to the Understanding.

The 1981 Understanding is not applicable or relevant to the present dispute

4.566 The 1981 Understanding is not applicable to the present case because it relates to the adoption of panel reports under a different legal norm to that under consideration in this case. This case concerns a violation of Article 3.1(a) of the WTO SCM Agreement whereas the 1981 Understanding concerned the adoption of panel reports under Article XVI:4 of GATT 1947.

4.567 The *DISC and Tax Legislation* cases were based on Article XVI:4 GATT 1947 as it existed in 1973 (the date the panels were established), which is probably very different in legal content from Article XVI:4 of GATT 1994 and – certainly very different from Article 3.1(a) of the SCM Agreement. As mentioned above, the economic approach taken in those cases was very different from the more legal analysis called for to establish "financial contribution", "benefit" and "export contingency" as required by the SCM Agreement.

²⁷⁴ L/5271, 28S/114.

4.568 If any confirmation of the inapplicability of the 1981 Understanding to the present case were needed, it can be found in the statement of the Chairman of the GATT Council at the time who expressly stated “this decision does not affect and is not affected by the Agreement on the Interpretation and Application of Articles VI, XVI, and XXIII²⁷⁵” (that is the Tokyo Round SCM Agreement). Its inapplicability to the SCM Agreement (which of course did not even exist at the time) can hardly be clearer.

4.569 The 1981 Understanding is also not relevant as part of the negotiating history of the SCM Agreement and the United States has expressly stated that it is not contending that it is (see United States written question n° 19 to the European Communities reproduced in Annex EC-1). Rather, the United States is arguing that if the SCM Agreement is ambiguous, resort may be had to the “history of treatment of tax exemptions for foreign-source income under the GATT” and that this is appropriate under Article XVI:1 of the WTO Agreement (see United States written question n° 15 to the European Communities reproduced in Annex EC-1).

4.570 The European Communities' response to this is first of all that Article 3.1(a) is not ambiguous. But the United States is also wrong to consider that Article XVI :1 WTO provides a basis for using elements of GATT history for the *interpretation* of possibly ambiguous WTO provisions. Article XVI :1 provides for the WTO to be guided by the decisions, procedures, and customary practices followed by GATT 1947, only where not otherwise provided. When it comes to the *interpretation* of WTO provisions there is a specific rule in the WTO and that is provided in Article 3.2 DSU which provides that this should be conducted in accordance with customary rules of interpretation of public international law, which the Appellate Body has confirmed means the rules laid down in Articles 31 and 32 of the *Vienna Convention on the Law of Treaties*.

4.571 Therefore, even if the SCM Agreement were ambiguous in any respect, the United States would have to establish that the 1981 Understanding is part of the negotiating history of the SCM Agreement (which it admits it is not) or that it is “subsequent practice” within the meaning of Article 31(3)(b) of the *Vienna Convention on the Law of Treaties*. It is this in effect that the United States is claiming (expressly in paragraph 103 of the United States First Written Submission). This would, however, at most, make the 1981 Understanding relevant for the interpretation of GATT 1994, not of the SCM Agreement.

4.572 The European Communities contests that the 1981 Understanding constitutes relevant “subsequent practice” within the meaning of Article 31(3)(b) of the *Vienna Convention on the Law of Treaties*.²⁷⁶ It could at most be “subsequent practice” for the purposes of Article XVI:4 GATT 1947. This provision is however no longer in force and Article XVI:4 is legally very different. It is not interpreted by the Tokyo Round Agreement or subject to instruments such as the 1960 Declaration which paid a large role in the *DISC and Tax Legislation* cases, not least because the parties to GATT 1994 are not the same as the parties to that agreement and declaration.

4.573 The European Communities also disagrees that the 1981 Understanding can be considered a decision of the GATT Contracting Parties which is carried over into the WTO by virtue of Article XVI:1 of the *WTO Agreement* and paragraph 1(b)(iv) of the introductory language to GATT 1994. It refers the Panel to the arguments it made in paragraphs 45 to 52 of its Statement to the First Meeting of the Panel.

4.574 The 1960 declaration on which the *DISC and Tax Legislation* reports and the thus the 1981 Understanding are founded is also not a decision within the meaning of paragraph 1(b)(iv) of the introductory language to GATT 1994 and not part of GATT 1994 and so the Understanding cannot be considered part of GATT 1994 by this means either.

²⁷⁵ Quoted in full above.

²⁷⁶ Paragraph 103 of the United States First Written Submission.

The Understanding relating to the DISC and Tax Legislation cases does not contain the claimed principle

4.575 In any event, even if the 1981 Decision were a decision to which paragraph 1(b)(iv) of the introductory language to GATT 1994 referred, this would only make it part of GATT 1994, not of the SCM Agreement.

4.576 A major purpose of the SCM Agreement is to provide clear definition of the term “subsidy” and a stricter prohibition of export subsidies than under previous law and in particular Article XVI:4 of GATT 1947. A decision taken in relation to Article XVI:4 of GATT 1947 cannot therefore assist in the interpretation of the SCM Agreement.

4.577 In any event, the 1981 Understanding relating to the *DISC and Tax Legislation* cases does not contain the principle or “controlling legal standard” claimed by the United States.

4.578 The United States is taking the terms of the Understanding out of context and interpreting it in contradiction to its own expressed belief²⁷⁷ that the WTO or SCM Agreement does not require Members to adopt a particular tax system or to follow certain tax principles.

4.579 The European Communities is firmly of the view that it was not the purpose of the GATT 1947 and is not the purpose of the WTO or SCM Agreement to generally regulate tax systems or methodologies; they do not “mandate²⁷⁸” Members to tax income in a certain way nor to give a “right²⁷⁹” to exempt certain income tax systems and methodologies they wish. The purpose of the Article XVI GATT 1947 (and now the SCM Agreement) is to impose disciplines on the granting of certain subsidies by Members. These disciplines apply to taxation just as to any other field of government action. Conflict between taxation and Article XVI GATT 1947 (and now the SCM Agreement) can be avoided in the same way as conflict between any other field of government action. Conflict with the export subsidy provisions of Article XVI:4 GATT 1947 could be avoided by ensuring that any subsidy did not “[result] in the sale of [a] product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market” (just as conflict with the SCM Agreement can be avoided by ensuring that rules are neutral in their trade effects, that are not *specific* within the meaning of Article 2 of the SCM Agreement and in particular not contingent on export performance).

4.580 When the 1981 Understanding states that economic processes located outside the territorial limits of the exporting country *need not* be subject to taxation by the exporting country it is simply saying that the mere fact that a tax system is territorial is not to be considered an export subsidy. It is not of course saying that a GATT Contracting Party may *specifically exempt* transactions contingent upon export performance.

4.581 The United States is not only disregarding the ordinary meaning of the words “need not” it is also erecting the sentence into a rule governing tax practices of GATT Contracting Parties and now WTO Members along the lines of “States are entitled to tax or not tax foreign economic processes as they please”. Not only is that not what it says, it is also not what it could say since it would be interfering in tax practices beyond what is necessary to avoid the granting of export subsidies.

4.582 This is a fundamental weakness of the United States case. Even if one accepts all the United States legal construction seeking to make the 1981 Understanding relevant to this case (and the European Communities does not) the Understanding does not say what the United States would wish it to say. It never did say what the United States would wish it to say as the European Communities

²⁷⁷ E.g. at paragraphs 27 and 28.

²⁷⁸ See paragraph 86 United States First Written Submission.

²⁷⁹ See paragraph 148 86 United States First Written Submission.

and seven other countries pointed out when they objected to the FSC and held formal consultations under Article XXII GATT 1947 on 26 March 1985.²⁸⁰

Conclusion

4.583 The 1981 Understanding is not applicable or relevant to the present dispute and in any event does not contain the “controlling legal standard” that the United States claims.

Whether the FSC scheme gives rise to "revenue forgone" which would be "otherwise due"

Introduction

4.584 The United States finally comes to consider Article 1.1 of the SCM Agreement and alleges that the European Communities fails to explain why potential tax revenues from income attributable to foreign economic processes are revenues that are “otherwise due.” Invoking its “controlling legal standard” it claims that

“In this case, WTO principles provide that the United States is not required to tax income attributable to foreign economic processes. The fact that the provision through which the United States chooses to exercise its *right not to tax* such income is often referred to as an “exemption” does not mean that taxes would be “otherwise due”.” (Emphasis supplied.)

4.585 Similarly in paragraph 8 of its Statement to the First Meeting of the Panel, the United States summed up its case as follows:

“Clearly, if under WTO rules a WTO Member is not obligated to tax certain categories of income, then the exemption of such income from taxation cannot constitute a subsidy, let alone an export subsidy.”

4.586 The United States is in effect treating the 1981 Understanding²⁸¹ as granting it a “right not to tax” income it designates as foreign on conditions of its choosing. The European Communities has discussed this error above and explained that neither the WTO (nor the GATT before it) grant rights to tax or not to tax - they simply provide that the tax system should not provide subsidies. The United States also misunderstands or misrepresents the European Communities' position when it states at paragraph 86 of its First Written Submission that the European Communities is arguing that the SCM Agreement “mandates” the taxation of certain income.

4.587 The absurdity of the United States reasoning is evident from the fact that nothing in the WTO “obligates” or requires a Member to tax any income at all and the United States logic would lead to the conclusion that it could exempt a particular company or industrial sector from tax as it pleases. Indeed Article 1.1(a)(1)(ii) SCM Agreement and Item (e) could never apply.

4.588 The European Communities stated that the various exemptions provided by the FSC scheme and the derogation from the application of the normal transfer pricing rules of Section 482 IRC led to revenue forgone and since they conferred benefits constituted subsidies. The United States claims that this is not a sufficient demonstration of the fact the revenue forgone would otherwise be due and that “shows nothing other than that if income that is exempt from tax were not exempt from tax, there would be additional government revenue.”²⁸²

²⁸⁰ See paragraphs 21 and 112 of the European Communities First Written Submission.

²⁸¹ The United States also appears to be claiming that such a right is also granted by footnote 59 to Item (e) of the Illustrative List in Annex I to the SCM Agreement but this is considered below.

²⁸² See paragraph 153 of the United States First Written Submission.

4.589 The European Communities will therefore now provide a more detailed explanation of why the FSC scheme gives rise to revenue forgone which would otherwise be due.

Interpretation of Article 1.1(a)(1)(ii) of the SCM Agreement

4.590 It is correct that, in order to establish whether revenue is forgone which would otherwise be due it is necessary to compare it with a comparable situation where the revenue is due. The European Communities is not arguing that this comparable situation is simply the situation which would prevail in the absence of the measure complained about. Its position is that the United States is deviating from the generally applicable rules and principles prevailing in its system as evidenced by the treatment it accords to comparable situations.

4.591 What is important is that there must be a deviation from or exemption to the generally applied rate or basis for collection for there to be a subsidy. Therefore, the European Communities would not argue that the decision of a WTO Member to reduce its standard rate of corporate income tax from 40 to 35 per cent is a subsidy, since 35 per cent then becomes the standard rate from which any deviation or exception is to be measured. If such a reduction in the basic rate were a subsidy, it could also be argued that the failure of a government to tax at any rate of less than 100 per cent is a subsidy. In the same way as the choice of the standard rate is not a subsidy, so also the adoption of a generally applicable tax rule cannot in itself be a subsidy.

4.592 The European Communities notes that the United States uses the same interpretation of Article 1.1(a)(1)(ii) of the SCM Agreement in its countervailing duty practice and countervails as subsidies deviations from or exemption to the generally applied rate or basis for collection of tax.²⁸³

4.593 The European Communities gave a number of examples of relevant comparisons in its First Written Submission to demonstrate that the FSC scheme deviated from the general system. Since the United States seems to have missed them, the European Communities will recall them:

- If the FSC scheme did not exist or if the export transaction through a FSC were not to qualify under the scheme (for example because it involved the export of goods from *another territory* than the United States, or the local content conditions were not satisfied), no part of the FSC's income from that transaction would be "exempt foreign trade income" and it would be subject to US taxation. The existence of the FSC scheme, or the applicability thereof to the transactions, will therefore lead to revenue forgone.
- If the FSC were to conduct an *import* transaction on behalf of its parent or sell the goods of its parent to a customer in the United States instead of conducting an export transaction, no part of the FSC's income from those transactions would be "exempt foreign trade income" and it would be subject to US taxation. The availability of the FSC scheme for the export transaction would lead to revenue forgone compared with the tax payable on the equivalent import or domestic transactions.
- If a manufacturer were to sell the goods on the domestic market or to export the goods directly itself instead of passing through the FSC, no part of the profit would be exempted from tax and thus the tax paid would be higher. The use of the FSC therefore leads to revenue forgone.

4.594 The European Communities would add that in the case of the last example, the analysis result would remain the same even if the manufacturer arranged to solicit, negotiate and conclude the sale abroad. The tax paid would still be higher than if an FSC were used and thus revenue is forgone which would otherwise be due.

²⁸³ See e.g. CVD on Salmon from Norway, imposed on 4 Dec 1991 - Case no. 403-802.

4.595 As regards the second subsidy, the availability of the special administrative pricing rules, the European Communities stated and the United States has not contested that these rules are the only deviation which exists from the generally applicable rules for determining prices for tax purposes between related companies contained in Section 482 IRC. An FSC can of course use the Section 482 IRC rules but it has a choice to use the special administrative pricing rules which is available nowhere else in the United States IRC.

The Amount of Revenue Forgone and Its Calculation

4.596 The European Communities has already pointed out that the United States itself admits in its periodic reports that the FSC scheme results in revenue cost which it calculates²⁸⁴ and estimates to be US\$2 billion in 1997. In case it should be argued that this does not correspond to revenue forgone within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement, the European Communities attaches as Exhibit EC-25 an extract from the United States contribution to a 1996 OECD Report on "Tax Expenditures – Recent Experiences".

4.597 The United States defines "tax expenditure" as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability"²⁸⁵ It explains that two benchmarks are used for determining tax expenditures: the normal tax baseline and the reference law baseline. The former would consist of a set of general principles (a "theoretical normal" tax system) while the latter would be the generally applicable existing law.

4.598 The European Communities does not consider that revenue is necessarily forgone which would otherwise be due within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement, if the revenue collected is less than a theoretical level (the "normal tax baseline" in United States terminology) only if there is revenue forgone compared with the generally applicable law (the "reference law baseline" in United States terminology). The United States also calls these measures "special exceptions in the tax law that serve programmatic functions ... such as national defence, agriculture or health care."²⁸⁶

4.599 The Report explains the **criteria** used in identifying a tax expenditure.²⁸⁷ The first is that "absent that special provision, the tax laws provided general rules to enable a taxpayer to determine his income tax due and payable". The second criterion would be that "it is necessary that the special provision apply to a sufficiently narrow class of transactions or transactors to permit the specification of a programme objective that could be administered on the direct spending side of the budget with appropriate funds".

4.600 Lastly, the report states that one of the categories that have been labelled as tax expenditures "would consist of deviations from general rules of the existing tax system that could be measured and evaluated in a manner comparable to the measurement and evaluation of subsidy and transfer programmes on the outlay side of the budget"²⁸⁸.

4.601 The FSC tax expenditure is listed on page 112 of the document "exclusion of income of foreign sales corporations" and the "Revenue forgone" (the Report's words) in 1995 is given as US\$1,400 million. It is clear from the report that the method used to measure this revenue forgone was the "reference law baseline" (cases where the normal tax method are used are indicated with a footnote 1 sign).

²⁸⁴ See paragraphs 100 and 138-139 of the European Communities' First Written Submission.

²⁸⁵ See Chapter I "Background" on page 107 of the document.

²⁸⁶ See Chapter III on page 108 of the document.

²⁸⁷ See Chapter III on page 108 of the document.

²⁸⁸ See last paragraph of Chapter III on page 109 of the document.

4.602 The United States has therefore admitted again in this report that the FSC scheme provides **an exemption to the generally applicable United States tax rules.**

The FSC scheme exempts from tax economic processes which are not foreign

4.603 Even if the United States were correct in its view (which the European Communities does not share) first that the SCM Agreement (or some other provision) gives WTO Members a *right not to tax* foreign economic processes and second that it is entitled to make this exemption contingent upon export, the FSC exemptions can still be demonstrated to be contrary to the SCM Agreement.

4.604 This is because the FSC scheme exempts from tax economic processes which are not foreign. There are three main reasons for this: first that FSCs are allowed to be located on (non-metropolitan) United States territory; second that the activities of FSC's can in reality be subcontracted back to the United States related supplier with no diminution of the share of the profit accruing to the FSC and thus partly sheltered from tax and third that the scheme derogates from the normal United States source rules and deems 15/23 of the FSCs income to be foreign source income where the generally applicable rules would provide for the income to be largely United States source.

FSCs are allowed to be located on US territory

4.605 The European Communities has already explained²⁸⁹ that most FSCs are situated in United States territories such as the US Virgin Islands. The European Communities does not accept these as foreign and has put to the United States a number of questions the answers to which will further demonstrate this. The European Communities has explained (and the United States has not contested) that:

- The US Virgin Islands are an organised, unincorporated territory of the United States, administered by the Office of Territorial and International Affairs in the US Department of Interior. It elects a member to the US House of Representatives.
- The US Virgin Islands are generally subject to the laws of the United States. In particular to its tax legislation which is contained in the US IRC. Section 932 of the IRC provides that the United States will be treated as including the Virgin Islands for purposes of determining the US tax liability of United States citizens or residents with Virgin Islands income. According to the US Naval Appropriations Act of 12 July 1921, "the income tax laws now in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States."
- The United States has also stated at the First Meeting of the Panel in answer to a question from the European Communities that the United States has WTO obligations in respect of the Virgin Islands.
- The only claim to foreignness that the European Communities believes is made for the US Virgin Islands is that they constitute a separate customs territory to the rest of the United States. According to the last page of Exhibit EC-18 to the European Communities' First Written Submission (containing an account of the relevant legal provisions relating to the US Virgin Islands), the customs duties of the US Virgin Islands are only imposed on goods coming from outside the United States.

4.606 If any rule along the lines of the United States' "controlling legal standard" does exist which gives WTO Members a *right not to tax* foreign economic processes (and such Member is entitled to make this exemption contingent upon export), then the term "foreign" must have some objective meaning. A WTO Member surely cannot deem certain parts of its territory to be places where

²⁸⁹ See paragraphs 42-49 of the European Communities' First Written Submission.

companies are entitled to conduct foreign economic processes and be entitled to give them tax privileges (and make those privileges contingent upon export). The European Communities submits that “foreign” can only mean outside a Member’s territorial sovereignty or at least located in a “separate customs territory possessing full autonomy in the conduct of its external commercial relations” within the meaning of Articles XXXI and XXXIII GATT 1994 and on neither of these bases are the US Virgin Islands and the other United States territories and possessions which qualify as FSC locations “foreign”. In particular a separate customs territory of a single WTO Member cannot be considered “foreign” in relation to the rest of the territory of that Member. Many Members have special customs zones including parts of their major ports.

4.607 It is only possible to bring dispute settlement proceedings against Members of the WTO, not against separate customs territories of those Members. Yet WTO Members are bound to respect WTO obligations in respect of all the territories of other Members for which those Members have accepted the WTO Agreement. For example the European Communities is bound by Article II GATT 1994 in respect of all United States territories. It cannot have been the intention of the WTO Members when they concluded the WTO Agreement that an exemption from taxation of companies established in a separate customs territory of a Member which is not and could not be a separate Member of the WTO but which enjoys WTO rights, could not be considered a subsidy.

4.608 Indeed the 1981 Understanding on which the United States places so much reliance speaks of “economic processes ... located outside the territorial limits of the exporting country”. When WTO Agreements refer to territory, they refer to the whole territory of a Member and when they refer to a separate customs territory this is specified.

4.609 Accordingly, any economic processes conducted by FSCs cannot be considered “foreign” by virtue their location in United States territories and possessions because these territories and possessions are not foreign in relation to the United States.

FSC activities can be sub-contracted back to the US related supplier

4.610 The European Communities has explained a number of times that an FSC is entitled under the FSC scheme to subcontract all its activities back to its related supplier and they may therefore be conducted in the United States almost exactly as if the FSC had not been established. Because of the way the special administrative pricing rules operate this may make no difference to the tax benefit obtained. The European Communities does not accept that activities that are in fact conducted in the United States by the related supplier may be considered “foreign” for the purposes of the SCM Agreement, even if this should be relevant.

The FSC scheme derogates from the normal US source rules

4.611 The European Communities explained in its First Written Submission that one of the tax exemptions accorded by the FSC scheme was exemption from the normal United States source rules. Section 921(a) IRC deems a FSC’s exempt foreign trade income to be “foreign source income which is not effectively connected with the conduct of a trade or business in the United States. Where the special administrative pricing rules are used this is 15/23 of the total foreign trade income as determined by those rules²⁹⁰ and where the standard arm’s length rules of Section 482 IRC are used, it is 30 per cent of the total foreign trade income as determined by those rules²⁹¹. Section 921(d) provides that the remainder of such foreign trade income “shall be treated as income effectively connected with a trade or business conducted through a permanent establishment of such corporation within the United States.”

4.612 Sections 921(a) and (d) are in effect special formulaic source rules for FSC income. A certain fraction is deemed foreign and the rest domestic.

²⁹⁰ See Section 923(a)(3) of the IRC in conjunction with Section 291(a)(4) of the IRC.

²⁹¹ See Section 923(a)(2) of the IRC in conjunction with Section 291(a)(4) of the IRC.

4.613 The generally applicable United States source rules on the other hand represent a highly developed code of what and how much income is properly considered domestic and how much foreign source for tax purposes. For example, income from sales activities carried on through an agent is not generally considered to be sourced at the residence of the person taking “legal and financial responsibility” but at the place the performance occurs²⁹². When services are performed partly within the United States and partly outside of the United States, income must be allocated accordingly²⁹³.

4.614 The special source formulae of the FSC scheme do not represent an effort to determine the true source of a FSC’s income. Exactly the same allocation is made for buy/sell and commission FSCs and whether the FSC carries out its functions itself or subcontracts them all back to its related supplier. Indeed, as for the special administrative pricing rules, the same formulae apply however much (or rather however little) of an FSC’s income would be considered foreign source under the generally applicable rules. The United States admits as much when it says:

“the FSC rules were not designed to force the FSC to perform all of the foreign economic activities itself; rather, they were designed to attribute to the FSC that income which is derived from foreign economic processes, regardless of the manner in which those processes are performed²⁹⁴,”

and that the amount exempted is

“a conservative approximation of the amount of foreign economic activity for which the FSC is responsible²⁹⁵”

4.615 Under normal sourcing rules, the income of a FSC might be considered foreign-sourced, domestic-sourced or a combination of both. In the case of a commission FSC, the sourcing of the FSC’s commission income would turn on the location(s) in which the FSC (acting directly or through its agents) performed the activities necessary to earn the commission. If those activities took place partly within and partly without the United States, the FSC’s income would be allocated accordingly. (Again, it is the place where the performance occurs, rather than the tax residence of the person performing the services, that is determinative.)

4.616 As we have previously discussed, these requirements were designed so that exporters could satisfy them relatively easily and with as little disruption to their normal business practices as possible. Once a FSC satisfies the requirements of Section 924 IRC (and the related requirements of Section 925(c)IRC), it is eligible to utilise the administrative pricing rules and to have the source of its income calculated under the purely formulaic approach of Sections 921 and 923 IRC. In contrast, as discussed above, the normal rules for determining the source of income are based to a far greater degree on an evaluation of the substance and value, as well as the location, of the economic activities that gave rise to the income.

Conclusion

4.617 The European Communities has shown that even if the United States “controlling legal standard” were to be accepted (which the European Communities does not) the FSC scheme does not meet it because in the largest proportion of cases where the FSC is incorporated in a United States territory or possession, none of the FSCs activities can be considered “foreign” at all. In other cases FSCs are entitled to subcontract all their activities back to the related supplier so that they may be carried out in the United States with out any loss of tax benefit. Also FSCs benefit from a derogation

²⁹² See Section 861(a)(3) of the IRC.

²⁹³ See Section 863(b) of the IRC.

²⁹⁴ Paragraph 127 of the United States First Written Submission.

²⁹⁵ Paragraph 130 of the United States First Written Submission.

from the normal source rules so that a much larger part of their income would be foreign source than would be the case under the generally applicable rules (especially in the case of commission FSCs).

The Special Administrative Pricing Rules

Introduction

4.618 The European Communities identified in its First Written Submission²⁹⁶ the special administrative pricing rules which are available to FSCs and their parents but to no other US tax payers as a distinct prohibited export subsidy resulting from an additional financial contribution from government in the form of revenue forgone compared with the situation which would prevail if the normal transfer pricing rules of Section 482 IRC had to be applied and compounding the revenue forgone resulting from the FSC exemptions. These special administrative pricing rules may be used *at the option* of the taxpayer, *ex post* and on a transaction by transaction basis when they give a more favourable result, have as a consequence lower tax revenues for the US Government than would be the case if these rules did not exist²⁹⁷.

4.619 The United States professes at paragraph 22 of its First Written Submission to find this second claim by the European Communities to be an “oddity” since, if the European Communities is correct about the first FSC subsidy, “then it really does not matter, for the purposes of WTO subsidy rules, whether 0, 50, or 100 per cent of the income earned in an export transaction is attributed to those activities”.

4.620 The European Communities had already given the explanation²⁹⁸ but will repeat it. It is because each of the FSC subsidies could exist in the absence of the other and it is important that both be held to be prohibited export subsidies so that both will have to be withdrawn. The European Communities is seeking to avoid a situation where the United States is able to evade bringing its FSC scheme into conformity with the WTO by removing or modifying the exemptions which FSCs and their parents enjoy but preserves for them the benefit of the special administrative pricing rules.

4.621 The European Communities will develop the following further points in this Section. First, it will clarify its position as to the legal basis for its view that the special administrative pricing rules constitute a prohibited export subsidy.

4.622 Second, it will apply these principles to the FSC scheme and explain why this establishes that the special administrative pricing rules lead to revenue forgone and are contrary to the SCM Agreement and that it is not necessary to prove on the basis of statistics or tax returns that they result in a significant saving of direct taxes.

The principles of the SCM Agreement concerning transfer pricing

4.623 The European Communities was asked by the Panel at its first meeting whether the second sentence of footnote 59 required the use of arm’s length pricing in all cases and whether it was the sole source of rules on the issue. The European Communities takes this opportunity to explain more fully its position on the subject.

4.624 The European Communities first repeats its view (which the United States has stated that it shares)²⁹⁹ that it is not the purpose of the SCM Agreement (nor indeed the WTO) to lay down rules

²⁹⁶ See esp. paragraphs 127, 135-137, and 142 of the European Communities' First Written Submission.

²⁹⁷ A good explanation of how beneficial the option of using these rules is see the Article from “Tax Notes International” entitled “A FSCful of Dollars: Maximizing FSC Benefits through Transaction Level Pricing,” submitted as Exhibit EC-8 to the European Communities' First Written Submission.

²⁹⁸ See paragraph 128 of the European Communities' First Written Submission and paragraph 23 of the European Communities' Oral Statement at the First Meeting of the Panel.

²⁹⁹ E.g. at paragraphs 27 and 28 of the United States First Written Submission.

for the taxation of income by Members, it merely provides that whatever taxation systems or methodologies are used, they must not give rise subsidies and in particular not export subsidies. In particular a footnote to an Illustrative List in an Annex cannot lay down absolute rules for the conduct of tax policy (that is rules which apply whether or not there is proved to be a subsidy).

4.625 The starting point for a consideration of when transfer pricing rules may give rise to a subsidy must be Article 1 to the SCM Agreement which defines what a subsidy is for the purposes of the Agreement and when subsidies are subject to the disciplines of the SCM Agreement (i.e. when they are specific).

4.626 Article 1.1(a)(1)(ii) of the SCM Agreement deems there to be a financial contribution by government if “government revenue which is otherwise due is forgone”. It has also explained that the baseline against which it needs to be assessed whether revenue is forgone may be considered to be the generally applicable tax law and that the United States shares the same view and calls this the “reference law baseline”³⁰⁰.

4.627 The above explains why the second sentence of footnote 59 states that “prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm’s length”. The use of the word “should” is necessary because the footnote cannot lay down a tax rule, only indicate when there might be an export subsidy.

4.628 Although WTO Members are in principle free as a matter of WTO law not to provide for the use of arm’s length pricing between related companies, it is clear that in doing so they run the risk of granting subsidies. This is because in considering whether a subsidy exists or not one of the factors to take into consideration will often be the situation which would prevail under market conditions. That is precisely what arm’s length pricing rules seek to achieve.

4.629 The European Communities returns to comment on the United States arguments on footnote 59 but now applies the above principle to the special administrative pricing rules of the FSC scheme.

Application of the above principles to the FSC scheme

4.630 The special administrative pricing rules of the FSC scheme are a derogation from the generally applicable (or standard) rules of the US tax system applicable to the regulation for tax purposes of the prices considered to be payable on transactions between related companies which as the United States concedes are contained in Section 482 IRC³⁰¹. They are only available to FSCs and their parents and give a more favourable result because there is a free choice between the standard Section 482 IRC method and the two special administrative pricing rules transaction by transaction and *ex post*. The enormous benefits this gives are demonstrated by the Article from “Tax Notes International” entitled ‘A FSCful of Dollars: Maximizing FSC Benefits through Transaction Level Pricing,’ submitted as Exhibit EC-8 to the European Communities' First Written Submission. It is also clear from the text of the FSC legislation itself that the 1.83 per cent gross receipts method can give twice the tax exemption of the 23 per cent of combined taxable income method. For a worked example of how this works the Panel can refer to the Example 3 given on page 198 of the Article “A FSCful of Dollars: Maximizing FSC Benefits through Transaction Level Pricing,” in Exhibit EC-8.

The special administrative pricing rules constitute a prohibited export subsidy

4.631 Having established that the special administrative pricing rules of the FSC scheme give rise to a subsidy it is clear that they are a prohibited export subsidy since they are contingent upon export performance and specifically related to exports as the European Communities has abundantly

³⁰⁰ See above and Exhibit EC-25.

³⁰¹ See paragraph 53 of the United States First Written Submission.

demonstrated in its First Written Submission and Statement to the First Meeting of the Panel. The European Communities notes that United States has not contested export contingency.

4.632 Footnote 59 confirms the conclusion but this is dealt with below.

Conclusion

4.633 The European Communities has clarified above its position as to why the special administrative pricing rules constitute a prohibited export subsidy. This is based on Articles 1 and 3 of the SCM Agreement and confirmed by Item(e) and its footnote. The European Communities will now proceed to consider the United States arguments on this issue which rely heavily on a distorted view of footnote 59 to Item (e) of the Illustrative List in Annex I to the SCM Agreement.

Footnote 59 to Item (e) of the Illustrative List in Annex I to the SCM Agreement

Introduction

4.634 The United States defence relies heavily on footnote 59 to Item (e) of the Illustrative List in Annex I to the SCM Agreement which it claims contains or is “predicated by” a “controlling legal standard” to the effect that a Member has a right not to tax foreign economic processes and may make non taxation of these foreign economic processes contingent upon any condition it pleases (or at least upon export performance).

4.635 The European Communities has already explained that the supposed source of this “controlling legal standard,” the 1981 Understanding on the basis of which the *DISC and Tax Legislation* Reports were adopted, is not applicable or relevant to this dispute and does not contain the standard claimed.

4.636 There remain however a number of issues arising from footnote 59 on which the European Communities still wishes to comment.

Item (e) in Context

4.637 It is first of all necessary to recall, lest it be forgotten, that Item (e) of Annex I and its footnote 59 are not necessary to the European Communities' analysis. The FSC subsidies are contrary to Article 3.1(a) of the SCM Agreement without any need to refer to the Illustrative List, except for confirmation.

4.638 The United States is wrong to argue that:

“Thus, if the Illustrative List treats a measure as an export subsidy, it is prohibited. Conversely, if the List treats a measure as not being an export subsidy, it is not prohibited. No further analysis is needed to divine the meaning of Article 3.1(a) with respect to measures addressed by the Illustrative List.”

4.639 The first sentence is correct. The second is also in principle correct, not as an *a contrario* deduction from the first sentence but as a paraphrasing of footnote 5 to Article 3.1(a) of the SCM Agreement. But Item (e) of the Illustrative List does not mention any measure as “not constituting export subsidies” (the correct wording) and the pretended deduction in the third sentence is completely wrong. First a footnote only *explains* a provision it does not *contradict* it as would be the result of the United States argument. Second, the footnote is providing guidance as to the meaning and significance of the terms in Item (e) and their relationship to the rest of the SCM Agreement. Thus to take the first sentence (not in issue in this case) it is simply recalling that if interest is charged on deferred payments, there will not be a subsidy. And the last sentence of footnote 59 is simply recalling the general principle (to which the European Communities subscribes) that it is not the purpose of the SCM Agreement to specify the tax systems Members may pursue. The sentence is not

excepting from the Agreement specific and export contingent exceptions to the systems which give rise to export subsidies.

4.640 The European Communities would also make clear that it is not the purpose of Item (e) or any other provision of the Illustrative List to specify what is or is not a subsidy, as the United States seems to be arguing. That question is exhaustively regulated by Article 1.1 of the SCM Agreement. It is only providing guidance about *export subsidies*. If it were otherwise the fact that a measure is referred to as not being an export subsidy would mean that it could not (even if applied *specifically* but not *export contingently*) ever be considered a subsidy covered by the Agreement at all.

The Second Sentence of Footnote 59

4.641 As the European Communities has already explained, the second sentence of footnote 59 confirms the European Communities position based on the other provisions of the SCM Agreement that the export contingent derogation which the FSC scheme contained from its arm's length pricing rules can and should be considered an export subsidy.

4.642 The United States however uses the second sentence of footnote 59 for a number of purposes. First it attempts to deduce from the sentence support for its "controlling legal standard" by suggesting that it is ambiguous and that the 1981 Understanding must be imported into the text to resolve this ambiguity. Second it attempts to defend the special administrative pricing rules of its FSC scheme by arguing that the reference to arm's length pricing it contains does not mean what it seems.

4.643 The United States claims to read this sentence of the footnote as allowing it to designate a certain category of economic processes as "foreign" – that is "distributor functions"³⁰² – and to exempt them from tax – provided of course that they relate to the export of United States goods. It candidly admits that the administrative pricing rules will not correctly allocate profit between the persons involved (the FSC and its related supplier) but claims that this is not its purpose and it is not referring to the kind of rules set out in Section 482 of the IRC or the OECD Guidelines but to the allocation of income between economic functions. According to the United States the FSC and its related supplier should not really be regarded as separate³⁰³ and that allocating all "income attributable to distributor functions" to the FSC is just a convenient device for taking advantage of a pretended WTO right.

4.644 Of course, footnote 59 says no such thing. It is plain from its text that it is referring to the need for prices for goods in export transaction between exporting enterprises and foreign buyers under their or the same control to be those that would be charged between independent persons acting at arm's length. They are not referring to the allocation of income between "*economic processes*." This is indeed logical as footnote 59, in setting out the abovementioned principle, correctly assumes that in a transaction between independent parties each party (in this case the seller) would charge a price which reflects the processes **actually** performed by that party (the reason being that, under normal trading conditions, it would not be possible to inflate the price by including charges for processes not performed, or the contrary, i.e. it would be unusual commercial behaviour not to include in the price charges for processes actually performed) It is even more alien to normal commercial behaviour to allow the price to be determined *ex post* according to alternative formulae so as to maximise the profit of the purchaser or agent but this is exactly what the FSC scheme does.

4.645 Thus the reason for footnote 59 adopting the "arm's length" rule is to approximate as far as possible the conditions which would have prevailed in the absence of the relationship between buyer and seller. The FSC legislation does nothing of the sort as it creates a fictitious allocation of income (on the basis of predetermined formulaic criteria) regardless of the processes actually performed by an FSC. As a result the United States theory of footnote 59 containing an "income allocation rule" could not be further away from reality.

³⁰² Paragraph 108 of the United States First Written Submission.

³⁰³ Paragraph 109 of the United States First Written Submission.

4.646 It is also clear that the current United States interpretation of footnote 59 does not reflect the original intention but is an *ex post* attempt to use this text to defend the FSC scheme. The United States view was different in 1978 when the text was negotiated. The European Communities submits as Exhibit EC-28 a letter from Richard R Rivers General Counsel for the US Office of the Special Representative for Trade Negotiations to the European Communities Commission indicating that the second sentence of footnote 59 was intended to refer precisely to guidelines such as those subsequently drafted by the OECD and indicating that this could apply at least with respect to Members of the OECD.

The Third Sentence of Footnote 59 and the de minimis Arguments

4.647 A further argument in defence of the FSC scheme is that the subsidies it provides are *de minimis* and therefore escape prohibition.

4.648 This is based on the reference in the third sentence to footnote 59 to a significant saving of direct taxes in export transactions. The sentence reads:

Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions.

4.649 The United States argument is misguided because the sentence only refers to the right to draw attention to such practices and the word “significant” is simply designed to avoid Members from invoking individual cases of minor importance.

4.650 The prohibition on export subsidies is absolute. There is no *de minimis* rule. The existence of a *de minimis* rule in countervailing duty cases is dictated by the different nature of this remedy and in particular the fact that countervailing duties can only be imposed where there is injury and injury is not likely where the price effect is less than 1 per cent. Also the *de minimis* rule in countervailing duty cases applies only to the imposition of duty on the product of an exporter which may be the cumulative value of a number of subsidy schemes each individually below 1 per cent. No subsidy *scheme* escapes countervailing duty because it amounts to less than 1 per cent of sales value.

4.651 In any event, the FSC subsidies are significant at US\$2 billion per year according to the United States own estimates. The success of the scheme demonstrates that it is of interest to exporters. As explained above, the real effect is more significant than may appear. Companies are normally quite keen to take measures that save 15-30 per cent of the tax charge on export transactions. This will after all increase their net profits by 5 - 10 per cent and this is what matters to companies.

4.652 Even the *ad valorem* effect can of course, in some cases, be much more than the 0.93 per cent claimed by the United States, since this is only an average.

4.653 The FSC scheme is important since it applies throughout the United States economy. In this regard, the United States argues that a 0.3 per cent increase in United States exports is insignificant. It is not. The European Communities does not agree. In 1998 United States goods exports were US\$683 billion. 0.3 per cent represents about US\$2 billion which is very significant and in any event much greater than trade effects the United States has complained of in the past.

4.654 The United States makes an argument based on the wording of the third sentence which the European Communities will now rebut. It argues that this sentence is only referring to *aggregate* tax savings across the whole economy because it refers to “saving” in the singular and “direct taxes” and “export transactions” in the plural. The European Communities regards this argument as specious. The fact that the words “direct taxes” and “export transactions” are in the plural is explained by the structure of the sentence and the fact that its subject of the second clause is “practices” in the plural. The use of the singular form for “saving” simply reflects linguistic usage and does not indicate that only the average reduction of taxes is relevant.

4.655 Such an interpretation would be contrary to the overall objective of the SCM Agreement which is to discipline *specific* subsidies. As explained in Article 2 of the SCM Agreement specificity includes in particular the grant of a particular advantage to enterprises or groups of enterprises. Looking at the aggregate effect on companies overall flies in the face of on of the primary principles of the SCM Agreement.

Commission FSCs

4.656 Even if the United States interpretation to footnote 59 were accepted (and the European Communities rejects it), it still would not assist most FSCs since the majority are commission FSCs which do not buy or sell goods.

Footnote 59 and the DISC and Tax Legislation Cases

4.657 Part of the United States argument that footnote 59 permits the FSC subsidies is in effect based on the notion that the footnote was designed to resolve the complex tax dispute³⁰⁴ arising out of the *DISC and Tax Legislation* cases and thus should now be interpreted in that light so as to permit the FSC scheme, which as the United States has claimed a number of times³⁰⁵, was specifically designed by the US Congress to satisfy what it perceived to be GATT 1947 requirements.

4.658 The first point that the European Communities would make in response to this argument is, with all due respect, that US Congress' view of the requirements of GATT 1947 are not authoritative. It is clearly stated in the General Explanation in Exhibit EC-6 that Congress, even in 1985, did not find the GATT arguments against DISC persuasive or credible³⁰⁶. In addition, the US Congress was designing a system to be defended under GATT 1947, not the SCM Agreement and so even if the FSC scheme had been compatible with GATT 1947 (a view the European Communities does not take but on which the Panel does not need to decide), that would not mean that it does not give rise to prohibited subsidies under the SCM Agreement of the WTO Agreement.

4.659 There have been numerous changes in the legal position since the entry into force of the WTO Agreement in 1995.

4.660 The Tokyo Round SCM Agreement which existed at the time was an "Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement" whereas the SCM Agreement is an Agreement separate to GATT 1994 and is, by virtue of the General Interpretative Note to Annex IA to the WTO to prevail in case of conflict with GATT 1994. It is therefore no longer an interpretation of GATT. Article 32.1 of the SCM Agreement does still refer to the SCM Agreement interpreting GATT but, it is submitted that this refers principally to Countervailing Duty Action under Article VI of GATT 1994 and is explained by its genesis (it was copied from Article 19.1 of the Tokyo Round SCM Agreement with only the "legal revision" changes to terminology). This is further reinforced by the fact that this provision is identical to Article 18.1 of the WTO Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 ("the Anti-dumping Agreement").

4.661 The SCM Agreement is not only independent of the GATT 1994 (which is not invoked by the European Communities in this case) it also makes fundamental changes in particular to the treatment of export subsidies. First, there is now for the first time a definition of the term "subsidy" (Article 1.1 of the SCM Agreement) and a clear statement that the disciplines of the Agreement only apply to *specific* subsidies (Article 1.2 of the SCM Agreement) and export subsidies are deemed to be specific (Article 2.3 of the SCM Agreement). Also export subsidies are now defined in general terms as subsidies which are contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance (Article 3.1(a)) and the (modified) Illustrative List is included as

³⁰⁴ See e.g. paragraphs 2, 16, and 38 of the United States First Written Submission.

³⁰⁵ See e.g. paragraphs 40, 53, 81, and 126 of the United States First Written Submission.

³⁰⁶ See first paragraph on page 1042 of the General Explanation in Exhibit EC-6.

illustrations of what is *included* in the prohibition. In general this is a much stricter and complete definition of export subsidies than existed before. The combination with the Article 1.1 of the SCM Agreement however (to be an export subsidy a measure must first be a subsidy) makes it more rigorous and precise and certain measures which might have been considered to fall under the prohibition of export subsidies of the Tokyo Round SCM Agreement are no longer prohibited if they do not result in a financial contribution by government and a benefit to the recipient.

4.662 A further difference with the Tokyo Round SCM Agreement is that the SCM Agreement now also contains a clear prohibition on local content subsidies in Article 3.1(b) of the SCM Agreement (also relevant to the present proceeding).

4.663 Finally, there are also some relevant changes to the Illustrative List itself. The old Illustrative List annexed to the Tokyo Round SCM Agreement, contained two provisions specifically designed to protect the US DISC/FSC legislation (a complete text of Annex I to the Tokyo Round SCM Agreement is included in Exhibit EC-29). These are:

- An addition after the sentence on deferral of tax of the following sentence:

“The signatories further recognize that nothing in this text prejudices the disposition by the CONTRACTING PARTIES of the specific issues raised in GATT document L/4422.”

GATT document L/4422 is the document containing the DISC Panel Report.
- An addition after the end of the text corresponding to the present footnote 59 of a paragraph stating that:

“Where measures incompatible with the provisions of paragraph (e) exist, and where major practical difficulties stand in the way of the signatory concerned bringing such measures promptly into conformity with the Agreement, the signatory concerned shall, without prejudice to the rights of other signatories under the General Agreement or this Agreement, examine methods of bringing these measures into conformity within a reasonable period of time.”

At the time the Tokyo Round Agreements were adopted, the United States had major difficulties ending the DISC and this had to wait until after the presidential elections in 1980.

4.664 Of course, the above quoted language from the Tokyo Round SCM Agreement is not part of the SCM Agreement or the WTO. Indeed its absence also indicates an intention not to continue any exemption for or tolerance of the DISC/FSC.

4.665 All the above differences between the Tokyo Round SCM Agreement and the situation prevailing under the GATT 1947 (and others mentioned elsewhere³⁰⁷) on the one hand and the SCM Agreement on the other hand demonstrate that an alleged compatibility of the FSC scheme with, or intention to comply with, the former agreements is entirely irrelevant in the present situation governed by the WTO and SCM Agreement.

Conclusion

4.666 The European Communities has shown above that footnote 59 is not necessary for its case but confirms it. It has also shown that footnote 59 provides no defence for the United States.

³⁰⁷ See above.

The **European Communities** argues as follows in response to a question from the United States following the First Meeting of the Panel:

4.667 Many United States questions relate to territorial tax systems and suggest that they have the same effect as the FSC scheme. The European Communities has given a description of these schemes in its Second Written Submission to which the Panel is referred. The European Communities doubts the relevance of the discussion of the territorial tax systems to the case at hand. It would simply repeat here that the FSC scheme does not “emulate” territorial tax systems and that the same SCM Agreement disciplines apply to territorial tax systems as apply to the FSC scheme.³⁰⁸

4.668 The European Communities' position is simply that WTO Members are not prevented by the SCM Agreement from not taxing foreign source income if this is done on a general basis. What is not acceptable is to exempt only foreign source income deriving from exports since this is a prohibited export subsidy. The fact that in territorial systems of taxation, taxes would often be generally higher to reach an equivalent level of revenue is an inherent disadvantage of this system compared to the foreign tax credit system (worldwide system of taxation).

The **United States** further responds in its Second Submission as follows:

The FSC Tax Exemption Is Not a Subsidy Under Article 1 of the SCM Agreement Because It Does Not Entail the Foregoing of Revenue that Is "Otherwise Due"

4.669 Applying the European Communities' approach and beginning with the general rather than the specific, Article 1.1(a)(1)(ii) of the SCM Agreement provides that a financial contribution exists where “government revenue that is otherwise due is foregone.” The European Communities has argued that the FSC is a subsidy under Article 1.1(a)(1)(ii) because it results in less tax revenue being collected wherever it applies.³⁰⁹ The European Communities has stated that “[i]f the FSC scheme did not exist or if the export transaction through a FSC were not to qualify under the scheme . . . no part of the FSC’s income from that transaction would be subject to US taxation. The existence of the FSC scheme, or the applicability thereof to the transactions [*sic*], will therefore lead to revenue forgone.”³¹⁰ The European Communities has further stated that the FSC “leads to revenue forgone” because less taxes accrue with respect to FSC transactions than comparable domestic and import transactions.³¹¹ In advancing this argument, the European Communities in effect is taking the position that *any* tax exemption, remission, credit, deduction or reduction constitutes a subsidy for purposes of Article 1. If accepted, this would mean that in any instance where income escapes taxation – or is taxed at a lower rate than other income – a subsidy is conferred.

4.670 The European Communities' argument might be correct if Article 1.1(a)(1)(ii) stated only that a subsidy exists where “government revenue . . . is foregone or not collected.” However, this is not what that provision says. The European Communities ignores a critical portion of the language of Article 1.1(a)(1)(ii); namely, the words “that is otherwise due.” The plain meaning of this language is that it is not enough for revenue to be foregone. Instead, the revenue in question must first be “otherwise due.”

³⁰⁸ Paragraphs 4.667-4.668 reflect the European Communities' response to the following question from the United States: In paragraph 14 of the European Communities' Oral Statement, the European Communities states that “countries which do not tax foreign source income” do “not necessarily provide an advantage” because “such a system results in a lower tax base and such countries will have to impose a tax at higher rates to achieve the same level of revenue.” Is the European Communities suggesting that exempting foreign source income from taxation, including such income that is related to exports, is permissible so long as taxes in general are increased to offset foregone revenue?

³⁰⁹ First European Communities Submission, paragraph 132.

³¹⁰ *Ibid.*

³¹¹ *Ibid.*

4.671 The crucial interpretative question posed by Article 1.1(a)(1)(ii) is what constitutes revenue that is “otherwise due.” The European Communities has intimated that revenue is “due” if domestic law makes it so.³¹² According to the European Communities, “revenue that is otherwise due is forgone” only where a measure initially makes a general category of income subject to taxation and then another measure, or a different provision of the same measure, creates an exception.³¹³

4.672 However, the European Communities has not provided the Panel with any interpretative analysis grounded in the rules of the *Vienna Convention on the Law of Treaties* (“VCLT”) for concluding that a subsidy exists where foreign-source income is not taxed. Instead, the European Communities ignores a detailed interpretative analysis, because it knows that such an analysis will lead the Panel down a path that the European Communities desperately wants the Panel to avoid. Specifically, the European Communities does not want the Panel to consider the *Tax Legislation Cases*, the 1981 Council Decision, or footnote 59 of the SCM Agreement. Individually and collectively, these interpretative sources disrupt the European Communities' simplistic legal analysis, because they clarify that the exemption from tax of income attributable to foreign economic processes does not constitute the foregoing of revenue that is “otherwise due.”

The Tax Legislation Cases and the 1981 Council Decision Are Relevant Sources for Interpreting Article 1.1(a)(1)(ii), Clarifying that the Exemption from Tax of Income Attributable to Foreign Economic Processes Does Not Constitute the Foregoing of Revenue that Is "Otherwise Due"

4.673 Although the United States position is that the 1981 Council Decision is dispositive in interpreting Article 1.1(a)(1)(ii), in order to properly understand the Council Decision, one first must be clear on what the panel found in the underlying *Tax Legislation Cases*. Because the Council effectively reversed the panel, the panel's reports in those cases provide the key to unlocking the significance of the Council Decision.

4.674 Consider, for example, the case against France. In the report in that case, the panel concluded as follows:

The Panel noted that the particular application of the territoriality principle by France allowed some part of export activities, belonging to an economic process originating in the country [and then continuing in a foreign country], to be outside the scope of French taxes. In this way France has *foregone revenue* from this source and created a possibility of a pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal *in foreign countries*.³¹⁴

Note in particular the reference to “foregone revenue.” Having previously found that “profits generated by undertakings operated abroad are exempt from French taxation,” the panel was declaring that the exemption of such profits from tax constituted “foregone revenue.”³¹⁵

4.675 The panel then found that this practice “constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market.”³¹⁶ From this the panel then arrived at the following conclusion:

³¹² *Ibid.*

³¹³ *Ibid.*

³¹⁴ *Tax Legislation - Income Tax Practice Maintained by France*, L/4423, BISD 23S/114, Report of the Panel adopted 7-8 December 1981, paragraph 47 (emphasis added). The panel made virtually identical findings in the cases against Belgium and the Netherlands. *Tax Legislation - Income Tax Practice Maintained by Belgium*, L/4424, BISD 23S/127, Report of the Panel adopted 7-8 December 1981, paragraph 34; and *Tax Legislation - Income Tax Practice Maintained by the Netherlands*, L/4425, BISD 23S/137, Report of the Panel adopted 7-8 December 1981, paragraph 34

³¹⁵ BISD 23S/114, paragraph 9.

In circumstances where different tax treatment in different countries resulted in a smaller total tax bill in aggregate being paid on exports than on sales in the home market, the Panel concluded that there was a partial exemption from direct taxes. The Panel further concluded that the practices were covered by one or both items (c) and (d) of the illustrative list of 1960 (BISD, 9 Suppl. P. 186).³¹⁷

4.676 The panel's conclusions are important not because they were followed by the GATT Council, but because they were rejected. The Council did not accept the panel's reasoning. However, rather than reject the reports or do nothing, the Council decided to adopt the reports by substituting its own reasoning that essentially reversed key findings of the panel. In particular, the 1981 Council Decision states that economic processes located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country. Put differently, the Council overturned the panel's findings that, by declining to tax income from foreign economic processes incurred as part of export activities, France, Belgium and the Netherlands had "foregone revenue."

4.677 The European Communities must argue that the *Tax Legislation Cases* are irrelevant because the rules emerging from those cases are fatal to its position. The European Communities would prefer that the Panel forget the underlying similarity between what the European Communities is accusing the United States of doing with the FSC and what the United States accused France, Belgium, and the Netherlands of doing in the 1970s. The European Communities also would prefer that the Panel forget that because they could not countenance the panel's conclusions in the *Tax Legislation Cases*, France, Belgium, and the Netherlands held up adoption of the reports until the Council reversed the panel.³¹⁸ Finally, the European Communities also would like the Panel to ignore that the 1981 Council Decision sanctified the differential tax treatment of foreign and domestic activities, even when those activities involve export transactions.

4.678 Instead, having enjoyed the protection of the Council Decision since 1981, the European Communities now wants to deny this to the United States by engaging in a bit of revisionist analysis that leads the European Communities to the conclusion that the Council Decision is not relevant. The European Communities offers three arguments in this regard: (1) the *Tax Legislation Cases* and the Council Decision involved GATT Article XVI, rather than the SCM Agreement; (2) the *Tax Legislation Cases* involved an allegation of dual pricing; and (3) the Council Decision sanctified the differential tax treatment of foreign and domestic activities only with respect to pure territorial systems. For the reasons set forth below, each of these arguments is incorrect.

Even Though the Tax Legislation Cases and the Council Decision Involved GATT Article XVI, They Are Highly Relevant for Purposes of Interpreting Article 1.1(a)(1)(ii)

4.679 The European Communities claims that the *Tax Legislation* panel reports and the 1981 Council Decision are irrelevant because they involved GATT Article XVI.³¹⁹ In so claiming, the European Communities oversimplifies a complicated issue. As the Appellate Body has explained, "[t]he relationship between the GATT 1994 and the other goods agreements in Annex 1A [to the WTO Agreement] is complex and must be examined on a case-by-case basis."³²⁰ Thus, while it is true that the panel reports and the Council Decision involved Article XVI of GATT 1947, that does not

³¹⁶ BISD 23S/114, paragraph 48. The panel made an identical statement in the Belgian and Dutch cases. BISD 23S/127, paragraph 35; BISD 23S/137, paragraph 35.

³¹⁷ BISD 23S/114, paragraph 50. The panel reached the same conclusions in the Belgian and Dutch cases. BISD 23S/127, paragraph 37; BISD 23S/137, paragraph 37.

³¹⁸ The United States readily admits that it, too, held up adoption of the DISC panel report until the reports in the three European cases were adopted. The point here is that the European Communities is disingenuous when it suggests that the delay in adopting the reports in the *Tax Legislation Cases* was solely due to objections by the United States.

³¹⁹ EC Oral Statement, paragraphs 45-46.

³²⁰ *Brazil - Measures Affecting Desiccated Coconut*, WT/DS22/AB/R, Report of the Appellate Body, adopted 20 March 1997, page 13 ("*Desiccated Coconut*").

render them irrelevant for purposes of interpreting Article 1.1(a)(1)(ii) of the SCM Agreement. Instead, an examination of the text of the SCM Agreement makes clear that the SCM Agreement and Article XVI are not to be construed in isolation from each other.

4.680 The relationship between the two is demonstrated by the very first article of the SCM Agreement. Article 1.1(a)(2), which deals with the definition of a subsidy, expressly references Article XVI when it refers to “any form of income or price support in the sense of Article XVI of GATT 1994”

4.681 Similarly, the notification and surveillance provisions highlight the relationship between Article XVI and the SCM Agreement. For example, Article 25.6 of the SCM Agreement provides as follows: “Members which consider that there are no measures in their territories requiring notification under paragraph 1 of Article XVI of GATT 1994 *and* this Agreement shall so inform the Secretariat in writing.” (Emphasis added). Similarly, Article 25.10, which deals with cross-notification, provides as follows: “Any Member which considers that any measure of another Member having the effects of a subsidy has not been notified in accordance with the provisions of paragraph 1 of Article XVI of GATT 1994 *and* this Article may bring the matter to the attention of such other Member.” (Emphasis added). Finally, Article 26.1 charges the Subsidies Committee with examining notifications “submitted under paragraph 1 of Article XVI of GATT 1994 *and* paragraph 1 of Article 25 of [the SCM] Agreement” (Emphasis added).

4.682 Even more to the point, paragraph (l) of Annex I to the SCM Agreement refers to “[a]ny other charge on the public account constituting an export subsidy *in the sense of Article XVI of GATT 1994.*” (Emphasis added). If the drafters of the SCM Agreement had intended to render Article XVI irrelevant for purposes of the SCM Agreement (which essentially is what the European Communities is claiming), they would not have written language that expressly directs one to Article XVI for purposes of identifying an export subsidy under the SCM Agreement.

4.683 Any doubt on this score is eliminated by Article 32.1 of the SCM Agreement, which provides as follows: “No specific action against a subsidy of another Member can be taken except in accordance with the provisions of GATT 1994, *as interpreted by this Agreement.*” (Emphasis added; footnote omitted). Thus, the SCM Agreement constitutes an interpretation of GATT 1994, including Article XVI. This means that Article XVI and the SCM Agreement cannot be interpreted in isolation from each other.

4.684 In the one case to date that considered the relationship between the SCM Agreement and the subsidy provisions of GATT 1994, both the panel and the Appellate Body reached this same conclusion. In the *Desiccated Coconut* case, which involved Article VI of GATT 1994, the panel observed as follows:

For example, Article 1.1 of the SCM Agreement contains a definition of “subsidy” and Article 16.1 of the SCM Agreement contains a definition of “domestic industry” both of which are “for purposes of this Agreement”. However, the terms “subsidy” and “domestic industry” are used both in Article VI of GATT 1994 and the SCM Agreement. If the term “this Agreement” were interpreted *strictu sensu* to mean the SCM Agreement, then the definitions of these key terms in the SCM Agreement would be inapplicable to the same terms as used in Article VI of GATT 1994. Such a result could not have been intended.³²¹

4.685 The panel went on to conclude that “the drafters expected that Article VI of GATT 1994 and the SCM Agreement would operate only in conjunction.”³²²

³²¹ *Brazil - Measures Affecting Desiccated Coconut*, WT/DS22/R, Report of the Panel, as modified by the Appellate Body, adopted 20 March 1997, paragraph 234.

³²² *Ibid.*, paragraph 285.

4.686 The Appellate Body reached the same conclusion as the panel. Noting that “[t]he authors of the new WTO regime intended to put an end to the fragmentation that had characterized the previous system”³²³, the Appellate Body concluded that

the negotiators of the *SCM Agreement* clearly intended that, under the integrated *WTO Agreement*, countervailing duties may only be imposed in accordance with the provisions of Part V of the *SCM Agreement* and Article VI of the GATT 1994, taken together. If there is a conflict between the provisions of the *SCM Agreement* and Article VI of the GATT 1994, furthermore, the provisions of the *SCM Agreement* would prevail as a result of the general interpretative note to Annex 1A.³²⁴

4.687 Although the *Desiccated Coconut* case involved the relationship between Article VI and the SCM Agreement, the reasoning of the panel and the Appellate Body apply equally to the relationship between Article XVI and the SCM Agreement. This is especially true given the numerous references in the SCM Agreement, discussed above, to Article XVI.

4.688 As the Appellate Body has noted, under the general interpretative note to Annex 1A, the SCM Agreement would prevail in the event of a conflict between one of its provisions and Article XVI.³²⁵ However, in the instant case, there is no conflict between Article XVI, as interpreted by the 1981 Council Decision, and Article 1.1(a)(1)(ii). As noted above, the phrase “government revenue that is otherwise due is foregone” is not self-defining, and, by its terms, does not conflict with the principle set forth in the Council Decision. The Council’s statement that foreign economic processes “need not be subject to taxation by the exporting country”³²⁶ is just another way of saying that revenue from such processes is not “otherwise due.”

4.689 Moreover, under public international law “[t]here is a presumption against conflicts in that parties do not normally intend to incur conflicting obligations.”³²⁷ As recognized by a prior panel, “[t]his presumption is especially relevant in the WTO context since all WTO agreements, including GATT 1994 which was modified by the Understandings when judged necessary, were negotiated at the same time, by the same Members and in the same forum.”³²⁸ What this means is that, to the extent possible, Article XVI and the SCM Agreement must be construed in a manner that avoids a conflict. In the context of this case, this means that Article 1.1(a)(1)(ii) must be construed in light of the 1981 Council Decision.

4.690 In summary, the text of the SCM Agreement and WTO jurisprudence demonstrate that Article XVI and the SCM Agreement must be interpreted in a harmonious manner. Therefore, notwithstanding the fact that the *Tax Legislation* panel reports and the 1981 Council Decision involved Article XVI, they are highly relevant to an interpretation of Article 1.1(a)(1)(ii) of the SCM Agreement.

The Fact that the Tax Legislation Cases Involved an Allegation of Dual Pricing Does Not Render Them or the 1981 Council Decision Irrelevant

4.691 The European Communities also notes that the panel reports in the *Tax Legislation Cases* were based on an allegation of dual pricing. According to the European Communities, because the

³²³ *Desiccated Coconut*, page 18.

³²⁴ *Ibid.*, page 17 (underscoring in original).

³²⁵ *Ibid.*, page 13.

³²⁶ BISD 28S/114.

³²⁷ *Encyclopaedia of Public International Law* (North-Holland 1984), page 470.

³²⁸ *Indonesia - Certain Measures Affecting the Automobile Industry*, WT/DS55/R, Report of the Panel adopted 23 July 1998, paragraph 14.28 (footnote omitted) (“*Indonesia Autos*”).

export subsidy rules of the SCM Agreement do not contain a dual pricing requirement, the panel reports and the 1981 Council Decision are no longer relevant.³²⁹

4.692 Here, the European Communities simply distorts the role of the dual pricing test. GATT Article XVI:4 (both the 1947 and the 1994 versions) does not contain a strict prohibition on export subsidies. Rather, it only prohibits an export subsidy “that 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.” Thus, two elements have to be proved under Article XVI:4: (1) that there is an export subsidy; and (2) that the export subsidy results in dual pricing. As the European Communities correctly notes, the dual pricing requirement was abolished in the Tokyo Round Subsidies Code, and continues to be absent from the SCM Agreement.³³⁰

4.693 However, the fact that dual pricing is no longer an element to be proved in advancing a prohibited export subsidy claim does not render the *Tax Legislation* panel reports or the 1981 Council Decision any less relevant. The panel in those cases found both elements present – the export subsidy and the dual pricing. However, had the dual pricing requirement not existed under Article XVI:4 (that is, had GATT 1947 been less tolerant of export subsidies), the panel still would have found the same violation. The only difference is that there would have been only one element to prove, not two, and the panel would have reached the same conclusions; namely, that by exempting from tax income attributable to foreign economic processes incurred in export transactions, France, Belgium and the Netherlands had foregone revenue, engaged in differential taxation of export and domestic sales, and conferred an export subsidy.

4.694 Moreover, the 1981 Council Decision did not address the dual pricing requirement at all. Instead, as discussed above, the Council reversed the panel’s conclusions regarding the existence of an export subsidy.

4.695 Thus, the fact that the *Tax Legislation Cases* involved dual pricing allegations does not undercut the relevance of the panel reports or the Council decision one iota. Indeed, the fact that the European Communities would even advance such a tenuous argument speaks volumes about the merits of the European Communities' case.³³¹

The 1981 Council Decision Does Not Require an "All-or-Nothing" Approach to the Taxation of Foreign Economic Processes

4.696 As a final attack on the relevance of the 1981 Council Decision, the European Communities argues that it requires a Member to exercise an all-or-nothing choice when it comes to income arising out of foreign economic processes. A Member must either exempt all income from all foreign economic processes or tax all income from all foreign economic processes.³³²

4.697 The European Communities' all-or-nothing theory is not supported by the text of the Council Decision, and the European Communities provides no other basis in support of its assertion. The European Communities simply makes an unsubstantiated claim that the Council intended that such a tax exemption may not be limited to instances where exported goods are involved, but instead must be all-encompassing.

4.698 The language of the Council Decision, though, states otherwise. The Council made two fundamental points that contradict the European Communities' theory. First, the Decision states that

³²⁹ EC Oral Statement, paragraph 49.

³³⁰ EC Oral Statement, paragraph 48.

³³¹ The European Communities' argument is akin to arguing that because an actionable subsidy claim requires a showing of adverse effects, a panel or Appellate Body interpretation of Article 1 of the SCM Agreement made in an actionable subsidy case would be irrelevant to an interpretation of Article 1 in a prohibited subsidy case.

³³² EC Oral Statement, paragraph 54.

“in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country.”³³³ Second, the Decision states that such processes “should not be regarded as export activities in terms of Article XVI:4 of the General Agreement.”³³⁴

4.699 With respect to the first point, if countries are under no obligation to tax income derived from foreign economic processes, then they should be free to exempt all such income or just part of it. There simply is nothing in the language of the Decision that compels a contrary conclusion.

4.700 As for the second point, if foreign economic processes are not export activities for purposes of Article XVI:4, then exempting such income from taxation cannot be considered to be contingent upon exports, as the European Communities contends. This is true irrespective of whether all foreign-source income or only foreign-source income related to export transactions is exempted. Indeed, as discussed below, EC member States do not themselves maintain pure territorial systems, and would not pass the test that the European Communities now expounds.

The 1981 Council Decision Is Authoritative

4.701 The European Communities also takes issue with the authoritative nature of the Council Decision. Citing the Appellate Body decision in the *Japan Liquor* case, the European Communities argues that adopted GATT panel reports constitute nothing more than proposals to the GATT CONTRACTING PARTIES.³³⁵

4.702 The United States does not dispute the Appellate Body’s rejection of the view that “adopted panel reports *in themselves* constitute ‘other decisions of the CONTRACTING PARTIES to GATT 1947’”³³⁶ However, the Appellate Body did acknowledge that adopted panel reports cannot be ignored, stating that

[a]dopted panel reports are an important part of the GATT *acquis*. They are often considered by subsequent panels. They create legitimate expectations among WTO Members, and, therefore, should be taken into account where they are relevant to any dispute. However, they are not binding, except with respect to resolving the particular dispute between the parties to that dispute.³³⁷

4.703 Thus, even though the panel reports in the *Tax Legislation Cases* – as opposed to the Council Decision – are not themselves legally binding in this dispute, the Panel should regard them as having greater interpretative weight with respect to the issues raised in the present dispute than is normally the case with adopted panel reports. Both the United States and the European Communities were parties to the *Tax Legislation Cases*. The United States enacted the FSC for the specific purpose of complying with the findings of the DISC panel, as interpreted by the Council Decision. And the tax measures of France, Belgium and the Netherlands, which the European Communities in the present dispute goes to great lengths to distinguish from the FSC with respect to their impact upon exports, are the same measures – essentially unchanged – that the panel in the *Tax Legislation Cases* found to be export subsidies.

4.704 Having said that, however, the 1981 Council Decision is quite different from the panel reports discussed by the Appellate Body in *Japan Liquor*. In that case, the Appellate Body based its decision concerning the status of adopted panel reports on the fact that

³³³ BISD 28S/114.

³³⁴ *Ibid.*

³³⁵ EC Oral Statement, paragraph 51.

³³⁶ *Japan - Taxes on Alcoholic Beverages*, WT/DS8/AB/R, Report of the Appellate Body adopted 1 November 1996, page 15 (“*Japan Liquor*”) (emphasis added).

³³⁷ *Japan Liquor*, page 13.

a decision to adopt a panel report did not under GATT 1947 constitute agreement by the CONTRACTING PARTIES on the legal reasoning in that panel report. The generally-accepted view under GATT 1947 was that the conclusions and recommendations in an adopted panel report bound the parties to the dispute in that particular case, but subsequent panels did not feel legally bound by the details and reasoning of a previous panel report.³³⁸

4.705 The GATT Council, though, went well beyond merely adopting the panel reports in the *Tax Legislation Cases*. First, the Council provided substantive views on the merits of the issues then under consideration, and, in an action that appears to be unprecedented in the annals of GATT, adopted the panel reports by changing the conclusions contained in those reports.

4.706 Second, there can be no doubt that the GATT Council intended its decision to have broader application than the specific cases then before it. The terms of the Council Decision specifically state that it applies “with respect to these cases, and in general” Had the Council been concerned merely with adopting the panel reports and putting an end to a long-running dispute, with or without an interpretative gloss applicable to the cases at issue, the words “and in general” would have been superfluous. Because it must be assumed that the insertion of these additional words was deliberate, the logical implication is that the Council intended to make a ruling that extended beyond the measures at issue in the *Tax Legislation Cases*. In the view of the United States, the unique nature of the 1981 Council Decision qualifies it as a “decision” within the meaning of Article XVI:1 of the WTO Agreement.³³⁹

4.707 Moreover, in issuing its decision, the Council was expressing the views of the CONTRACTING PARTIES under Article XXV of GATT 1947. Article XXV:1 states that “[r]epresentatives of the contracting parties shall meet from time to time for the purpose of giving effect to those provisions of this Agreement which involve joint action *and, generally, with a view to facilitating the operation and furthering the objectives of this Agreement.*” (Emphasis added).

4.708 The Council was authorized to speak for the CONTRACTING PARTIES. The Council was established to replace the Inter-sessional Committee, which theretofore had been the GATT body designated to handle matters between meetings of the CONTRACTING PARTIES.³⁴⁰ Unlike its predecessor, which had limited membership, the Council was “composed of representatives of all contracting parties willing to accept the responsibility of membership therein.”³⁴¹ In addition, unlike its predecessor, which had a limited mandate for action, the Council was given broad powers, including the power “to deal with such other matters with which the CONTRACTING PARTIES may deal at their sessions.”³⁴² In order to protect individual contracting parties from unexpected inter-sessional action, each contracting party had the right to “suspend the operation of such action by the Council through the submission of a written appeal to the CONTRACTING PARTIES.”³⁴³ Thus, the Council was authorized to act on behalf of the CONTRACTING PARTIES and, absent objection

³³⁸ *Japan Liquor*, page 12.

³³⁹ In this regard, the Chairman’s note to the 1981 Council Decision states that the Decision in no way seeks to amend the GATT or the Tokyo Round Subsidies Code. BISD 28S/114. At the first meeting of the Panel, the European Communities cited the Chairman’s note to suggest that the United States was improperly invoking the Council Decision to amend or otherwise alter the meaning of the GATT or the Subsidies Code. Nothing could be further from the truth. In the view of the United States, the Chairman’s note clarifies that the Council Decision merely reiterates, in general terms, the existing understanding of the CONTRACTING PARTIES that Article XVI:4 does not require countries to tax the profits derived from activities taking place outside of their borders, including transactions involving exported goods. The panel had upset this understanding, and the Council acted to restore it.

³⁴⁰ BISD 9S/7 (1961), pages 7, 8. The Intersessional Committee had been established in 1951. BISD, Vol. II (1952), page 205.

³⁴¹ BISD 9S/7, pages 7, 8.

³⁴² *Id.*, pages 8-9.

³⁴³ *Id.*, page 9.

from an individual contracting party, the Council's actions would be binding under GATT Article XXV as if the CONTRACTING PARTIES had themselves acted.

4.709 The authority conferred upon the Council to interpret GATT 1947 was akin to the powers currently bestowed on the WTO Ministerial Conference and the General Council, which under Article IX:2 of the WTO Agreement "have the exclusive authority to adopt interpretations of this Agreement and of the Multilateral Trade Agreements." Just as the Conference and the Council may issue authoritative interpretations of the WTO agreements, so too was the Council empowered to interpret GATT 1947. When the Council, in the *Tax Legislation Cases*, substituted its reasoning for that of the panel, the Council was exercising that power.

4.710 As important as the 1981 Council Decision was under GATT 1947, it is even more significant under GATT 1994. Article 1(b)(iv) of GATT 1994 states that the Agreement consists of GATT 1947 and, among other things, "other decisions of the CONTRACTING PARTIES to GATT 1947." Thus, whereas the Council Decision was an interpretation of GATT 1947, it actually is a part of GATT 1994. Because GATT 1994 includes not only GATT 1947, but also rectifications, amendments, protocols, certifications and "other decisions of the CONTRACTING PARTIES,"³⁴⁴ the Appellate Body has recognized that "[i]n many ways therefore, the provisions of the GATT 1994 differ from the provisions of the GATT 1947."³⁴⁵

4.711 In summary, the European Communities confuses the adopted panel reports in the *Tax Legislation Cases* with the Council Decision itself. While the reports may not be authoritative, the Council Decision is.³⁴⁶

In the Absence of a Clear Statement to the Contrary in the SCM Agreement, the Panel Must Conclude that the Drafters Intended to Preserve the Principles Contained in the Council Decision

4.712 In light of the foregoing, the Panel could ignore the 1981 Council Decision only if there were some clear indication in the SCM Agreement that the drafters intended a meaning at odds with the Council Decision.³⁴⁷ However, no such indication exists.

4.713 Instead, as the European Communities acknowledged at the first meeting of the Panel, neither the taxation of income from foreign economic processes in general, nor paragraph (e) or footnote 59 in particular, was the subject of negotiation during the Uruguay Round. Given this, it simply is not possible to maintain, as does the European Communities, that in negotiating a single undertaking with respect to subsidies rules that included both Article XVI and the SCM Agreement, the drafters *sub silentio* decided to repeal the Council Decision.³⁴⁸

³⁴⁴ See Article XVI:1 of the WTO Agreement and paragraph 1(b)(iv) of Annex 1A incorporating the GATT 1994 into the WTO Agreement.

³⁴⁵ *Desiccated Coconut*, page 13.

³⁴⁶ As discussed above, while they are not legally binding, the panel reports are important to understanding the significance and nature of the Council Decision.

³⁴⁷ In this regard, the European Communities previously has acknowledged that if the drafters of the SCM Agreement had intended to make fundamental changes to GATT rules affecting subsidies, one would have expected the drafters to leave evidence of such an intention. In connection with the relationship between the SCM Agreement and GATT Article III, the European Communities has made the following argument: "If, as claimed by Indonesia, the WTO Agreement had rendered GATT Article III inapplicable to subsidies, one would expect to find some indication in the SCM Agreement of the drafters' intention to introduce such a fundamental change with respect to the situation existing under GATT 1947. Yet, the SCM Agreement does not contain the slightest trace of such intention." *Indonesia Autos*, paragraph 5.286. In the context of the instant case, the SCM Agreement does not contain the slightest trace of an intention to discard the principles of the 1981 Council Decision.

³⁴⁸ In this regard, in the exchanges that took place at the first meeting of the Panel, it became apparent that with respect to the European Communities argument that the Council Decision should be ignored, the

4.714 In this regard, it is instructive to compare the issue facing this Panel with the issue that the Appellate Body confronted in the *Cotton Underwear* case.³⁴⁹ In that case, the Appellate Body had to determine whether the Agreement on Textiles and Clothing (“ATC”) permitted the backdating of the effective date of a restraint measure. In resolving this issue, the Appellate Body considered a predecessor agreement, the Multifibre Arrangement (“MFA”), which the Appellate Body considered to be part of the context of the ATC. The Appellate Body noted that the MFA expressly allowed backdating, but that this authority was not carried over into the ATC. This led the Appellate Body to the following conclusion:

We believe the disappearance in the *ATC* of the earlier *MFA* express provision for backdating the operative effect of a restraint measure, strongly reinforces the presumption that such retroactive application is no longer permissible. This is the commonplace inference that is properly drawn from such disappearance. We are not entitled to assume that that disappearance was merely accidental or an inadvertent oversight on the part of either harassed negotiators or inattentive draftsmen. That no official record may exist of discussions or statements of delegations on this particular point is, of course, no basis for making such an assumption.³⁵⁰

4.715 The same logic applies with respect to the Council Decision, albeit in reverse. The fact that nothing in the SCM Agreement references a repudiation of the principles of the Council Decision raises the presumption that the drafters did not, in fact, intend to repudiate those principles. Without such an indication, the Panel is not entitled to assume that in an agreement which repeatedly references Article XVI, “harassed negotiators or inattentive draftsmen” decided to repudiate one of the most important decisions concerning Article XVI in the history of GATT.³⁵¹

European Communities premises its argument in no small part on a distorted view of the changes wrought by the Uruguay Round with respect to export subsidy disciplines. While the United States agrees that the Uruguay Round brought about significant improvements in those disciplines, these improvements largely did not involve matters related to the definition of an export subsidy. Instead, the major improvements were: (1) an improved dispute settlement system; (2) the application of export subsidy disciplines to developing country Members; and (3) the potential application of SCM Agreement export subsidy disciplines to agricultural products.

However, with respect to the definition of an export subsidy, the changes were relatively minor. The definition in Article 3.1(a) is largely a restatement of principles that previously could be gleaned from the Illustrative List of the Tokyo Round Subsidies Code. With respect to the Illustrative List itself: (1) the word “provision” was substituted for “delivery” in paragraph (d) and a footnote was added; (2) the “consumed in production” standard was substituted for the “physical incorporation” standard in paragraphs (h) and (i); and (3) the word “manifestly” was deleted from paragraph (j). In addition, Annexes II and III, which had been developed as part of the work of the Subsidies Code Committee, were added, modified to take into account the noted change to paragraphs (h) and (i).

None of these changes, either individually or cumulatively, is indicative of a drafting intent to make a complete break from prior export subsidy rules or to depart from the general objective of the Uruguay Round drafters to “bring the legal history and experience under the GATT 1947 into the new realm of the WTO in a way that ensures continuity and consistency in a smooth transition from the GATT 1947 system.” *Japan Liquor*, page 13.

³⁴⁹ *United States - Restrictions on Imports of Cotton and Man-Made Fibre Underwear*, WT/DS24/AB/R, Report of the Appellate Body adopted 25 February 1997.

³⁵⁰ *Cotton Underwear*, page 17.

³⁵¹ In this regard, at the first meeting of the Panel, the European Communities suggested that if the United States had wanted to ensure the continuation of the principles set forth in the Council Decision, it was incumbent on the United States to negotiate language to that effect in the SCM Agreement. The United States disagrees.

As discussed above, the status quo under the pre-WTO regime was that income attributable to foreign economic processes (including those incurred in connection with export transactions) did not have to be taxed without running afoul of GATT subsidy rules. This was true whether one looked at the issue from the perspective of Article XVI or the Subsidies Code. Because the Subsidies Code was an agreement that interpreted, *inter alia*, Article XVI, the Council Decision would have been equally applicable to the provisions of the Subsidies Code, although a decision by the Subsidies Code Committee might not have been applicable

Footnote 59 Supports an Interpretation of Article 1.1(a)(1)(ii) that the Exemption from Tax of Income Attributable to Foreign Economic Processes Does Not Constitute the Foregoing of Revenue that Is "Otherwise Due"

4.716 In the preceding sections, the United States demonstrated that the 1981 Council Decision informs an interpretation of Article 1.1(a)(1)(ii) of the SCM Agreement, and leads to the conclusion that the exemption from tax of income attributable to foreign economic processes does not constitute the foregoing of revenue that is “otherwise due” within the meaning of that provision. This conclusion is reinforced when one takes into account footnote 59 of the SCM Agreement. Under the general rules of Article 31.2 of the *VCLT*, footnote 59 forms part of the context of Article 1.1(a)(1)(ii).³⁵² Moreover, it is a particularly important part of the context in light of the fact that footnote 59 qualifies paragraph (e) of the Illustrative List, which, in turn, constitutes a specific application of the general principle contained in Article 1.1(a)(1)(ii).³⁵³

Footnote 59 Narrows the Scope of Paragraph (e)

4.717 The European Communities and the United States appear to agree that paragraph (e) of the Illustrative List and footnote 59 are pertinent to this dispute, but part company on the import of footnote 59. The European Communities has disputed the United States interpretation of the footnote, maintaining that the footnote clarifies paragraph (e), and may even expand its coverage. As the European Communities asserted at the first meeting of the Panel, the language of footnote 59 “does not say or even imply that the exporting country has the right to exempt from tax income from an export transaction which would otherwise bear tax. If it did, it would be directly contradicting both Item (e) and Article 3.1(a).”³⁵⁴

4.718 The European Communities overlooks the fact that the language of footnote 59 explicitly narrows, rather than expands, the scope of paragraph (e). The clearest example of this can be seen in the final sentence of footnote 59, which states: “Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.” This sentence makes clear that paragraph (e) is not applicable to measures imposed by Members to avoid double taxation of foreign-source income. It means that any such measure does not fall within the Article 3.1(a) prohibition, even if the measure in question

with respect to Article XVI depending upon the nature of the issue and the contracting parties involved. *See, e.g., United States - Imposition of Countervailing Duties on Imports of Fresh and Chilled Atlantic Salmon from Norway*, SCM/153, Report of the Panel adopted 28 April 1994, paragraph 239 (panel convened under the Subsidies Code considered an adopted report of Group of Experts established under GATT Article VI for purposes of interpreting Subsidies Code).

Thus, going into the Uruguay Round, the FSC was protected by the Council Decision under both Article XVI and the Subsidies Code, and there was no need for the United States to “pay” for protection that it already had and that the text of the new SCM Agreement did not affect. In light of the texts of the WTO Agreement and the SCM Agreement, the Council Decision would inform the interpretation of the relevant provisions of the SCM Agreement, just as it previously had informed the interpretation of Article XVI and the relevant provisions of the Subsidies Code.

Indeed, given that the key principle of the Council Decision at issue here was proposed by EC member States and endorsed by the European Communities, it would seem to have been incumbent upon the European Communities to negotiate language in the SCM Agreement expressly terminating that principle if the European Communities no longer found the principle to be in its interest.

³⁵² *Cf., United States - Anti-Dumping Duty on Dynamic Access Memory Semiconductors (DRAMs) of One Megabit or Above from Korea*, WT/DS99/R, Report of the Panel adopted 19 March 1999, paragraph 6.21 (“[T]he entire text of the AD Agreement may be relevant to a proper interpretation of any particular provision thereof.”).

³⁵³ Again, for the reasons set forth in the First US Submission, a proper analysis of the FSC should begin with the most specific provision of the SCM Agreement, footnote 59. However, for the reasons set forth herein, an analysis that begins with general provisions, as advocated by the European Communities, does not change the outcome that the FSC is not a subsidy.

³⁵⁴ EC Oral Statement, paragraph 42.

otherwise would constitute a “full or partial exemption . . . specifically related to exports, of direct taxes” within the meaning of paragraph (e).

4.719 The qualifying nature of footnote 59 is reinforced by the second sentence, which states “[t]he Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm’s length.” This language protects against WTO Members conferring an impermissible tax advantage on domestic-source income by allowing their exporting enterprises to shift income to tax-advantaged, related foreign enterprises. This could occur if taxing authorities allowed higher-taxed “exporting enterprises” to undervalue prices in relation to lower-taxed “foreign buyers.” Artificially shifting income in this way would result in a tax savings only if the related foreign company was taxed at a lower rate or not at all.

4.720 The European Communities concedes that “this sentence [in footnote 59 regarding the arm’s length principle] assumes that the foreign related buyer may not be taxed at the same level as the exporter and this may lead to a lower total tax charge for the income arising from the export transaction.”³⁵⁵ In fact, the sentence is relevant and has meaning only if WTO Members are permitted to tax foreign-source income to a lesser extent than domestic-source income or to exempt foreign-source income from tax altogether. If WTO Members are not free to do so, there would be no need for the drafters of the SCM Agreement to have included this provision. In such a circumstance, paragraph (e) would ban any tax advantage conferred on the income of foreign entities taking part in export transactions.

4.721 A final indicator that footnote 59 narrows the scope of paragraph (e) is the opening sentence, which states that “[t]he Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected.” This sentence makes plain that, in certain circumstances, a deferral of taxes specifically related to exports would not constitute a prohibited subsidy. The sentence gives as an example the situation where an appropriate interest rate is charged, but indicates more generally that there may be other circumstances where a deferral does not give rise to an export subsidy.

4.722 In summary, footnote 59 belies the European Communities’ claim that under paragraph (e) any exemption, remission, or deferral of tax, even when contingent upon exportation, constitutes the foregoing of revenue that is “otherwise due” within the meaning of Article 1.1(a)(1)(ii).

Footnote 59 Indicates that Foreign-Source Income Need Not Be Taxed

4.723 As demonstrated in the preceding section, footnote 59 narrows the scope of paragraph (e). In the context of this dispute, however, the most important aspect in which footnote 59 narrows the scope of paragraph (e) is the second sentence. As explained above, this sentence is relevant only if WTO Members are permitted to exempt foreign-source income from tax or tax it at a lesser rate than domestic-source income.³⁵⁶

4.724 The second sentence of footnote 59, like the rest of the footnote, forms part of the context for purposes of interpreting Article 1.1(a)(1)(ii). The second sentence reinforces the conclusion drawn from a consideration of the 1981 Council Decision that the exemption from tax of income attributable to foreign economic processes does not constitute foregone revenue that is “otherwise due.”³⁵⁷

³⁵⁵ EC Oral Statement, paragraph 42.

³⁵⁶ Even Japan, a third party that has intervened on the side of the European Communities, agrees that the purpose of the arm’s length principle in footnote 59 is to allocate “profits between domestic activities and foreign activities” Submission of Japan, 2 February 1999, paragraph 19. Of course, as a separate matter, Japan contests whether the FSC administrative pricing rules perform this allocation properly.

³⁵⁷ Of course, for the same reasons as discussed above in connection with Article 1.1(a)(1)(ii), the 1981 Council Decision also informs the interpretation of footnote 59, thereby reinforcing the conclusion that the

Footnote 59 Reflects the GATT's Historical Treatment of Tax Exemptions for Foreign-Source Income

4.725 The conclusions set forth above regarding footnote 59 are confirmed by a consideration of the GATT history that preceded the SCM Agreement. Most notably, the disciplines in the SCM Agreement concerning export subsidies are not, as claimed by the European Communities, some new concept that first emerged from the Uruguay Round. Instead, they derive directly from a more narrow proscription contained in GATT Article XVI:4. Likewise, the Illustrative List of Export Subsidies was first issued in connection with Article XVI:4, and paragraph (e) of the current List traces its lineage to paragraph (c) of the 1960 List. Because paragraph (c) was proposed by a country, France, that exempted foreign-source income from taxation so as to confer an advantage on exports of goods as compared to domestic sales of goods, it is unlikely that the exemption of such income from taxation was intended to be considered an export subsidy under paragraph (c) and Article XVI:4. To apply a contrary interpretation now to the current Illustrative List would run counter to Article XVI:1 of the WTO Agreement, which, as interpreted by the Appellate Body, was intended to “ensure[] continuity and consistency in a smooth transition from the GATT 1947 system.”³⁵⁸

Footnote 59 Is Dispositive With Respect to the Question of Whether the Exemption of Income Attributable to Foreign Economic Processes Constitutes a Subsidy

4.726 Thus far, the United States has been discussing footnote 59 as part of the context of Article 1.1(a)(1)(ii), using the European Communities approach of starting with the general instead of the specific. However, the correct approach is to begin the analysis with footnote 59, the specific provision of the SCM Agreement which most directly deals with an income tax exemption. The FSC tax exemption does not constitute an export subsidy under footnote 59. For the reasons set forth below, footnote 59 is dispositive of this question.

4.727 While the European Communities and the United States both agree that the Illustrative List is “illustrative,” they disagree on the manner in which the List is illustrative. The European Communities appears to argue that if a particular type of financial contribution is described by a particular paragraph in the Illustrative List, but cannot be considered as an export subsidy under the standard contained in the particular paragraph, that financial contribution nonetheless can be found to be an export subsidy under some other standard.

4.728 In the view of the United States, this is not what the drafters intended when they used the term “illustrative” to refer to Annex I of the SCM Agreement. Instead, a more reasonable interpretation is that the drafters used the term “illustrative” to signify that not all types of financial contributions were covered by Annex I. For example, with the exception of export credits, which are dealt with in paragraph (k) and which relate to the sale of goods, the Illustrative List does not address export-contingent loans, such as government loans provided solely to exporters for purposes of capacity expansion. Similarly, with the exception of export credit-related guarantees, which are dealt with in paragraph (j), the List does not address loan guarantees to producers that are contingent on export performance. Likewise, the List does not address forgiveness of government-held debt which may be contingent upon export performance. Finally, the List does not address export-oriented equity infusions, a practice recently alleged in a pending panel proceeding.

4.729 However, where a particular paragraph of the Illustrative List does address a particular type of financial contribution, that paragraph sets forth the standard for determining whether the financial contribution is or is not a subsidy. Consider, for example, paragraph (j) of the Illustrative List, which deals with export guarantee and insurance programmes. Looking just at the standard for premium rates, premium rates give rise to an export subsidy if they are “inadequate to cover the long-term operating costs and losses of the programmes.” Implicit in paragraph (j), however, is the notion that

second sentence of footnote 59 evidences an intent of the drafters to permit Members to refrain from taxing income attributable to foreign economic processes.

³⁵⁸ *Japan Liquor*, page 13.

premium rates do not give rise to an export subsidy if they are “adequate” to cover long-term operating costs and losses. Thus, on its face, paragraph (j) provides Members with a predictable standard to use in establishing and administering export guarantee and insurance programmes.

4.730 Under the European Communities' approach to the Illustrative List, however, any predictability is lost. Because, under the European Communities' approach, paragraph (j) would only be “illustrative,” there are numerous ways in which an export insurance or guarantee programme could be considered to be an export subsidy even though the premium rates conform to the standard in paragraph (j). If premium rates were inadequate to cover *short-term* operating costs *or* losses, a programme could be considered to be an export subsidy. If premium rates were inadequate to cover short- or long-term *non-operating* costs, a programme could be considered to be an export subsidy. If premium rates were less than what an exporter might pay for comparable coverage in the marketplace, there could be an export subsidy under a “benefit to recipient” approach. This would be particularly true in a situation where a specific export transaction involves an unusually severe risk of non-payment or currency fluctuation.

4.731 It is extremely unlikely that the drafters of the SCM Agreement went to the trouble of crafting in the Illustrative List specific and detailed rules for particular types of financial contributions, such as the rules in paragraph (j), with the intent that those rules could be readily ignored in favor of more general standards found elsewhere in the SCM Agreement. Instead, a more plausible reading is that the drafters intended to use the Illustrative List as a vehicle for establishing detailed rules for certain types of financial contributions, rules that elaborate on the general principles contained in Article 1 but that cannot be ignored in favor of those more general principles.

4.732 This reading of the Illustrative List is supported by footnote 5 of the SCM Agreement, which specifies that a measure referred to in the Illustrative List as not constituting an export subsidy “shall not be prohibited under [Article 3.1(a)] or any other provision of this Agreement.” Footnote 5 would lose its meaning if, as the European Communities suggests, an export-related measure could be regarded as a prohibited export subsidy notwithstanding the fact that the measure does *not* constitute an export subsidy under one of the paragraphs of the Illustrative List. Because such an outcome is incorrect under public international law³⁵⁹, a correct interpretation of the Illustrative List is that its provisions are controlling with respect to the measures addressed therein.

The European Communities' Interpretation of "Otherwise Due" Exalts Form Over Substance

4.733 As established above, when Article 1.1(a)(1)(ii) is interpreted in light of the 1981 Council Decision and footnote 59, it becomes apparent that the exemption from taxation of income attributable to foreign economic processes does not constitute the foregoing of revenue that is “otherwise due.” However, an additional flaw in the European Communities' argument to the contrary is that it exalts form over substance.³⁶⁰

4.734 The European Communities focuses not on the nature of the tax exemption, but on the manner in which the exemption is conferred. A measure is no more or less a subsidy if a government makes a financial contribution by (1) subsuming a type of income within a general tax principle and

³⁵⁹ See, e.g., *Japan Liquor*, page 11.

³⁶⁰ The United States also would note that if the European Communities' theory is accepted, then a portion of its claim against the FSC must be dismissed. The European Communities has challenged (1) the exemption of FSC income from current taxation; and (2) the dividends received deduction for FSC dividends when they are repatriated. However, as explained in the First US Submission, paragraph 23, the norm under the US income tax system is to defer the taxation of income from foreign subsidiaries of US corporations until such time as the earnings of the subsidiary are transferred to the US parent in the form of dividends. While the United States may tax the current income of a foreign subsidiary of a US corporation under “anti-deferral” provisions such as Subpart F of the Internal Revenue Code, these provisions are exceptions to the norm of deferral. See *id.*, paragraph 24. Therefore, even under the European Communities' theory, the exemption of FSC income from current taxation would not constitute foregone revenue that is “otherwise due.”

then formally carving out a subset of that income; or (2) not subjecting a certain type of income to taxation in the first place. Both methods have the same effect – that is, to exempt some income from taxation and thereby to forego revenue.

4.735 Some European territorial systems, for example, exempt foreign-source income from direct taxes by relying on method (2) – that is, these systems simply do not extend tax liability to foreign-source income. However, these systems have the same general effect as the FSC – which relies on method (1) – in that export transactions are subject to a lower tax burden than domestic transactions.³⁶¹ However, nothing in Article 1.1(a)(1)(ii) indicates that one of these methods of exempting income from taxation constitutes a subsidy while another is not. The form of the exemption should not matter. What should matter is the nature of the income the exemption shields from taxation.

4.736 The European Communities' position, if accepted and taken to its logical conclusion, would require WTO Members to tax all income – irrespective of where it is earned or by whom; otherwise, their tax systems would inherently constitute subsidies. However, it defies reason to *require* WTO Members to tax income earned outside their borders by foreign enterprises. Surely, the European Communities would not contend that Japan, for example, confers a subsidy to the extent that it fails to tax income earned by a Brazilian subsidiary operating in Germany. Would the European Communities call Thailand's failure to tax the income of a French business operating in Canada a subsidy? If these practices are not subsidies, and of course they are not, then the United States likewise does not confer a subsidy when it exempts income earned in Brazil by a FSC incorporated in the Netherlands.

The FSC Properly Exempts from Taxation Income Derived from Foreign Economic Processes in Transactions Involving Exported Goods

Contrary to the European Communities' Assertions, the Concept of "Foreign Economic Processes" Is Not Complicated or Ambiguous and Includes Distribution Activities

4.737 The European Communities attempts to diminish the significance of the 1981 Council Decision by suggesting that the concept of “foreign economic processes,”³⁶² as articulated by the Decision and applied to export transactions, is so vague that any objective attempt by a Member to distinguish between processes that come within the definition – and therefore, need not be taxed – and processes that do not come within the definition is impossible. According to the European Communities, any attempt at classification would be “arbitrary” and would lead to income being “exempted from tax on any condition [the Member] pleases”³⁶³

4.738 Fortunately, the task of interpreting the Council Decision is not as daunting as the European Communities makes it out to be. Dictionaries provide straightforward definitions of the words “economic” and “processes.” “Economic” is defined as “relating to, or concerned with the production, distribution, and consumption of commodities.”³⁶⁴ “Process” is defined as “a particular method or system of doing something, producing something, or accomplishing a specific result.”³⁶⁵

³⁶¹ The European Communities concedes as much when it states that a country that does not tax foreign-source income of its companies “will have to impose tax at higher rates to achieve the same level of revenue.” EC Oral Statement, paragraph 14. In other words, domestic-source income will have to be taxed at a higher rate to compensate for the foregone revenue on foreign-source income incurred as part of an export transaction.

³⁶² Of course, the United States uses the phrase “foreign economic processes” as a shorthand expression for “economic processes (including transactions involving exported goods) located outside the territorial limits of the export country”, the phrase actually used by the Council.

³⁶³ EC Oral Statement, paragraph 62.

³⁶⁴ *Webster's Third New International Dictionary of the English Language Unabridged*, G. & C. Merriam (1961), page 720.

³⁶⁵ *Ibid.*, page 1808.

From these definitions, as well as from common experience, it is evident that manufacturing and distribution are the two primary processes involved in the production and sale of a good, including a good sold for export.

4.739 In an export transaction, distribution activities often occur outside the territorial limits of the exporting country. Once a good is manufactured, it must be distributed to a customer, and distribution activities frequently take place close to the market in which the customer is located. As part of the distribution process, firms expend considerable cost and time in promoting their products, through advertising, participation in trade shows, and demonstrating the product to potential customers. The distribution process also involves the preparation and negotiation of sales contracts and associated legal documentation, arrangement of financing, preparation and transmittal of invoices, receipt of payment, and delivery of the product to the customer.

4.740 There is often no direct relationship between the amount of distribution costs incurred and the value of a sales transaction. Sometimes a major order may be placed following relatively little promotional effort by a firm; in other cases an extensive sales campaign may result in minimal or no sales – the order may go to a competitor. Many distribution costs represent “fixed overhead” to the seller, regardless of the size of the transaction.

4.741 These distribution costs, particularly those associated with sales promotion, are commonly located at or near the place of business of the customer or potential customer. Accordingly, in the case of sales to domestic customers, distribution activities normally would take place domestically. Conversely, in the case of exports, many of these activities typically take place outside the country of manufacture: either in the country of the potential customer, or in a third country that is more convenient to the potential customer than the country of manufacture.

4.742 Distribution activities, as described in the preceding paragraphs, clearly are substantial economic processes that are essential to the sale and delivery of a manufactured good to a customer and to the resulting receipt of income arising out of such sale and delivery. To the extent that these activities are performed outside the territory of the country of manufacture, they are foreign economic processes.

The "Foreign" Character of an Economic Process Depends on Where It Is Performed

4.743 The European Communities fails to recognize that for purposes of the principle articulated in the Council Decision, the “foreign” character of an economic process is determined by where the process is performed. If the process is carried out within the territory of a Member, it is a domestic economic process. If it is carried out outside the territory of the Member, it is a foreign economic process. If an economic process is carried out outside the territory of the Member by a natural person, that process is “foreign,” regardless of the nationality or citizenship of that person. If the economic process is performed by a corporate entity outside the territory of the Member, it is irrelevant whether the corporation is incorporated abroad, or whether its principal place of business is abroad. Should the corporate entity performing the foreign economic process be affiliated with another legal entity, the foreign or domestic situs of incorporation or principal place of business of the affiliate is similarly irrelevant in determining where the economic process is performed. It is also irrelevant to the “foreignness” of a process whether the process is carried out by an employee or agent.

4.744 That the European Communities takes issue with such a simple concept is astounding when one considers that it was France, Belgium, and the Netherlands that proposed the “foreign economic processes” component of the 1981 Council Decision. France, for example, proposed that the panel report concerning its tax practices be adopted along with a statement “to the effect that economic activities which take place after the export operation, *and therefore outside of the country of origin*, are not taxable by that country and cannot be regarded as an export activity within the meaning of the General Agreement.”³⁶⁶ Belgium and the Netherlands each made similar statements.³⁶⁷ The principle

³⁶⁶ GATT Doc. No. C/114 (8 December 1980) (emphasis added).

proposed by these three EC member States, now disavowed by the European Communities, is central to the resolution of this case.

4.745 The European Communities' position is rendered all the more astounding in light of the fact that the European Communities expressly endorsed the proposal made by France, Belgium, and the Netherlands. The European Communities went on record as “shar[ing] the views expressed by each of the three member States with respect to adoption of the three Reports with qualifications concerning the notion of ‘export activities’.”³⁶⁸ Because three EC member States proposed the concept of “foreign economic processes” and the European Communities expressly endorsed that proposal, it is disingenuous for the European Communities to now come before this Panel and claim that the concept is meaningless and fraught with the potential for abuse. This is yet another example of the European Communities attempting to rewrite GATT history.

The FSC Administrative Pricing Rules Do Not Constitute a Subsidy or an Export Subsidy

Introduction

4.746 With respect to its claim that the FSC administrative pricing rules constitute an export subsidy, the European Communities fundamentally misconstrues the meaning of the arm's length principle of footnote 59 as it applies in this case. The European Communities cites definitions of arm's length from United States law and the OECD, but these definitions have not been incorporated into the SCM Agreement. As a result, the European Communities has provided the Panel with essentially no analysis of how to interpret the meaning of arm's length for present purposes and has adduced no evidence proving that, whatever the correct standard may be, the United States fails to meet it. In short, the European Communities' argument regarding the FSC administrative pricing rules can be reduced to the European Communities' claim that the rules are inconsistent with standards that simply do not apply in the WTO.

4.747 In contrast, the United States has advanced an interpretation of the arm's length principle that gives meaning to its terms and that is consistent with its context and purpose. The United States has explained that, where a tax exemption for foreign-source income is at issue, the arm's length principle is designed to guard against improperly shifting higher-taxed domestic-source income to a related foreign entity that is taxed at a lower rate or not at all. The United States also has explained that “administrative or other practices” like the FSC administrative pricing rules are expressly allowed under the language of footnote 59 and that Article 3.1(a) is not violated by such practices unless a “significant saving” of direct taxes on domestic-source income results. Because the European Communities has failed to prove that the FSC administrative pricing rules result in any saving of taxes on domestic-source income, let alone a “significant” saving, its claims must be rejected.

The European Communities' Interpretation of Arm's Length Is Incorrect

4.748 The European Communities has argued that the FSC administrative pricing rules constitute prohibited export subsidies because they violate the arm's length principle.³⁶⁹ The European Communities maintained that this was so because “[t]he administrative pricing rules of the FSC scheme are a major departure from the principles applied by developed countries to deal with the problem of transfer pricing between related companies as reflected in the [OECD] Guidelines.”³⁷⁰ The European Communities alleged that the OECD Guidelines are relevant to the present dispute because “an international consensus has built up about how to deal with these issues and is set out in the OECD's *Transfer Pricing Guidelines*.”³⁷¹ The European Communities further asserted that the

³⁶⁷ GATT Doc. No. C/115 (8 December 1980) (Belgium); GATT Doc. No. C/116 (8 December 1980) (Netherlands); and GATT Doc. No. C/M/145 (14 January 1981), pages 1-4.

³⁶⁸ GATT Doc. No. C/M/145 (14 January 1981), page 4.

³⁶⁹ First EC Submission, paragraph 158.

³⁷⁰ *Ibid.*, paragraph 68.

³⁷¹ *Ibid.*, paragraph 67.

FSC administrative pricing rules achieve results different from those that would be obtained under IRC Section 482.³⁷² The European Communities contends that this alleged derogation from Section 482 proves that the FSC administrative pricing rules violate Article 3.1(a).³⁷³

4.749 Once again, the European Communities has misconstrued the governing legal provision applicable to its claims. Neither the OECD Guidelines nor Section 482 provides the definition of arm's length for purposes of footnote 59. The OECD Guidelines and Section 482 may be two of the leading advancements made regarding arm's length pricing, but they have not been incorporated into the SCM Agreement.

4.750 In many respects, the European Communities' position with regard to Section 482 and the OECD Guidelines is difficult to understand. Clearly, the domestic law of a single WTO Member, such as Section 482, cannot be used as the benchmark for determining WTO norms of arm's length pricing.

4.751 The OECD Guidelines are equally irrelevant to this dispute.³⁷⁴ Nowhere does the SCM Agreement provide that the definition of arm's length for purposes of footnote 59 may be supplied by the rules of another organization. As highly esteemed as the OECD Guidelines may be, they cannot be engrafted upon the SCM Agreement where there is no indication that that was the intention of the Agreement's drafters.³⁷⁵ Only a small minority of WTO Members has formally agreed to adhere to the Guidelines. The fact that "[a]n international consensus" of developed countries is reflected in the Guidelines is not a basis on which the rights and obligations of WTO Members may be altered. Undoubtedly, the majority of WTO Members would be surprised to learn that, in joining the WTO, they undertook to implement and abide by the OECD Guidelines.

4.752 The United States has argued that the WTO's lack of specific rules on transfer pricing is the principal reason why footnote 59 indicates that parties "shall normally" take their transfer pricing-related grievances to appropriate tax fora. In particular, the United States has argued that this matter should be reviewed, at least in the first instance, by the OECD, because that body has a well-established and specific set of rules in place – rules that the WTO lacks – regarding the issues the European Communities raises. Having brought its claims to the wrong forum, the European Communities now attempts to apply rules that are not within the purview of the WTO.

4.753 The fundamental difference between the approaches of Section 482 and the OECD Guidelines, on the one hand, and footnote 59, on the other, is the level at which the arm's length analysis applies. Section 482 and the OECD Guidelines focus at the level of the specific related party transactions of specific taxpayers, and inquire whether those specific transactions reach arm's length results. By contrast, footnote 59 focuses on the aggregate results of "administrative or other practices," and inquires whether such practices cause a systematic distortion in the allocation between domestic and foreign income so as to "result in a significant saving of direct taxes in export transactions."

4.754 By taking an aggregate perspective, the US Congress was able to ensure that the FSC administrative pricing rules overall would not "result in a significant saving of direct taxes in export transactions." At the same time, Congress was able to make available methods that afford considerable administrative ease to both taxpayers and tax authorities. Because the administrative pricing rules are aimed at producing arm's length results in the aggregate, they can relieve both

³⁷² *Ibid.*, paragraph 75.

³⁷³ *Ibid.*, paragraph 78.

³⁷⁴ In this regard, the United States reiterates that the European Communities has not explained how OECD Guidelines that came into existence *after* the entry into force of the WTO Agreement could be considered to have been incorporated into the SCM Agreement.

³⁷⁵ The fact that the second paragraph of item (k) to Annex I incorporates by reference the OECD Arrangement on Guidelines for Officially Supported Export Credits indicates that the drafters of the SCM Agreement knew how to incorporate OECD standards when they desired to do so.

taxpayers and tax authorities from delving into the factual complexities attendant to a taxpayer-specific, transaction-specific transfer pricing analysis.

4.755 In fashioning the FSC administrative pricing rules to meet the footnote 59 standard, Congress was able to legislate methods that have validity and stability in the aggregate, notwithstanding variances that may occur in individual cases. The realities of export business necessitates performing sales and distributional efforts close to the target; *i.e.*, a foreign market. While the magnitude of these foreign economic processes may vary in particular cases, the administrative pricing rules were designed to conservatively limit the FSC tax exemption on the order of the aggregate amount of these foreign economic activities occurring in export transactions. As discussed below, the empirical data support the conclusion that the administrative pricing rules generate aggregate results that are consistent with the arm's length principle of footnote 59.

4.756 Nevertheless, it is incumbent upon the European Communities as the complaining party to provide a definition of what arm's length means and why the FSC administrative pricing rules are somehow inconsistent with the definition. Because the European Communities has not done so, the European Communities has failed to make even a *prima facie* case that the FSC administrative pricing rules violate United States obligations under the SCM Agreement.

A Measure Is Not Inconsistent With the Arm's Length Principle Merely Because It Is Designed for Administrative Ease

4.757 The European Communities has asserted that the FSC administrative pricing rules violate Article 3.1(a) of the SCM Agreement, at least in part, because they are designed for administrative ease. The European Communities has stated that the OECD Guidelines frown upon some types of formulae, but, at the same time, the European Communities has acknowledged that the Guidelines permit the use of certain other formulae.³⁷⁶ However, the European Communities has identified no textual basis in the SCM Agreement that supports its assertion that the SCM Agreement – and footnote 59 in particular – precludes the use of methods that promote administrative ease and efficiency.

4.758 The SCM Agreement does not mandate the method by which Members are to perform their transfer pricing analyses. Rather, it speaks in terms of results. Footnote 59 makes clear that the arm's length principle is satisfied where, for tax purposes, the “prices” used “for tax purposes” between related entities are the prices that would be used by independent parties. The provision never states how such “prices” are to be determined. Thus, as long as the end results are correct, the principle is not contravened.

4.759 Furthermore, the text of footnote 59 contemplates that Members may use “administrative or other practices” in calculating transfer prices. Such practices are permissible according to the footnote as long as they do not result in a “significant saving of direct taxes in export transactions.” The clear import of this language is that the administrative convenience afforded by such practices outweighs the possibility that exporters might receive an insignificant tax saving from them.

4.760 The European Communities has conceded that there is no one accepted method for transfer pricing. The European Communities has stated that “[t]he [OECD] Guidelines acknowledge that the existence of alternative methods of deriving an arm's length price may be appropriate . . .”³⁷⁷ In addition, the European Communities has stated with respect to Section 482 that “[i]t provides for a full range of techniques to be employed based on the latest understanding of the arm's length principle as set out in the OECD's Guidelines.”³⁷⁸

³⁷⁶ *Ibid.*, paragraph 72.

³⁷⁷ *Ibid.*, paragraph 71.

³⁷⁸ *Ibid.*, paragraph 73.

4.761 Given the European Communities' concession that a variety of methods may be used in transfer pricing, the United States respectfully submits that the European Communities must provide some basis other than pointing to the OECD Guidelines to demonstrate that the methodology underlying the FSC administrative pricing rules contravene the arm's length principle of footnote 59. The European Communities will not be able to do so, however, because footnote 59 does not proscribe the use of any particular method. Under footnote 59, it is the achievement of arm's-length results that matters, not how those results are obtained.

The Strict Purchase Price Analysis Proposed by the European Communities Is Incorrect

4.762 In asserting that the FSC administrative pricing rules contravene the arm's length principle of footnote 59, the European Communities apparently has adopted an analysis of FSC transfer pricing based on the assumption that all FSCs purchase goods from their parent companies and then resell them. Thus, the European Communities seeks to establish precise transfer prices like those that might be used for customs valuation purposes when a product is sold in a cross-border transaction. Unfortunately, this analysis is deeply flawed for a number of reasons, the most important of which is that the majority of FSC transactions do not fit within the European Communities' assumption.

4.763 Many FSCs never use a so-called "buy-sell" model in their transactions. In other words, they do not take title to goods before reselling them to customers. A large proportion of FSC transactions, and perhaps a majority of FSC sales, use a "commission" model, in which the FSC acts as a distribution agent for the related producer and is compensated with a commission rather than making a profit on its resale of the goods. The distribution and sales functions for which the FSC takes responsibility for tax purposes do not differ as between the two paradigms, and the transfer pricing computations are the same in both cases. Nevertheless, a "commission" FSC does not buy goods from a supplier, and thus no transfer price for goods actually exists under such circumstances.

4.764 Furthermore, many FSC transactions do not involve sales at all, but instead involve leases or the provision of services. In these transactions, neither the FSC nor the related supplier can point to a purchase price equivalent to the sale price for a commodity. Leased goods remain the property of the producer, and the FSC's role as distributor is to facilitate the leasing transaction. In the case of services, no tangible goods may be involved at all, but the FSC must still perform its intermediary functions.

4.765 What is at issue in FSC transfer pricing (which is purely for tax purposes) is not the price of goods at a fixed point in time, but the overall value of a FSC's functions during the taxable year. As the United States has previously explained, the FSC statute attributes to FSCs, for tax purposes, all foreign distribution and sales functions in connection with a FSC transaction. If the FSC did not perform all of those functions itself, it is obligated under the law to pay for them. It is this group of functions for which the FSC is responsible that forms the basis for allocating income to the FSC. As demonstrated below, the FSC administrative pricing rules properly allocate income to the FSC based on the foreign functions attributed to it.

A Tax Measure Is Consistent with the Footnote 59 Arm's Length Principle if It Achieves Results that Approximate a Range of Arm's Length Values

4.766 The European Communities has conceded that arm's length pricing under footnote 59 involves a "range" of values and only an "approximation" of prices that independent parties would charge. In particular, the European Communities has stated that the arm's-length principle requires "prices practised between associated enterprises to be adjusted so as to reflect the prices that would have been practised between independent enterprises."³⁷⁹ According to the European Communities, these adjustments need only "deliver a sufficiently close approximation to arm's length in a . . . wide variety of cases over time."³⁸⁰ In fact, the European Communities even concedes that the arm's length

³⁷⁹ *Ibid.*, paragraph 69.

³⁸⁰ *Ibid.*, paragraph 80.

principle is satisfied as long as the results of a particular measure are within an accepted ‘range of tolerance.’³⁸¹

4.767 The United States does not disagree with any of the foregoing positions taken by the European Communities. In fact, the United States will demonstrate below that the FSC administrative pricing rules do approximate arm’s length results in a “wide variety of cases over time.”

The European Communities Has Not Shown that the FSC Administrative Pricing Rules Exempt Domestic-Source Income from Taxation and that They Do So to a "Significant" Extent

4.768 The European Communities has not provided any substantive analysis of how to determine whether the results attained by the FSC administrative pricing rules are or are not at arm’s length. More specifically, the European Communities has not apprised the Panel of how it would determine what the outer points of the accepted range of arm’s length values would be for a given transaction or group of transactions. It seems only fitting that, when one Member of the WTO accuses another Member of conferring an export subsidy by allegedly allowing its traders to deviate from the arm’s length principle for tax purposes, the complaining Member should have the burden of first identifying the range of arm’s length prices applicable to the dispute and then explaining the extent to which the results produced by the challenged measure do not fall within that range.

4.769 While the European Communities has not provided the Panel with even a basic analytical framework to find the FSC administrative pricing rules to be in violation of the SCM Agreement, the United States has articulated the correct standard to be applied in this dispute. The United States respectfully submits that, with regard to the FSC administrative pricing rules, analysis of conformity with the arm’s length principle of footnote 59 entails a two-step analysis. The Panel must first ask if the administrative pricing rules exempt foreign-source, as opposed to domestic-source, income, from taxation. If so, the analysis can stop, for the United States is under no obligation to tax foreign-source income and the exemption of such income from taxation cannot be regarded as a subsidy, let alone a prohibited export subsidy.

4.770 However, to the extent that the Panel finds that the FSC administrative pricing rules exempt domestic-source income from taxation, it must then determine whether the tax savings on domestic-source income earned in export transactions is “significant.” This requirement derives directly from the language of footnote 59, which states that “[a]ny Member may draw the attention of another Member to administrative or other practices which may contravene this [arm’s length] principle and which result in a significant saving of direct taxes.”

4.771 This two-step analysis is necessary in the present dispute because the FSC was designed to emulate the basic aspects of European territorial tax systems which do not tax foreign-source income. To the extent that foreign-source income need not be taxed under WTO rules, then any tax saving in relation to foreign-source income is irrelevant. In this context, the arm’s length principle guards against WTO Members conferring a subsidy by allowing higher-taxed domestic-source income to be shifted to a related entity so that it is treated as lower-taxed foreign-source income. As long as domestic-source income is not exempted from taxation in this manner, the FSC administrative pricing rules are not conferring a subsidy or an export subsidy.

4.772 The European Communities has presented the Panel with no evidence that the FSC administrative pricing rules exempt domestic-source income from taxation or that they result in a “significant saving” of taxes on domestic-source income. Absent such proof, the European Communities’ position must be rejected.

Available Data Indicates that, in the Aggregate, the FSC Properly Allocates Foreign-Source Versus Domestic-Source Income

³⁸¹ *Ibid.*, paragraph 86.

4.773 As previously discussed, the US Congress adopted a new set of tax provisions that were designed to conform to the principles articulated in the 1981 Council Decision and to take advantage of the flexibility that it provided. In doing so, the Congress was quite explicit in its objective. It specifically cited the controlling legal principle of the Council Decision, noting that “[u]nder GATT rules, a country need not tax income from economic processes occurring outside its territory.”³⁸² Congress similarly stated its objective that “certain income attributable to economic activities occurring outside the United States should be exempt from US tax.”³⁸³ Its unambiguous purpose in exempting such income was “to afford United States exporters treatment comparable to what exporters customarily obtain under territorial systems of taxation.”³⁸⁴

4.774 The vehicle Congress chose to achieve this purpose was the FSC, and the statutory rules that Congress devised were shaped by two considerations. The first was to realize the benefit that was authorized by the Council Decision; namely, to, eliminate or reduce US tax on income from foreign economic processes. The second was to assure that, in any event, the revenue cost to the US Government of the FSC partial tax exemption was no greater than the revenue cost of the DISC provisions that it replaced. With those objectives in mind, Congress developed and enacted the FSC statutory provisions that have been in effect in the United States since 1986.

4.775 Congress chose three different approaches for approximating, through the FSC, the amount of income attributable to foreign economic processes or activities. The two that have been challenged in this case are the CTI method, which attributes 23 per cent of the total profit share to the FSC, and the gross receipts method, which attributes to FSCs a profit margin of 1.83 per cent of total gross receipts. These methods, it must be stressed, were not necessarily designed to allocate income based on what activities the FSC itself performed; rather, they were designed to approximate the amount of income fairly attributable to foreign economic activities that occurred in connection with the transaction in which the FSC participated.

4.776 To implement that objective in the context of the existing US tax system, the Congress required not only that the FSC be a foreign corporation and perform a specified number of economic activities outside of the United States, but also that the FSC be legally and financially responsible for essentially all of the distribution functions of the transaction. These include marketing, sales, delivery, and the like. Accordingly, the FSC must either perform such functions itself with its own resources or contract with another company to perform them. The FSC was then required to pay for these functions.

4.777 In this manner, the Congress sought to attribute to FSCs an amount of income that approximated the income derived from foreign economic activities. To assure that these provisions did not allocate to FSCs more profits than the foreign economic activities warranted, and to assure that the revenue cost of the FSC did not exceed that of its predecessor the DISC, the Congress exempted from taxation only a portion of the income allocated to FSCs under the FSC transfer pricing rules.

4.778 The central issue with respect to the FSC administrative pricing rules that the Panel must address is whether they in fact achieve the purpose that the US Congress intended or whether, as the European Communities asserts, they provide a tax benefit that is greater than Congress intended and what the rules of the SCM Agreement permit. Stated differently, the question is whether the FSC systematically over-allocates income to FSCs, thereby, in effect, reducing US taxes on income from *domestic* economic processes. For the European Communities to support its contention, it must show that the income attributable to foreign economic processes under the FSC administrative pricing rules does not, in fact, approximate on an aggregate basis the total amount of foreign economic activity but, instead, (1) systematically allocates more income to FSCs than would be justified under the arm’s

³⁸² Exhibit EC-6, page 1042.

³⁸³ *Ibid.*

³⁸⁴ *Ibid.*

length principle; and (2) that the aggregate tax saving from such a systematic misallocation results in a significant saving of direct taxes in export transactions.

4.779 The European Communities has offered no factual evidence that would support the proposition that FSC rules systematically allocate more income to FSCs than the level of foreign economic activity would justify. The burden to make such a showing is on the European Communities, and the United States is not obliged to prove the contrary in this proceeding. Nonetheless, the United States notes that to the extent that there is available empirical evidence on this question, it tends to show that the overall level of foreign economic activities undertaken in connection with FSC transactions equals or exceeds the amount of foreign activity that would be required to justify the income allocated to FSCs and the corresponding tax exemption.

4.780 To test this proposition, the United States examined a variety of empirical analyses. First, relying on data that is publicly available, the United States examined income data showing the levels of profit realized by independent distributors and unrelated manufacturer-suppliers. Using these data, the analyses then considered the aggregate amount of profit and determined the relative share of total profits realized by distributors and the relative share of profits realized by manufacturer-suppliers. These figures were then compared with the relative share of profits attributed to FSCs under the FSC administrative pricing rules and the relative share of profits left with manufacturer-suppliers. Because the baseline data involved unrelated distributors and manufacturer-suppliers, that data reflected, by definition, an “arm’s length” distribution of profits between distributors and manufacturer-suppliers.

4.781 Five such analyses were undertaken. Three tested the 23 per cent CTI method, which is used far more widely by FSCs, and two tested the 1.83 per cent gross receipts rule. All five analyses showed that the share of profit that the FSC administrative pricing rules allocate to FSCs – which are responsible for distributor-like functions – corresponds to the relative share of aggregate profits realized by independent distributors when dealing with unrelated manufacturer-suppliers. Although these analyses address an analogous allocation of income rather than FSCs themselves, they provide a relevant and informative empirical data point that supports the reasonableness of the income allocations that the FSC administrative pricing rules achieve.

4.782 These five studies, which are discussed in greater detail in US Exhibit 20, provided as part of the answer of the United States to European Communities Question #17, are based on two different sources of data. The first is the publication of the US Internal Revenue Service that reports aggregate income by industrial sector. The second is aggregate data drawn from corporate filings with the US Securities and Exchange Commission. In both cases, data from thousands of companies formed part of the total, which fairly reflects the distribution and production sectors subject to US taxation and regulation.

4.783 The studies on the CTI method analysed the relative profit share of distributors and producers, using two slightly different approaches in order to confirm that the results would not change significantly depending on the analytical methodology employed. The arm’s length ranges varied somewhat under the three analytical approaches; however, all show that the 23 per cent profit share allocated to FSCs under the CTI method is a conservative measure of a distributor’s return. The studies analysing the gross receipts method looked at the overall profit margin of distributors on their sales. Both studies found that the 1.83 per cent profit return on gross receipts allowed under the FSC administrative pricing rules fell within the arm’s length range reflected in empirical data.

4.784 The type of analysis employed in these five instances is the same type of analysis that is employed to test the acceptability of a transfer pricing figure for US tax purposes. These empirical data suggest that the return provided to FSCs under the administrative pricing rules corresponds to the return realized by independent distributors when dealing with unrelated manufacturer-suppliers. Indeed, the empirical data suggest that the CTI method is conservative in terms of the amount of income allocated to a FSC.

4.785 The second empirical data point examined by the United States is provided by survey data designed to show the overall level of foreign activities that major US FSC users undertake in connection with transactions in which FSCs participate. To gather this information, questionnaires were sent to 27 of the largest United States exporters that use FSCs. The 27 represent a cross-section of the largest companies in industrial sectors with the highest volume of FSC exports. The survey asked for a determination of what percentage of total expenses incurred by each surveyed company and its FSC were incurred outside the territory of the United States.

4.786 Sixteen of the 27 companies surveyed responded to the survey, which is described in detail in US Exhibit 21, provided in response to EC Question #22. The survey results showed the following: (a) the overall level of foreign activities undertaken in connection with transactions in which FSCs participated corresponded to or exceeded the maximum level of the tax benefit available to FSCs, which is approximately 15-16 per cent of the total income of a FSC transaction; and (b) for more than two-thirds of all of the companies that responded, the percentage of their economic activities that occurred outside the United States exceeded the percentage of a FSC's income that can qualify for a tax exemption. For these two-thirds, the tax benefit allowed under the FSC rules was accordingly less than would be available if all foreign economic activities were exempt from US tax.

4.787 Accordingly, to the extent that empirical economic data is available, it contradicts the contention that the European Communities would have to prove in order to meet its burden in this case. Indeed, although the available data provide only approximate benchmarks, they tend to suggest that for most users of the FSC, a full exemption of income from foreign economic processes would result in greater tax benefits than the FSC currently allows. In other words, the data confirm that the FSC administrative pricing rules, as intended by Congress, constitute "administrative or other practices" that are consistent with the arm's length principle of footnote 59.

Even if the FSC Administrative Pricing Rules Were Regarded as Misallocating Some Domestic-Source Income to FSCs, Any Such Misallocation Does Not Violate the SCM Agreement Because Any Resulting Tax Saving Is Not "Significant"

4.788 Finally, even if the FSC administrative pricing rules were regarded as misallocating some domestic-source income to FSCs, those rules would not violate the SCM Agreement. This is because footnote 59 requires that any such misallocations result in a "significant saving of direct taxes in export transactions." As demonstrated previously, the most recent data available for the FSC regime indicates that the total tax exemption amounts to only 0.93 per cent *ad valorem*, an amount considered as *de minimis* under the SCM Agreement.³⁸⁵ Moreover, as previously explained, this figure overstates any possible subsidy resulting from the FSC administrative pricing rules themselves.³⁸⁶

4.789 Although the European Communities grudgingly concedes that the word "significant" in footnote 59 is "designed to avoid Members from invoking individual cases of minor importance",³⁸⁷ the European Communities never even tries to explain how a tax saving of less than 0.93 per cent can be considered as "significant."³⁸⁸ The European Communities does not even offer a proposed definition of what "significant" means.

4.790 Instead, the European Communities appears to argue that because the less-than-0.93 per cent figure is an average, some companies may derive a greater tax savings from income misallocations than others.³⁸⁹ However, the European Communities offers no support for the proposition that the

³⁸⁵ See First US Submission, paragraph 137-147 and Exhibit EC-5.

³⁸⁶ First US Submission, paragraph 146.

³⁸⁷ EC Oral Statement, paragraph 69.

³⁸⁸ To reiterate, any subsidy attributable to a misallocation of income by the FSC administrative pricing rules would be less than 0.93 per cent *ad valorem*. The United States lacks the data to make a precise calculation, but, in any event, the burden is on the European Communities, as the complainant in this case, to provide data demonstrating that the FSC administrative pricing rules result in a significant tax saving.

³⁸⁹ EC Oral Statement, paragraph 72.

standard in footnote 59 was intended to apply on an individual company basis. To the contrary, the text of footnote 59 appears to contemplate an aggregate approach,³⁹⁰ and it is unlikely that the drafters intended a standard that could be assessed only on the basis of individual taxpayer data, data that in many countries is protected from disclosure. Indeed, it is noteworthy that in the *Tax Legislation Cases*, the panel based its conclusions regarding the European tax systems on the fact that “different tax treatment in different countries resulted in a smaller total tax bill *in aggregate* being paid on exports than on sales in the home market”³⁹¹

Other Issues

FSCs are Foreign Corporations for Purposes of the SCM Agreement

4.791 Although the European Communities does not appear to contest the fact that FSCs are foreign corporations for purposes of United States law, it alleges – focusing on the US Virgin Islands – that FSCs located in territories or possessions of the United States are not “foreign” corporations for purposes of the SCM Agreement. Although the European Communities does not contest the fact that the territories eligible for FSCs are outside of US customs territory, the European Communities asserts, without citation to any authority, that “[t]his is not the correct test.”³⁹²

4.792 At the outset, the United States notes that nothing in the FSC statute requires FSCs to be established in US territories. Although historically most FSCs have chosen to locate in US territories, presumably such choices are based on a variety of business considerations, including the tax regime in place in the host country. Based on anecdotal evidence of FSC activity since 1992, the period covered by the most recent Treasury Department report on the FSC, the United States understands that an increasingly large number of FSCs are incorporated in Barbados, Jamaica, and Bermuda. If the Panel were to accept the European Communities' assertion that FSCs located in US territories outside of US customs territory are not sufficiently “foreign,” that would simply accelerate the trend toward these countries.

4.793 Moreover, the “evidence” cited by the European Communities is inaccurate and misleading. The European Communities cites the fact that the US Virgin Islands elects a member to the US House of Representatives, but fails to note that the member has non-voting status.³⁹³ The European Communities' reference to the Naval Appropriations Act in paragraph 78 of the European Communities Oral Statement ignores the fact, as explained in the United States response to EC Question #2, that the United States has limited authority over the tax systems of the territories in general, and that those territories are free to reduce the tax liability of FSCs but are not required to do so.³⁹⁴ The superficial nature of the European Communities' understanding, though, is best reflected by its assertion that the Solomon Islands, an independent country and WTO Member, is a territory of the United States.³⁹⁵

4.794 However, the fundamental problem with the European Communities assertion is that the term “territory” is generally used throughout GATT to mean “customs territory.” For example, GATT Article XXIV:1 refers to the GATT applying on the basis of customs territories, and Article XXIV:2 contains a definition of what a “customs territory” is. Similarly, GATT Article I:2(b) permits, as an exception to the MFN obligation in Article I:1, “[p]references in force exclusively between two or more territories which on 1 July 1939, were connected by common sovereignty or relations of protection or suzerainty and which are listed in Annexes B, C and D, subject to the conditions set forth therein” Annex D, which applies to the United States, lists, *inter alia*, the “United States of

³⁹⁰ See First US Submission, paragraph 134.

³⁹¹ BISD 23S/114, paragraph 50 (France) (emphasis added). The panel used the same language to describe the effects of the Belgian and Dutch tax practices.

³⁹² EC Oral Statement, paragraph 80.

³⁹³ EC Oral Statement, paragraph 76.

³⁹⁴ See Attachment A, US Response to EC Question #2.

³⁹⁵ See Attachment A, US response to EC Question #1.

America (customs territory)” and “Dependent territories of the United States of America.” Thus, as a matter of GATT and WTO law, as well as United States law, FSCs located in United States possessions outside of US customs territory constitute foreign corporations for purposes of the SCM Agreement.

4.795 The European Communities' argument to the contrary is made all the more puzzling by the fact that it is at odds with the position taken by the European defendants in the *Tax Legislation Cases*. For example, France asserted that “[i]n the GATT sense, it is obvious that export is the sale of a national product or service to a foreign country, *the criterion being the passage of the customs frontier of the exporting country.*”³⁹⁶

4.796 Instead of a legal argument, the European Communities offers a policy argument; namely, that WTO Members are not obligated to have customs territories, and that if they are allowed to have them, there will be a tremendous scope for abuse.³⁹⁷ However, the fact is that Members have customs territories, have had them since the inception of the GATT system, and the abuse cited by the European Communities does not seem to have occurred.

4.797 Moreover, the European Communities stance on the US territories reflects a profound ignorance (wilful or not) about the territories and possessions of some European Communities member States. For example, in a recent decision, the European Court of Justice (“ECJ”) held that an individual bringing a boat from the Netherlands Antilles into the Netherlands was liable for VAT imposed by Dutch authorities, because entry into the Netherlands of goods from the Netherlands Antilles qualified as entry into the European Communities.³⁹⁸ The European Communities' opinion does an excellent job of highlighting, in a manner relevant to this dispute, the tension between the Netherlands Antilles' status as a part of the Kingdom of the Netherlands and its status as a geographically and juridically separate possession.

The European Communities Has Failed to Meet Its Burden of Proof

4.798 As the complaining party in this dispute, the European Communities has the burden of initially presenting the Panel with sufficient facts and legal arguments to raise a presumption that the United States has violated its obligations under the SCM Agreement and the AA. The European Communities has not met its burden on any of its claims. For the convenience of the Panel, the United States briefly summarizes below the reasons why this is so.

The European Communities Has Failed to Prove that the FSC Tax Exemption Constitutes a Subsidy under Article 1

4.799 In order to prevail on its claim that the FSC tax exemption is a prohibited subsidy, the European Communities must first prove that the FSC is a subsidy within the meaning of Article 1 of the SCM Agreement. The European Communities, though, has failed to show that the FSC involves the United States foregoing revenue that is “otherwise due.” The European Communities has failed to articulate a legal argument as to why income exempted by the FSC is “otherwise due.” As discussed above, the United States, like all other WTO Members, is under no obligation to tax such “foreign-source” income. This principle derives from prior GATT practice and from footnote 59, both of which form part of the context of Article 1. Accordingly, the exemption of foreign-source income under the FSC cannot be said to be revenue that is “due” for purposes of Article 1 and the failure to tax it is not a subsidy. The European Communities' mere assertions to the contrary are insufficient to form a legal basis for its claims.

³⁹⁶ GATT Doc. No. C/97 (15 March 1977) (emphasis added).

³⁹⁷ EC Oral Statement, paragraph 81.

³⁹⁸ See US Exhibit 22.

The European Communities Has Failed to Prove that the FSC Tax Exemption Violates Article 3.1(a)

4.800 Just as the European Communities has misconstrued Article 1, it also has misread Article 3.1(a) by ignoring the central legal provision applicable to this dispute, footnote 59. Footnote 59 narrows the scope of paragraph (e) of Annex I by providing that the exemption of foreign-source income from direct taxation does not constitute an export subsidy. Footnote 5 of the SCM Agreement provides that, if a measure is referred to in Annex I as not being an export subsidy, then that measure is immune from all prohibitions in the SCM Agreement. Given that the FSC is designed to exempt foreign-source income in export transactions, and that such income need not be taxed under footnote 59, the FSC is immune from the prohibition of Article 3.1(a).

4.801 As a result of its failure to apply the correct legal standard to its claim, the European Communities has not provided the Panel with evidence proving that the FSC provides a tax exemption on export income other than foreign-source income. In this context, it is important to recall that the European Communities has asserted that the only evidence it needs to rely upon in this case is the FSC statute itself.³⁹⁹ Because the FSC statute does not demonstrate that the FSC exempts anything other than income attributable to foreign economic processes, the European Communities' failure to provide any other supporting evidence should prove fatal to its claim under Article 3.1(a).

The European Communities Has Failed to Prove that the FSC Administrative Pricing Rules Violate Article 3.1(a)

4.802 The European Communities has failed to make a *prima facie* case with respect to its claim that the FSC administrative pricing rules violate Article 3.1(a) because it has misconstrued the applicable legal standard and because it has failed to present the Panel with evidence demonstrating that those rules contravene the arm's length principle of footnote 59 by systematically misallocating domestic-source income to FSCs. The European Communities has not even identified for the Panel what the arm's length principle of footnote 59 contemplates. Instead, it simply alleges that whatever the relevant standard may be, the FSC administrative pricing rules do not conform to it.

4.803 The European Communities has failed to recognize the seminal question pertaining to its claim regarding the administrative pricing rules, which is whether the FSC pricing rules properly allocate foreign-source versus domestic-source income in covered export transactions. On this all-important question, the European Communities has provided no evidence. As the United States has already pointed out, the European Communities has presented no evidence proving that the FSC rules have resulted in domestic-source income receiving a tax exemption instead of foreign-source income. The European Communities has not shown that the overall tax exemption conferred by the FSC includes any income derived from economic activities occurring *within* the United States. Moreover, the European Communities has still not adduced evidence showing that, to whatever extent the administrative pricing rules could be said to allow for the exemption of direct taxes on domestic-source income, the resulting tax savings for domestic-source income is "significant," a finding that is required under footnote 59 in order for an "administrative or other practice" dealing with transfer pricing to be considered a prohibited export subsidy. The European Communities has not even proposed a standard for what "significant" means.

4.804 Unless and until the European Communities provides the Panel with evidence showing that the allocation of foreign-source as opposed to domestic-source income under the administrative pricing rules is not done on an arm's-length basis and results in a significant tax saving, the European Communities' claim regarding the administrative pricing rules must be rejected.

Territorial Tax Systems Provide More Favourable Tax Treatment to Foreign Distribution Activities than to Domestic Distribution Activities

³⁹⁹ European Communities' Response to US Preliminary Objections (25 January 1999), paragraph 13.

4.805 The tax exemption under the FSC rules emulates the exemption under territorial tax systems.⁴⁰⁰ In that context, during the course of the first meeting, the Panel requested additional information on territorial tax systems. This section responds to the Panel's question.

The Concept of a "Territorial" Tax System Is Not Precise and Many Income Tax Systems in Europe Incorporate Some Type of Hybrid System

4.806 At the outset, it should be recognized that while tax systems broadly referred to as "territorial" are common internationally⁴⁰¹, it is difficult to identify a specific income tax system that is strictly "territorial" in that it exempts all income from foreign economic processes. Also, it is difficult to find any two tax systems that exempt exactly the same amount or type of foreign income or that accomplish the foreign income exemption in exactly the same way. There are so many individual variations between statutory schemes involving the exemption of foreign income that it is difficult to capture all of these variations in summary form. Just as there is no single model income tax system internationally, there is no single model territorial tax system. Therefore, the European Communities cannot be correct in its contention at the first meeting of the Panel that the United States cannot "pick and choose" elements from diverse territorial systems to be included in its own partial exemption system. So long as the system chosen achieves the designated objective of exempting only income from foreign economic processes, its form and scope is not a matter for disapproval under the SCM Agreement.

4.807 With respect to European tax systems, in particular, so-called "territorial" tax systems encompass a broad spectrum. For example, some European tax systems provide a full or partial exemption for both foreign branch income (some under domestic law and others by income tax treaty)⁴⁰² and for the foreign income of foreign subsidiaries, subject to certain exceptions. An exemption for foreign subsidiary income is accomplished by permitting deferral of the subsidiary's undistributed current income (even income earned in low-tax jurisdictions) and ultimately exempting the earnings when distributed through a so-called participation exemption.⁴⁰³

The Tax Exemption Available to Income of Foreign Branches and Subsidiaries under Territorial Tax Systems Effectively Results in a Lower Tax on Income from Foreign Distribution Activities than on Income from Domestic Distribution Activities

4.808 Various versions of a territorial tax system accomplish a reduction of tax on income from foreign distribution activities as compared to domestic distribution activities. The Dutch system is one of three territorial systems whose favoured treatment of foreign-source income was closely scrutinized by a GATT panel in the *1976 Tax Legislation Cases*. Based on the United States

⁴⁰⁰ See, e.g., First US Submission, paragraph 84.

⁴⁰¹ Outside of Europe, the following countries would be considered as having "territorial" systems: Algeria, Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Central African Republic, Congo (Brazzaville), Costa Rica, El Salvador, Eritrea, Ethiopia, Gabon, Guatemala, Ivory Coast, Kuwait, Lebanon, Malawi, Mali, Mauritania, Morocco, Namibia, Nicaragua, Niger, Panama, Paraguay, Senegal, Togo, Tunisia, Uruguay, Venezuela, Zambia, and Zimbabwe. Many other countries around the world, such as Pakistan and the Solomon Islands, have full deferral for the income of foreign branches and subsidiaries and, thus, no taxation until income is repatriated to the home office. When the *Tax Legislation Cases* were being considered for adoption, the French representative "noted that the system of territoriality was applied by some *eighty* countries" GATT Doc. No. C/M/145 (14 January 1981), page 2 (emphasis added). The Commentary to Article 23 Concerning the Methods for Elimination of Double Taxation, OECD Model Tax Convention, discusses various methods, including different types of exemption systems. See US Exhibit 23.

⁴⁰² Western European countries that provide for some type of exemption for certain foreign branch income, whether by domestic statutory provision or by income tax treaty, include Belgium, France and Germany.

⁴⁰³ The domestic income tax laws of many Western European countries, including Belgium, France, the Netherlands and Spain, provide for a participation exemption. In addition, under the Parent-Subsidiary Directive of the European Union, all EC Member States are required to provide a tax exemption for most dividends paid by a subsidiary in an EC member state to a parent company in another EC member State.

understanding of Dutch tax law, which has not changed substantially since these cases, the fundamentals of Dutch treatment of the taxation of foreign income are as follows. Companies resident in the Netherlands are subject to tax on their worldwide income. The rate is currently 35 per cent. In the case of income earned abroad by a Dutch company, the company is entitled to relief that has the effect of excluding foreign income from Dutch tax. In the case of dividends from a foreign subsidiary, the participation privilege constitutes an exemption from tax for that income. The effect of these provisions is to confer a tax exemption on most foreign income, particularly export sales income attributable to a foreign entity.

4.809 The following example, which compares the income tax treatment of income from a domestic sale with the treatment of a sale through a foreign branch or foreign subsidiary, illustrates the effect of the Dutch system on the taxation of exports:

- (a) Domestic sale. A Dutch corporation having a profit for the tax year of \$200 on a sale within the Netherlands would pay tax at the regular 35 per cent corporate rate and therefore would pay a Dutch tax of \$70.
- (b) Sale through a foreign branch. Although a Dutch corporation is subject to Dutch tax on its income from all sources, there is proportional relief given by Dutch law that has the practical result of exempting foreign-source income received through a foreign permanent establishment. The relief applies if the income is subject to tax (without regard to the rate) in the foreign country in which it is sourced. There is no requirement that foreign tax actually be paid. Thus, the requirement is satisfied even if the income is exempt from foreign tax because of a tax treaty or a tax holiday.

The relief is the amount which bears the same proportion to the Dutch tax payable on the total taxable income as the foreign-source income bears to the total taxable income. In the case under consideration (that is, a Dutch company with \$100 of domestic income and a foreign branch of that company with \$100 of income on the sale), the total Dutch tax would be \$70, and the credit would be \$35, computed as follows:

<u>Foreign income (\$100)</u>	Dutch tax on
Total income (\$200)	X total income = \$35 credit

This \$35 credit is equal to the Dutch tax that would have been imposed on the foreign income if it had been earned domestically and therefore constitutes a total exemption from tax of this income. In this example the Dutch tax actually paid would be \$35, compared to a tax of \$70 if the sale had been purely domestic.

- (c) Sale to a foreign subsidiary. Because profits of a foreign subsidiary are not consolidated with the profits of its Dutch parent, there is no Dutch tax directly on the subsidiary's profits. Moreover, there is not merely deferral of Dutch tax until profits are repatriated to the Dutch parent in the form of dividends. Rather, in most cases, there is exemption from tax for those earnings because the dividends are fully tax exempt, thereby resulting in remission of Dutch tax on the subsidiary's profits from Dutch exports. Under Dutch law, a Dutch company is exempt from Dutch taxes on all "benefits" connected with a qualifying shareholding (participation exemption), including cash dividends, dividends in kind, bonus shares, "hidden" profit distributions and capital gains realized on the disposal of the shareholdings, provided certain conditions are met, including the minimum shareholding requirement, a mostly theoretical "subject to tax" requirement, and requirements that would exclude a mere investment in securities. The participation exemption is applicable to dividends from a domestic company as well as a foreign company. The difference between the treatment of domestic and foreign companies is that the domestic

subsidiary is subject to Dutch tax on its profits, whereas the foreign subsidiary would pay no tax to the Netherlands. Assuming that goods are manufactured in the Netherlands by a Dutch company at a cost of \$300, that they are sold for \$400 to a foreign subsidiary with respect to which the above tests are met, that the foreign subsidiary sells the goods to an unrelated purchaser in a third country for \$600 and incurs expenses of \$100 in connection with the sale; and that \$98 (the \$100 of profit less, say, a 2 per cent tax imposed by the foreign country) is distributed to the Dutch parent corporation free of withholding tax, then the tax imposed by the Netherlands on the entire transaction would be \$35.00 (35 per cent x \$100 manufacturing profit), and the entire profit after Dutch tax on the entire transaction would be reduced by the \$2 tax levied by the foreign country, leaving net cash of \$163. The total Dutch and foreign tax paid would be \$37.00. If the sale had been purely domestic (case (a) above) the total amount of tax paid would have been \$70 (35 per cent on the manufacturing profit of \$100 and 35 per cent on the distribution profit of \$100).

4.810 The export-promoting character of territorial tax systems of the Netherlands, Belgium and France was established in the *Tax Legislation Cases*. The panel in the *Tax Legislation Cases* noted that the exemption method utilized by the Netherlands amounts to a credit, not for foreign, but for Dutch tax on foreign income.⁴⁰⁴ The Panel also focused on the tax relief for distributions of foreign subsidiary earnings, the panel apparently not realizing that, while dividends from foreign subsidiaries qualify for tax relief if they are channelled through a permanent establishment in another country, the dividends are eligible for relief whether or not channelled through a permanent establishment, provided that the underlying profits are “subject to tax” in the other country. In responding to the panel, the Netherlands did not contest the very limited nature of its “subject to tax” requirement, and recognized that it presents certain inherent dangers with regard to certain tax havens.⁴⁰⁵ Nevertheless, the Netherlands defended it on the basis that “those dangers must not be avoided at the expense of developing countries.”⁴⁰⁶

4.811 Nevertheless, the panel found that, because different tax treatment in different countries resulted in a smaller total tax bill in aggregate being paid on exports than on sales in the home market, there was a partial exemption from direct taxes and that the practices were prohibited by the illustrative list of 1960. The panel concluded that this aggregate differential tax treatment for exports resulted from the fact that, under the Dutch system, the Netherlands did not levy a tax on profits from export sales by foreign branches or subsidiaries when these were subject to tax abroad, irrespective of whether these tax rights were exercised.⁴⁰⁷ Two other European income tax systems, the Belgian⁴⁰⁸ and French⁴⁰⁹ systems, each featuring different variations of the territorial principle, were also held to be covered by the 1960 illustrative list of export subsidies. Although the 1981 Council Decision in effect overruled the panel decisions, the factual conclusions of the panel regarding the effect of the territorial systems in question on exports continue to be correct.

4.812 In addition there are other countries, not a part of the earlier dispute, that present the same issues because their systems effectively favor exports under a combination of foreign income tax provisions. Of particular interest is the income tax system of Spain, under which, as a general rule,

⁴⁰⁴ BISD 23S/137, page 138.

⁴⁰⁵ *Ibid.*, page 141.

⁴⁰⁶ *Ibid.*

⁴⁰⁷ *Ibid.*, page 145.

⁴⁰⁸ A foreign branch of a Belgian corporation generally is not taxed on its foreign-source income, including export income. Where Belgium has a treaty with the country in which the branch is situated, the treaty generally provides that foreign branch profits are totally exempt from Belgian tax. Where earned in a non-treaty country, 75 per cent of the foreign branch income is exempt. A foreign subsidiary of a Belgian corporation is not taxed on most foreign-source income, including export income, through a combination of a tax exemption on undistributed income and a 95 per cent participation exemption on distributions of earnings.

⁴⁰⁹ Generally, foreign income directly attributable to operations conducted abroad is exempt from tax in France. A foreign subsidiary of a French corporation generally is not subject to tax on any of its undistributed income. On distribution, most foreign subsidiary earnings are eligible for a participation exemption.

resident companies and permanent establishments in Spain are subject to corporate income tax on their worldwide income.⁴¹⁰ Non-resident legal entities without a permanent establishment are, in general terms, subject to tax only on Spanish-source income resulting from payments made by resident persons or entities. A branch in Spain of a non-resident entity, whether engaged in selling or manufacturing, constitutes a permanent establishment in Spain and is therefore subject to corporate tax on its total net taxable income. Under Spanish law, relief from double taxation is generally granted by way of a tax credit method.

4.813 The Spanish tax system cannot be considered purely a worldwide tax system using the foreign tax credit of alleviating double taxation. The participation exemption available under Royal Decree-Law 8/1996 of 7 June (LIS, Art. 30 bis) provides for a tax exemption achieved through granting a 100 per cent tax credit, computed as all Spanish corporate income tax attributable to the foreign dividends paid with regard to the underlying foreign subsidiary profits. There are limitations, including that the non-resident company must be subject to a tax “comparable” to the Spanish corporate income tax with no possibility of being exempt and it may not be a resident in a country or territory considered to be a tax haven, although it is unclear how this limitation works in practice because Spanish law does not define the concept of a comparable tax and a taxpayer that reasonably interprets the rule is not subject to penalty. Capital gains realized on the disposal of shares in non-resident companies are granted relief from double taxation in the same manner as relief is granted for foreign dividends. Although generally Spain does not tax the undistributed earnings of foreign subsidiaries, Spain has controlled foreign corporation (CFC) legislation that would result in taxation at the level of the parent company when the CFC is resident in a tax haven (forty-eight tax havens are identified in Royal Decree 1080/1991 of 5 July 1991, with effect from 25 July 1991). For tax-haven CFCs, a stricter scheme applies, because it is presumed (although with a right of rebuttal) that:

- (a) the corporate tax actually paid on any kind of income by the CFC is less than 26.25 per cent;⁴¹¹
- (b) all income accruing to the CFC is “passive”; and
- (c) the annual minimum income derived by the CFC is equal to 15 per cent of the acquisition cost of the underlying participating interest.⁴¹²

4.814 Under Spain’s CFC provisions, there is a specific provision favoring services related to exports. Under this specific exception from the CFC regime, income is considered “passive,” and therefore subject to the CFC rules, if it is, *inter alia*, income from credit, financial and insurance facilities or services (*other than export-linked services*) [italics added for emphasis] supplied directly or indirectly to Spanish resident individual or corporate related parties if these related parties are entitled to deduct expenses related to that type of income (*i.e.*, financial interest, insurance premiums and service fees).⁴¹³ Therefore, the Spanish anti-deferral rules provide a specific exception for certain export-linked foreign subsidiary income from transactions between related parties. Although the European Communities tries to isolate the FSC provisions as “unique” and different in character from its own income tax systems, in fact, in its treatment of foreign-source income from distribution activities, the partial exemption afforded under the FSC rules is not essentially different from various European tax systems that the European Communities presumably would defend as being fully consistent with the relevant EC member States’ obligations under the SCM Agreement.

⁴¹⁰ See “The Taxation of Companies in Spain,” revised and updated by Stella Raventos Calvo, *The Taxation of Companies in Europe, Guides to European Taxation: Volume II*, 1997 International Bureau of Fiscal Documentation at 1 - 140 (copy of the specific pages referring to particular provisions described are provided as US Exhibit 24).

⁴¹¹ The regular corporate income tax rate is 35 per cent.

⁴¹² Note that these presumptions do not apply when the CFC consolidates its accounts with a Spanish resident entity.

⁴¹³ See US Exhibit 24, section 8.4 (Anti-avoidance measures).

Exemption of a Part of a FSC's Income Provides the Same Treatment that Many European Tax Systems Provide

4.815 Because the United States income tax system overall is a worldwide, rather than a territorial, system, it generally taxes the foreign branch activities of United States corporations and defers from tax (subject to certain anti-avoidance rules) the undistributed foreign income earned by foreign corporations, which is taxed on repatriation. As compared to the US tax system, European tax systems provide even a more favourable tax regime for foreign-source income from distribution activities by imposing very limited anti-avoidance rules that permit greater deferral of undistributed foreign subsidiary earnings, and providing for a participation exemption. For qualified export-related distribution income, the United States has elected to adopt a system that is partially territorial. The difference between the United States and many European systems, which amounts to a difference only in form, is that the United States has put its rules in a single set of provisions and has maintained complete transparency in the application of the provisions. The mere fact that the partial exemption for FSCs under the US tax system is more transparent, as compared with some European tax systems, should not result in the FSC being treated differently under the SCM Agreement.

The **European Communities** further rebuts the United States' response in its Oral Statement at the Second Meeting of the Panel as follows:

US Exhibits 20 and 21

4.816 The United States has produced some detailed new factual information in its Exhibits 20 and 21. According to the working procedures they should have been produced in the First Written Submission. The European Communities question to which these answers respond were clearly posed in the European Communities' First Written Submission. The delay in producing them has prevented the European Communities from analysing them and responding to them in the detail that it could have done if they had been produced at the correct time.

4.817 It is however immediately obvious that the *ex post facto* justification for the FSC formulae is unconvincing. The European Communities' reasons for this are more legal than factual but it is convenient to deal with them here.

Exhibit 20

4.818 Exhibit 20 attempts to show that the administrative pricing rules generate profit allocations to FSCs that are broadly consistent with 'arm's length' transfer pricing. The paper purports to conclude that the 23 per cent CTI and 1.83 per cent gross receipts rules correspond with the share of profit deriving to *independent* wholesalers and distributors for different US industries.

4.819 A number of initial objections can be made to the analysis in Exhibit 20. The European Communities will only mention two:

The paper does not show that administrative pricing rules generate profit allocations to FSCs consistent with 'arm's length' transfer pricing

4.820 First a comparison between FSC profit allocations and allocations between independent wholesalers and distributors at an aggregate level is not very meaningful. Independent wholesalers and distributors are remunerated for their activity and the more they do the higher the share in overall profits. No such correlation between the activity performed and the profit allocation, however, exists for FSCs under the administrative pricing rules. The latter prescribe a fixed share of common *profit to be allocated to FSCs even if the latter's' activity has been close to zero.*

4.821 Second, there is no basis for supposing that the activities of FSCs correspond to those of independent wholesalers and distributors *in the sample* and the paper makes no attempt to analyse the differences. Wholesalers and distributors carry out many functions that FSCs do not. Indeed the

activities that qualify for FSC treatment are exhaustively listed in Section 924(a) IRC and do not include all the activities that are commonly undertaken by independent wholesalers and distributors. Commission FSCs are more akin to export agents than to distributors.

4.822 The paper therefore tells us nothing about whether the profit allocation *for FSCs* under the administrative pricing rules is similar to those that would result from the application of ‘arm’s length’ pricing rules to *FSCs*.

The analysis ignores the fact that the two administrative pricing rules act as lower bounds and a safe harbour

4.823 The FSC can choose the most advantageous of the two administrative pricing rules, so that the profit allocations derived from each act as lower bounds on the profit that can be allocated to the FSC. Exhibit 20 ignores this lower bound issue when analysing relative profits. It also ignores that under Section 482 the IRC can intervene *ex post* if profits have been allocated excessively to distributors and wholesalers. This is not the case for FSCs using the administrative pricing rules.

Exhibit 21

4.824 Exhibit 21 uses a survey of FSCs to attempt to determine whether the proportion of FSC taxable income that is tax-exempt corresponds to the level of FSC functions carried on outside the United States.

4.825 The survey was sent to 27 companies. These were the largest companies in each of five industry sectors that had the largest volume of FSC exports (based on 1992 data). The survey was completed by 16 companies, which between them were responsible for *circa* 9 per cent of total United States exports in 1994.

4.826 Exhibit 21 does not in fact support this conclusion for a number of reasons of which the European Communities will only mention three:

Representativeness and size of the sample

4.827 There are over 5000 FSCs. Even though the respondents are said to account for 9 per cent of total United States exports, the sample size of 16 is still too small to be representative.

Did the respondents know the purpose of the survey?

4.828 The firms surveyed are not identified but in view of the fact that large United States exporters are lobbying the US Government to defend the FSC scheme, it is likely that the respondents knew the purpose of the survey. It is therefore doubtful whether they completed the survey objectively. If a respondent did not provide accurate answers, this would be very difficult to identify, as the respondents were not asked to provide a breakdown of actual costs within each category.⁴¹⁴

4.829 Furthermore, the respondents were able to select the year of the data provided.⁴¹⁵ This would allow respondents some flexibility in choosing the year which provided the ‘right’ results.

The questionnaire sent to the firms is unclear

4.830 The questionnaire used in the survey asks for “Foreign expenses (incurred by both the FSC and related supplier) included in the CTI.”

⁴¹⁴ See paragraph 8 of US Exhibit 21.

⁴¹⁵ See paragraph 7 of US Exhibit 21.

4.831 It is unclear both whether these expenses include *all* foreign expenses incurred by the related supplier (i.e. the US parent) and also what exactly was meant by “foreign”.

4.832 Exhibit 21 claims that the confidential nature of the data had to be protected and it is probable that the approach taken by different enterprises was variable and unverifiable.

Conclusion on US Exhibits 20 and 21

4.833 Thus, leaving aside the considerable data problems involved in these exhibits even if the calculations were correct, US Exhibits 20 and 21 do not demonstrate the US objective since. First as regards Exhibit 20, FSC activities are by no means comparable to those of independent distributors. The fact that the results of the survey of independent domestic wholesalers and distributors show that their profits correspond to some extent to the formulae used in the FSC scheme administrative pricing rules in fact demonstrates that these provide an over-allocation of profit to FSCs who do not and are not even able to carry out a similar range of activities.

4.834 It is also important to note that under Section 482, the IRS maintains the possibility to correct misallocations *ex post*. This is not the case under the administrative pricing rules which provide for a fixed allocation of common profit to the FSC irrespective of their actual activities. No *ex post* correction mechanism exists if the FSC activity has been close to zero.

4.835 Coming to US Exhibit 21, results stemming from replies from companies which are the main beneficiaries of the FSC programme can hardly be convincing. There is no way to verify the accuracy of the answers provided.

4.836 Both the allocation of a certain percentage of common profits to FSCs and the determination of the share of FSC profits exempt from tax is arbitrary. They are dictated by two conflicting goals:

- to provide an export incentive by exempting a certain proportion of common profits from US income tax
- limit the Treasury's cost in terms of lost tax revenue.

4.837 The European Communities considers that Exhibits 20 and 21 are both irrelevant for the purposes of this case and unreliable. It is however prepared to answer any questions the Panel may have on them.

Other Tax Systems

4.838 The United States devotes considerable space to discussing the tax systems of other countries. The European Communities notes that the only tax measures under review in this proceeding are those of the United States and declines to enter into a discussion of other tax systems which would be burdensome, inappropriate, time-consuming and beyond the terms of reference of this Panel. If the United States has problems with the tax systems of other countries it is free to address them in an appropriate manner.

4.839 The European Communities offers only one comment on the subject of territoriality which may help to clarify matters for the Panel. It is that there is a fundamental difference between a tax system which specifically exempts only export revenue that it would normally tax and a country that does not generally tax revenue outside what it defines as its jurisdiction. In the latter case any reduction of tax charge on transactions that may result is simply the result of a difference between the systems, that is an absence of harmonisation. It is not an objective of the WTO to harmonise tax systems. The tax saving in the case of a territorial system is as much a consequence of other countries' tax systems as that of the country under consideration. The FSC subsidies about which the European Communities is complaining result entirely from the operation of the US tax system.

4.840 Of course, the European Communities is prepared to answer questions that the Panel may have to the extent that this is possible.

Legal Issues

The 1981 Understanding

Introduction

4.841 Turning now to the legal issues we start with the 1981 Understanding. Not because it is applicable or relevant (the European Communities' position must be clear to you by now) but because it is so fundamental to the case the United States is making. Indeed this is understandable in view of the fact that the FSC scheme is so flagrantly export contingent and falls so clearly under Article 3.1(a) of the SCM Agreement. In an attempt to justify the FSC the United States is driven to say:

“the 1981 Council Decision sanctified the differential tax treatment of foreign and domestic activities, even when those activities involve export transactions.”⁴¹⁶

4.842 The dictionary says that “sanctify” means “purify from sin,” so this does make sense on the basis of the United States interpretation of what the 1981 Understanding allows. It is also striking to see the working of the GATT Council assimilated to those of the Vatican and its like.

The 1981 Understanding is not applicable or relevant to the present dispute

4.843 The European Communities has made clear that it does not disagree with the 1981 Understanding **properly understood**. The United States refuses, in these proceedings, to understand it properly.

4.844 The European Communities has shown two things. First that the 1981 Understanding is not applicable to the present case. Second that it simply does not say what the United States is attempting to make it say. The European Communities has already given a lot of reasons for these two points.⁴¹⁷ Today it will take an alternative approach which demonstrates the correctness of many of the European Communities' arguments and puts the matter beyond any doubt.

⁴¹⁶ See paragraph 26 of the US Second Written Submission.

⁴¹⁷ See paragraphs 45 to 56 of the European Communities' Statement to the First Meeting of the Panel and paragraphs 52 to 71 of the European Communities' Second Written Submission.

4.845 In order to illustrate the true meaning of the 1981 Understanding and the true intent of the parties, the European Communities refers the Panel to the framework in which the reports and understanding were adopted and to the minutes of the GATT Council meeting at which it was adopted.

4.846 The European Communities would first recall that the GATT procedure which was being applied was that applicable to dispute settlement between parties not rule making. When the *Tax Legislation* panels were established, the United States had proposed that all four cases be referred to a “working party ... charged with the duty of recommending the type of international rules which contracting parties could adopt to govern their income tax practices with respect to export sales. This would give to all interested contracting parties an opportunity to express their views and participate in the formation of such rules, an opportunity that was not adequate in Article XXIII:2 proceedings ...”. This proposal was rejected and a panel established.⁴¹⁸

4.847 The dispute settlement rather than rule-making mode of decision making is also clear in minutes of the Council meetings at which the Reports and Understanding were adopted. The European Communities will be quoting from these now and the Panel is invited to turn to Exhibit EC-32.

4.848 On page 5, the matter is wearily introduced by the Chairman who recalls the numerous times these reports had been on the agendas of Council Meetings and that the principally concerned parties had been meeting to try to formulate an “understanding,” which had been revised and was now presented as document C/W/376/Rev.1. The first point to note then is that the Understanding is a text drawn up by the United States and European Communities to allow the adoption of the reports in the *Tax Legislation* cases.

4.849 The representative of Canada then immediately expresses “the reluctance of some to see the Council adopt Panel Reports in this fashion, with a text of a proposed understanding which was not immediately apparent as to its intention and meaning.” He goes on however to stress the saving grace of the Understanding that the adoption “would not diminish rights and obligations under Article XVI:4.” The representative of the United States then expressly agrees with this statement as does the representative of the European Communities.

4.850 It is only after taking note of these statements that the Council adopts the Reports on the famous Understanding.

4.851 That is what the GATT Council agreed to: To adopt the reports as qualified by the Understanding but on the express understanding that they were not adding to or diminishing rights under GATT.

4.852 The actual wording of the disclaimer found in the Chairman’s statement on page 7 is even more to the point. He said “... the decision does not modify the existing GATT rules in Article XVI:4 as they relate to exported goods.” He added “this decision does not affect and is not affected by the Agreement on the Interpretation and Application of Articles VI, XVI and XXIII” (that is the Tokyo Round SCM Agreement).

4.853 The United States argues in a footnote (35) to its Second Written Submission that the statements reflect the belief of the GATT Contracting Parties that the Understanding reflected the meaning that Article XVI:4 had always had and that is why they said it did not affect the GATT or the Tokyo Round SCM Agreement. That is in the view of the European Communities another way of making the European Communities' point. The Understanding was not intended to change the meaning of Article XVI:4 GATT 1947 or to be binding for the future. It was not therefore a decision under Article XXV of GATT 1947 (which is nowhere mentioned in the discussions) and it is not a

⁴¹⁸C/M/89, p. 10.

decision carried over into GATT 1994 by paragraph 1(b)(iv) of the introductory language to GATT 1994 nor by Article XVI:1 of the WTO Agreement.

4.854 It should also be mentioned that in any event the GATT Council had no authority to interpret the Tokyo Round SCM Agreement. And of course if it did not modify the Tokyo Round Agreement it did not affect the Tokyo Round Illustrative List and can hardly be considered relevant for the interpretation of the Uruguay Round Illustrative List.

4.855 After the adoption, there was a veritable parade of Contracting Parties seeking reassurance and expressing their reserves which further demonstrates the correctness of the European Communities' position on this Understanding.

4.856 The representative of Brazil states (bottom of page 7) that it did not support the Understanding but did not block consensus so as not to be "an obstacle to solving an old and serious problem in the GATT." He noted (top of page 8) that general interpretations, in GATT practice, were formulated through different mechanisms". This is further confirmation, if any is needed, that it was not a decision under Article XXV:1 GATT 1947 and was not considered by anyone to be so (the United States is wrong to pretend that it was at paragraph 55 of its Second Written Submission). Brazil generally reserved its rights. Australia, Argentina, and Chile did likewise.

4.857 That is clear enough. The European Communities trusts that it has said enough about the status and relevance of the 1981 Understanding but also refers you to the arguments in its Statement to the First Meeting of the Panel and Second Written Submission that the 1981 Understanding is not part of GATT 1994 nor is it relevant "guidance" for the purposes of Article XVI: 1 of the WTO Agreement.

The Meaning of the 1981 Understanding

4.858 The European Communities has had spent some time on explaining its view of the status and relevance of the 1981 Understanding because the United States insists on trying to give it an inappropriate quasi-constitutional character. But the European Communities has said that it does not disagree with the 1981 Understanding **properly understood** and there is also enlightenment on this score in the Council minutes you have before you.

4.859 If you will please turn to the fourth complete paragraph of page 8 of the minutes you will see that after all the expressions of reserves which we have just discussed, the United States tries to have the last word and put down a marker for its own unilateral interpretation of the Understanding. Its representative states that:

"it was of the view of his government that the rules applicable to cases involving Article XVI:4 required that the level of taxation to be assessed upon exported products be at least equal to the level which would apply in the event that a territorial system of taxation were adopted by the country in question."

4.860 Sounds familiar does it not? This is precisely the rationale on which the United States bases its "controlling legal standard". According to the United States, the FSC scheme is allowed because it "emulates the tax treatment received by the foreign sales subsidiary of a manufacturing company in a territorial-type system".⁴¹⁹

4.861 The European Communities (bottom of page 8) and Canada (top of page 9) immediately distance themselves from this statement.

⁴¹⁹ See paragraphs 55 and 84 of the US First Written Submission and 119 and 177 of the US Second Written Submission.

4.862 It is therefore disingenuous indeed for the United States to suggest that the 1981 Understanding represents an agreement between the GATT Contracting Parties on its “controlling legal standard.”

4.863 The European Communities has already said a lot about why the United States interpretation of the 1981 Understanding is wrong.⁴²⁰ This has concentrated on the United States’ error in considering that a statement that foreign economic processes *need not be subject to taxation* means that there is a *right not to tax*⁴²¹ income from such activities on any condition a country chooses. There are other errors in the United States reasoning about the meaning of the 1981 Understanding. These permeate its further reasoning on the “controlling legal standard” and the European Communities deals with them below.

Conclusion

4.864 Thus even if the 1981 Understanding were part of GATT 1994 or relevant guidance under Article XVI:1 of the WTO Agreement, it is clear not only from the text but also from the above discussion that the “controlling legal standard” invented by the United States is not part of GATT 1994 or the WTO.

4.865 The European Communities hopes that this disposes of the 1981 Understanding.

The Relationship Between Article XVI of the GATT and the SCM Agreement

4.866 The United States makes a number of points about the relationship between Article XVI GATT and the SCM Agreement designed to strengthen its case that the 1981 Understanding should be read into the SCM Agreement.

4.867 It is true that a number of provisions of the SCM Agreement refer to Article XVI GATT and that there is even a reference in Article 32.1 to Article XVI “as interpreted by this Agreement”.⁴²² The European Communities is even prepared to accept with the Appellate Body that “the relationship between the GATT 1994 and the other goods agreements in Annex 1A is complex and must be examined on a case-by-case basis.”⁴²³

4.868 However none of this helps the United States case. It is clear that the SCM Agreement is more than an interpretation of Article XVI GATT. It is better described as a development of Article XVI and other GATT provisions. The European Communities has already noted that the title of the SCM Agreement no longer refers to it as an interpretation of the GATT (the title of the Tokyo Round SCM Agreement did refer to it being an interpretation).

4.869 The Tokyo Round SCM Agreement was a major advance over Article XVI:4 GATT. The European Communities remarked at our last meeting that President Jimmy Carter welcomed it as it would permit the United States to “limit foreign subsidy practices” and that it introduced a “flat prohibition of export subsidies” and “a definition of export subsidy which abolishes the existing dual pricing requirement”.⁴²⁴

4.870 The Uruguay Round SCM Agreement achieved even further progress in combating subsidies since it introduced a clear definition of subsidies which did not exist before and strengthened the prohibition on export subsidies.

⁴²⁰ See paragraphs 65 to 70 of the European Communities' Second Written Submission.

⁴²¹ See e.g. paragraph 153 of the US First Written Submission.

⁴²² See European Communities position in paragraph 147 of the European Communities' Second Written Submission.

⁴²³ *Brazil - Measures Affecting Desiccated Coconut*, WT/DS22/AB/R, adopted 20 March 1997, page 13.

⁴²⁴ See page 1935 of the document in Exhibit EC-22 to the European Communities Statement to the First Meeting of the Panel.

4.871 It is especially the new definition of subsidy which renders Article XVI GATT and the 1981 Understanding redundant for our purposes. The United States is seeking to import the vague language of the 1981 Understanding into the clear wording of Article 1 of the SCM Agreement and thus undo the clarification which was one of that Agreement's main achievements. The United States accused the European Communities of "revisionist analysis" of the 1981 Understanding in its Second Written Submission. That was wrong and unjust since the record discussed a moment ago shows the European Communities' interpretation has not changed. The United States is in fact engaging in a modern form of Luddism by refusing to accept the progress realised with the Uruguay Round SCM Agreement and seeking to maintain the comfort of its outdated and unilateral interpretation of subsidy based on a text that is no longer applicable. (Mr Ludd was the leader of a 19th century English revolt against the introduction of machinery – which his men went round smashing up – and the consequent loss of jobs. Of course as we have learnt from history Luddism appears attractive to those who feel threatened but in the end it is counterproductive.)

4.872 The United States further seeks to argue that since (according to it) the FSC scheme is compatible with Article XVI:4 GATT in the light of the 1981 Understanding, it must also be compatible with the SCM Agreement since the Agreements must be construed "not in isolation from each other"⁴²⁵ or "in harmony"⁴²⁶.

4.873 The European Communities disagrees for a whole series of reasons, not the least being that it does not accept that the FSC scheme is compatible with Article XVI:4 GATT 1994 just as it never accepted that it was compatible with Article XVI:4 GATT 1947.

4.874 The European Communities did not cite Article XVI:4 GATT 1994 in its request for a Panel as this is superfluous. The SCM Agreement is a development *inter alia* of Article XVI:4 and has more detailed and clearer provisions than Article XVI:4 GATT 1994. Since the FSC subsidies clearly fall under Article 3 of the SCM Agreement, there is no need to invoke Article XVI:4 GATT 1994.

4.875 The argument made by the United States that compatibility with Article XVI must entail compatibility with the SCM Agreement, would render the latter redundant and such a result would be contrary to the principle of effective treaty interpretation.⁴²⁷

4.876 The fact that the SCM Agreement should prevail over Article XVI:4 is also confirmed by the General Interpretative Note to Annex IA of the WTO Agreement in which both are included. As is well known, this provides that in the event of conflict between a provision of the GATT 1994 and a provision of another agreement in Annex 1A such as the SCM Agreement, the provision of the latter shall prevail to the extent of the conflict.

4.877 The United States relies a number of times on the *Desiccated Coconut* case to argue that its interpretation of Article XVI:4 (and therefore of the 1981 Understanding) should prevail over the European Communities' case based on the SCM Agreement. However in that case it was the SCM Agreement which prevailed over an argument based only on a GATT provision, the opposite of what the United States is attempting here.

4.878 The United States also brings up an argument drawn from the *Indonesia - Cars* panel⁴²⁸ where Article 3.1(b) of the SCM Agreement was considered not to have rendered the Article III:4 GATT 1994 inapplicable to subsidies. In case there should be any doubt, the European Communities does not consider that Article XVI:4 is no longer applicable to export subsidies. It merely considers that the SCM Agreement also applies. It is the United States which seems to be arguing that

⁴²⁵ Paragraph 28 of the US Second Written Submission.

⁴²⁶ Paragraph 151 of the US First Written Submission.

⁴²⁷ See, e.g., *Japan - Alcoholic Beverages*, page 11.

⁴²⁸ *Indonesia - Certain Measures Affecting the Automobile Industry*, WT/DS55/R, Report of the Panel adopted 23 July 1998.

Article XVI:4 GATT (or rather its view of the 1981 Understanding) renders the SCM Agreement inapplicable to the FSC subsidies.

4.879 The United States has to engage in circular reasoning to make its case. On the one hand it says that “to the extent possible, Article XVI and the SCM Agreement must be construed in a manner that avoids a conflict. In the context of this case, this means that Article 1.1(a)(1)(ii) must be construed in light of the 1981 Council Decision.⁴²⁹” On the other hand it seeks to dismiss the Interpretative Note just referred to because “there is no conflict between Article XVI, as interpreted by the 1981 Council Decision, and Article 1.1(a)(1)(ii).⁴³⁰”

4.880 For the above reasons, the Panel should dismiss the United States attempts to complicate and confuse this case by referring to the misty history of Article XVI:4 GATT 1947 and restrict its analysis of this case the provisions in its terms of reference – those of the SCM Agreement.

Whether the FSC Scheme Gives Rise to "Revenue Forgone" which Would Be "Otherwise Due"

Introduction

4.881 This brings us at last to the proper starting point in our analysis is Article 1.1 of the SCM Agreement and in particular the expression “revenue that is otherwise due is foregone.”

4.882 There is a fundamental difference in this case between the European Communities and the United States as to the basis on which to assess whether revenue is “otherwise due”.

4.883 The European Communities' approach has been to demonstrate that the United States is deviating from the generally applicable rules in its system as evidenced by the treatment it accords to a series of comparable situations. As explained in the European Communities' Second Written Submission, this is also the approach which the United States takes to what it calls “foreign subsidies”, that is the subsidies of countries other than the United States. The European Communities will return to this matter in a moment.

4.884 The approach that the United States seeks to take in the *present* case however, is for “otherwise due” to be assessed on the basis of some notional tax system required or authorised by the WTO Agreements in some way.

4.885 This is another manifestation of its “controlling legal standard” derived from the 1981 Understanding which the European Communities decisively rejects.

4.886 The United States is therefore arguing that it has a “right not to tax” income it designates as foreign. This is rather curious in the light of the statement at paragraph 27 of the US First Written Submission that:

“There is no rule of international law that requires nations to conform to a single tax system. A country can have a worldwide system, a territorial system, or a system that incorporates elements of both.”

And at paragraph 28 that:

“The WTO never was intended (and is not well equipped) to establish international tax norms..”

⁴²⁹ Paragraph 37 of the US Second Written Submission.

⁴³⁰ Paragraph 36 of the US Second Written Submission.

4.887 Such statements are not repeated in the US Second Written Submission, no doubt because the United States now realises that it is arguing the opposite.

4.888 The European Communities agrees with both of the above-quoted statements of the United States from its First Written Submission. Neither the WTO (nor the GATT before it) grant rights to tax or not to tax – They simply provide that the tax system should not provide specific subsidies or discriminate.

4.889 The United States is in fact arguing that revenue is not “otherwise due” if a Member has a *right not to tax it*⁴³¹ (and does not consider it relevant whether it would normally be taxed under that Member's general rules). Such a proposition cannot be correct. Nothing in the WTO requires (or “obligates”) a Member to tax any income at all. The United States logic would lead to the conclusion that it could exempt a particular company or industrial sector from tax as it pleases. Indeed Article 1.1(a)(1)(ii) of the SCM Agreement and Item (e) could never apply. Countries always have the right not to tax.

4.890 For the European Communities the position is clear. Once a Member chooses to tax certain categories of revenue, it must do so in a general manner and if it creates certain kinds of exemptions, for example exempting certain companies or exempting the revenue contingently upon export performance, it will be granting a subsidy and if this should be specific it will be subject to the disciplines of the SCM Agreement.

The US Contribution to the 1996 OECD Report on "Tax Expenditures – Recent Experiences"

4.891 As the European Communities has repeatedly pointed out⁴³², the United States itself admits in its periodic Treasury Reports that the FSC scheme results in a revenue cost which it calculates and estimates to be US\$2 billion in 1997.⁴³³

4.892 In its Second Written Submission⁴³⁴, the European Communities referred the Panel to a 1996 OECD Report on “*Tax Expenditures - Recent Experiences*” (Exhibit EC-25).

4.893 In that document, the United States defined “tax expenditure” as “revenue losses attributable to provisions of the Federal tax laws which allow a **special** exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”⁴³⁵ The United States also calls these measures “special exceptions in the tax law that serve programmatic functions ... such as national defence, agriculture or health care.”⁴³⁶

4.894 The European Communities agrees that this is the correct approach for assessing whether “revenue that is otherwise due is foregone”.

4.895 That Report gave the FSC “revenue forgone” (the Report's words) in 1995 as US\$1,400 million.

The US Practice in Countervailing Duty Cases

⁴³¹ See esp. paragraph 153 of the US Second Written Submission.

⁴³² See paragraphs 100 and 138 to 139 of the European Communities' First Written Submission.

⁴³³ See *The Operation and Effect of the Foreign Sales Corporation Legislation*, Department of the Treasury, November 1997 in Exhibit EC-5, at p.12-17. The estimates for future growth are contained in Table 5.1 on page 17.

⁴³⁴ See paragraphs 84 to 90 and Exhibit EC-25 of the European Communities' Second Written Submission.

⁴³⁵ See Chapter I “Background” on page 107 of the document.

⁴³⁶ See Chapter III on page 108 of the document.

4.896 The European Communities pointed out in its Second Written Submission⁴³⁷ that the United States uses the same approach to defining revenue forgone in countervailing duty practice. The definition of subsidy in Article 1 of the SCM Agreement applies to countervailing duty proceedings as well as to prohibited subsidies and the United States is obliged to respect it. Let us consider what the United States countervailing duty rules say on the subject. (Exhibit EC-33 contains the relevant extracts from the United States countervailing duty rules.)

4.897 Section 351.509 of the United States countervailing duty rules states:

“In the case of a programme that provides for a full or partial exemption or remission of a direct tax (e.g., an income tax), or a reduction in the base used to calculate a direct tax, a benefit exists to the extent that the tax paid by a firm as a result of the programme is less than the tax the firm would have paid in the absence of the programme.”

4.898 There is a curious rider that has been added in November 1998 (“*in tempo suspecto*”) at the end of the commentary which says:

“... in the case of a foreign tax measure that exempts from taxation (either in whole or in part) income attributable to economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country, the Department would not consider such a measure to be an export subsidy, provided that the measure complied with other relevant WTO rules.”

4.899 The last few words are interesting “provided that the measure complied with other relevant WTO rules.” Thus it appears that at least insofar as foreign subsidies are concerned, the United States considers that there are other WTO rules which are still applicable to measures falling under the 1981 Understanding, including presumably Article 3.1(a) of the SCM Agreement. The European Communities considers the same principle applies to United States subsidies.

4.900 Of course the European Communities does not automatically consider the countervailing duty practice of the United States to be authoritative, but this particular United States countervailing duty rule reflects a correct interpretation of the SCM Agreement.

The application of the "revenue that is otherwise due is forgone" principle to FSCs

4.901 The European Communities has applied just these principles in this case when it demonstrated by the use of examples that the FSC subsidies gave rise to revenue forgone compare with comparable situations where the normal United States tax rules applied. The European Communities notes that the United States has not stated that the comparisons are incorrect in any way except one point which the European Communities will deal with directly. It merely insists that it is entitled to exempt “foreign economic processes” on any condition it pleases.

4.902 The only time that the United States comments on the European Communities' examples showing that revenue that is otherwise due is forgone was in footnote 56 to its Second Written Submission where it reasons that if the European Communities' theory is accepted, then a portion of its claim against the FSC must be dismissed because:

“the norm under the United States income tax system is to defer the taxation of income from foreign subsidiaries of United States corporations until such time as the earnings of the subsidiary are transferred to the United States parent in the form of dividends. While the United States may tax the current income of a foreign subsidiary of a United States corporation under “anti-deferral” provisions such as

⁴³⁷ Paragraph 80 of the European Communities' Second Written Submission.

Subpart F of the Internal Revenue Code, these provisions are exceptions to the norm of deferral. ... Therefore, even under the European Communities' theory, the exemption of FSC income from current taxation would not constitute foregone revenue that is "otherwise due."

4.903 This comes down to saying that the European Communities is complaining about an exception to an exception. The European Communities does not accept that the Subpart F rules are an "exception" in the sense this word is being used here (that of exemption); they are part of the United States system of raising tax revenue – they do not result in the forgoing of revenue. It is the FSC scheme which is the exemption since it exempts revenue from this regime of taxation and therefore revenue is forgone which is otherwise due.

4.904 The European Communities is prepared to discuss these examples further (and indeed other examples which it has available) if the Panel considers that the appropriate comparisons have not been made.

Conclusion

4.905 This discussion of the meaning of the phrase "revenue that is otherwise due is foregone" has taken some time but is important as it forms the basis of any correct analysis of the FSC scheme. Revenue is forgone which would be otherwise due when it would normally be taxed under that Members general or standard tax rules. Once this test is accepted, it is clear that both the FSC tax exemptions and the special administrative pricing rules result in revenue forgone which would be otherwise due. The United States has not argued that there is no revenue forgone compared with the application of its normal rules, just that the test is its "controlling legal standard".

The Substance over Form Debate

4.906 The United States has often responded to the European Communities' correct and methodical approach to the interpretation of the SCM Agreement and its application to this case by accusing it of "exalting form over substance."⁴³⁸

4.907 This is a remarkable accusation to make in defence of the FSC scheme which operates precisely by seeking to hide the substance of export subsidisation behind the form of complex tax arrangements.

4.908 The European Communities would like to make clear that it is complaining about the substance of the FSC subsidies, not the form. Also, it is asking the Panel to condemn the substance not the form.

4.909 The European Communities can easily reject the United States accusation that its approach, taken to its logical conclusion, would condemn "Thailand's failure to tax the income of a French business operating in Canada as a subsidy."⁴³⁹ As the European Communities has explained a moment ago, there is revenue forgone which would be otherwise due when a country makes a specific exemption or derogation to its generally applicable tax rules.

4.910 It is of course necessary for the purposes of a proper analysis to start by looking at the detailed rules and thus the form of FSC scheme⁴⁴⁰. But the European Communities hopes that it has made clear that the exemptions, derogations and special rules give rise to a *substantive exemption* when it shows, as it reminded you a moment ago, how FSC transactions are less taxed than equivalent transactions – whether export, import or domestic.

⁴³⁸ See e.g. paragraphs 81 to 84 of the US Second Written Submission.

⁴³⁹ Paragraph 84 of the US Second Written Submission.

⁴⁴⁰ The European Communities set out the nature of the exemptions at paragraph 65 of its First Written Submission and paragraph 9 of its Statement to the First Meeting of the Panel.

4.911 Let us pursue the substance over form approach and see what the substance of the United States claims really is.

4.912 In answer to the European Communities question 13:

“Is it true that, with respect to the same transaction, a FSC which carries out all the activities required by Section 925(c) by itself may receive the same amount of tax benefit as an FSC which subcontracts back all its activities to its parent company?”

The United States replied:

“whether the FSC carries out foreign economic activities itself or subcontracts them to another party, such as its parent, does not matter under the applicable legal standard.”

4.913 In its Response to the European Communities question 8⁴⁴¹, the United States states:

“Its [the FSC scheme’s] purpose is to provide a suitable mechanism for isolating and collecting the income attributable to such processes.”

4.914 It then explains that because of the nature of the US tax system,

“This objective was accomplished by requiring that the FSC be legally and financially responsible for such activities, **but allowing the United States parent to conduct many of the activities on its behalf.**”

4.915 Effectively the United States is saying that

- foreign economic processes are **always “foreign”** even if carried out by domestic parties; this is why the parent companies of FSCs are allowed to actually carry them out on behalf of FSCs;
- the only reason such processes cannot be carried out **directly** by United States producers is that such an explicit exemption would **have clashed with the principles of the United States residence-based system of taxation**. There was a need, therefore, for a **foreign** corporation – the FSC – to be formed to create a mechanism for collecting all of the transaction-related activities of the United States parent and the FSC that **occur outside** the United States.⁴⁴²

4.916 In other words, the United States position is that there is no need from a WTO point of view for a special vehicle abroad and FSCs could in principle be established on the mainland territory of the United States and the US Congress could exempt from tax whatever proportion of their income it considered was “foreign”. Indeed why should not the US Congress (or another WTO Member without a clash of the kind the United States apparently would have with its tax system) not grant the tax exemption for a portion of the export profits directly to the exporters ? After all, substance should prevail over form and so why should a Member oblige exporters to have foreign subsidiaries. (This no doubt explains why following the 1981 Council Decision, the United States made a declaration in April 1982 that the DISC was not a subsidy.)

4.917 That is the logical consequence of the United States approach, a direct tax exemption for part of the profits of exporters because part can be considered “foreign”. If one is not convinced by the arguments about the US tax system, an alternative explanation for the need to set up FSCs in FSC havens, is of course that the subsidy is less apparent.

⁴⁴¹ Paragraph 27 of the US answers.

⁴⁴² Paragraph 27 of the US answers.

4.918 The European Communities also recalls in this connection that its question number 8 was designed to explore exactly how much income could be exempted by the FSC scheme. In the last sentence of this question the European Communities asked:

“Could a scheme which allowed an offshore subsidiary which had legal and financial responsibility for all aspects of the manufacture, sale and delivery of a product be devised and be compatible with the WTO, which would allow an exemption from income tax of the profits of those activities (which could be deemed a foreign economic process)?”

To which the United States replied that according to it:

“A “scheme” as posited by the European Communities in the last sentence of this question could very well be compatible with applicable WTO principles, if the exemption covered income derived from economic processes that take place outside of the territory of the relevant taxing jurisdiction. However, such a structure is not the only “scheme” that would comply with applicable WTO principles.”

4.919 What better demonstration can there be that the United States interpretation of footnote 59 is wrong.

Export Contingency

4.920 The United States did not contest the export contingency of the FSC subsidies in its First Written Submission or its Statement to the First Meeting of the Panel. There is some indirect consideration of this issue in the Second Written Submission of the United States, which the European Communities will now address.

4.921 This occurs when the United States seeks to respond to the European Communities' point that the 1981 Understanding refers to economic processes *in general* including those related to export activities when saying that they *need not* be subject to taxation by the exporting country. (And that it does *not say* that a GATT Contracting Party may *specifically exempt* transactions relating to exported goods even where other economic processes, which may be considered outside the territorial limits of the exporting country, *are* subject to tax⁴⁴³.)

4.922 The United States misrepresents the European Communities' argument as an “all-or-nothing” approach i.e. .

“A Member must either exempt all income from all foreign economic processes or tax all income from all foreign economic processes.”⁴⁴⁴

4.923 Of course, as an aside, this was not the European Communities' argument and the European Communities trusts that the Panel will, in this case as all others, refer to the arguments the European Communities has actually made and not the United States misrepresentations of them. But what interests us at the moment is not the misrepresentation but the United States reply since this is the only argument it makes on export contingency.

4.924 The United States argues that:

‘First, the Decision states that “in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country.” Second, the

⁴⁴³ The European Communities argument is at paragraph 54 of its Statement to the First Meeting of the Panel.

⁴⁴⁴ See paragraph 44 of the US Second Written Submission.

Decision states that such processes “should not be regarded as export activities in terms of Article XVI:4 of the General Agreement.”

With respect to the first point, if countries are under no obligation to tax income derived from foreign economic processes, then they should be free to exempt all such income or just part of it. There simply is nothing in the language of the Decision that compels a contrary conclusion.

As for the second point, if foreign economic processes are not export activities for purposes of Article XVI:4, then exempting such income from taxation cannot be considered to be contingent upon exports, as the European Communities contends. This is true irrespective of whether all foreign-source income or only foreign-source income related to export transactions is exempted.⁴⁴⁵

4.925 The first point is a complete *non sequitur*. It simply does not follow from the fact that countries are under no obligation to tax income derived from foreign economic processes, that they should be free to exempt just part of it on any condition they please.

4.926 The second point is clever false logic. One may consider that “foreign economic processes” (in the correctly understood sense of the 1981 Understanding) are not export activities for the purposes of Article XVI:4” but it does not follow that exempting from taxation income from “foreign economic processes” cannot be considered to be contingent upon exports. The statement A is contingent on B means that A is dependent upon or is conditional on B. For our purposes A is a subsidy and B is export performance. The subsidy in this case is the exemption from tax of certain income which the United States claims to arise from foreign economic processes. The condition for obtaining the subsidy is exporting United States “export property” as defined in Section 927(a) IRC. Even if it were to be the case that the FSC subsidies in this case (A) derive from a tax exemption of foreign economic processes which are not in themselves “export activities”, it is nonetheless clear that this advantage is contingent upon something that obviously is an export activity: the exporting of United States “export property” as defined in Section 927(a) IRC. The exportation of export property” is, the European Communities submits, an “export performance” (B in the definition of contingency just given).

4.927 Of course, this reasoning which the European Communities has just presented is designed to demonstrate the United States’ false logic and assumes for this purpose the United States propositions. Even on the basis of these propositions it is still export contingent. To be clear, the European Communities still maintains its position that many of the economic activities which are attributed to FSCs are not “foreign economic processes” at all.

4.928 The only other time that the United States mentions export contingency is where it says that

“In summary, footnote 59 belies the European Communities’ claim that under paragraph (e) any exemption, remission, or deferral of tax, even when contingent upon exportation, constitutes the foregoing of revenue that is “otherwise due” within the meaning of Article 1.1(a)(1)(ii).”

4.929 Here the United States is saying that footnote 59 excuses the FSC subsidies *even when contingent upon exports*. It does not and this is a matter which we will now consider.

Footnote 59 to Item (e) of the Illustrative List in Annex I to the SCM Agreement

Introduction

4.930 The United States relies heavily on footnote 59 to Item (e) of the Illustrative List in Annex I to the SCM Agreement which it claims contains or is “predicated by” a “controlling legal standard” to the effect that a Member has a right not to tax foreign economic processes and may make non taxation of these foreign economic processes contingent upon any condition it pleases including export performance. The European Communities will therefore spend some time going over the various

⁴⁴⁵ See paragraphs 46 to 48 of the US Second Written Submission.

elements of footnote 59 in order to leave the Panel in no doubt that it does not help the United States case.

The Nature of the Illustrative List

4.931 To put matters in context it is necessary to first recall the European Communities' position on the nature of the Illustrative List.

4.932 The European Communities has always insisted that the Illustrative List is *illustrative* – that is it contains a certain number of subsidies which are *deemed* to be *included* in the prohibition of export subsidies in Article 3.1(a). Footnote 5 excludes from the prohibitions of the SCM Agreement any subsidy which is referred to in the list as *not constituting* an export subsidy. This footnote does not however mean that the Illustrative List in Annex I can be applied *a contrario* so that a measure which does not fall within the terms of one of the Items of Annex I is not an export subsidy (or even is not a subsidy) and escapes the disciplines of the Agreement, including the general prohibition in Article 3.1(a). To benefit from footnote 5, it is necessary that there be a clear statement in Annex I that a measure *does not constitute* an export subsidy. There is one clear example of such an exemption and that is the second paragraph of Item (k) which exempts certain export credit practices which comply with the OECD Understanding.

4.933 If it were otherwise, the Illustrative List would be an exhaustive list and all sorts of measures could be argued to escape the prohibition. For example, Item (a) prohibits:

“The provision by governments of direct subsidies to a firm or an industry contingent upon export performance.”

4.934 An *a contrario* approach to the Illustrative List would mean that *indirect* subsidies to a firm or an industry contingent upon export performance escaped Item (a) and therefore prohibition by Article 3 !

4.935 The United States endeavours to make footnote 59 exhaustive of the disciplines applying to the FSC and would wish that if it could justify the FSC scheme under footnote 59 it would not need to be concerned with the clear incompatibility with Article 3.1. It argues as follows⁴⁴⁶:

The term “illustrative” signifies simply that not all types of financial contributions are covered by Annex I;

Where a particular paragraph of the Illustrative List does address a particular type of financial contribution, that paragraph sets forth the standard for determining whether the financial contribution is or is not a subsidy;

4.936 The United States interpretation makes the word “illustrative” lose its meaning and become a nullity. Article 3.1(a) already contains a general prohibition and the word “including” before the reference to the list. One does not therefore need the word “illustrative” to make clear that measures of a kind not described in the list may be covered by Article 3.1(a). The United States interpretation is reducing the word “illustrative” to inutility and would be contrary to the principle of effective treaty interpretation⁴⁴⁷.

4.937 The United States goes on to argue:

⁴⁴⁶ Paragraphs 76 to 77 of the US Second Written Submission.

⁴⁴⁷ See, e.g., Japan - Alcoholic Beverages, page 11.

The European Communities' approach to the Illustrative List would reduce predictability. Even if the terms of the item are complied with, a measure may still be a prohibited export subsidy;⁴⁴⁸

4.938 Of course the United States approach increases predictability. The narrower a prohibition, the more predictable it is. The more exhaustive a list, the more predictable it will be. Apart from footnote 5 (to which we will come in a moment), the European Communities sees no indication that the reference to the Illustrative List was designed generally to increase predictability about what does not fall under Article 3.1 – only to make clear that the listed measures do. On the contrary the general terms of the prohibition in Article 3.1 and the word “including” indicate a desire to establish a general principle, not detailed rules.

4.939 The United States then resorts to a presumed drafting history by arguing that it is

“extremely unlikely that the drafters of the SCM Agreement went to the trouble of crafting in the Illustrative List specific and detailed rules for particular types of financial contributions ... with the intent that those rules could be readily ignored in favor of more general standards found elsewhere in the SCM Agreement”;⁴⁴⁹

4.940 The European Communities disagrees with the United States views of the intent of the drafters of the SCM Agreement. As the United States has pointed out itself (in the context of a different argument), the Illustrative List in Annex I was taken over with very few changes from previous agreements were originally contained in a 1960 Working Party Report and approved in a Declaration. That working party made the following statement:

“The Working Party agreed that this list should not be considered exhaustive or to limit in any way the generality of the provisions of paragraph 4 of Article XVI.”⁴⁵⁰

4.941 That seems clear enough. In taking over the Tokyo Round development of this list with hardly any changes into the WTO SCM Agreement, WTO Members surely had the same intention not “to limit in any way the generality” of Article 3.1(a) of the SCM Agreement and the language they used reflected this.

4.942 Finally, the United States argues that footnote 5 would lose its meaning if an export-related measure could be regarded as a prohibited export subsidy notwithstanding the fact that the measure does *not* constitute an export subsidy under one of the paragraphs of the Illustrative List.⁴⁵¹

4.943 Footnote 5 does not lose its meaning under the European Communities' approach. It derogates from Article 3.1 but only where Annex I states that a measure does *not* constitute an export subsidy. The European Communities has given one clear example and that should suffice. Panels should not interpret provisions they do not need to interpret.⁴⁵²

4.944 Finally in this connection, the European Communities must add that as an exception to a general prohibition footnote 5 is to be construed restrictively and the burden of proving that a measure benefits from it would lie with the United States in this case.

Item (e)

⁴⁴⁸ See paragraph 78 of US Second Written Submission.

⁴⁴⁹ See paragraph 79 of US Second Written Submission.

⁴⁵⁰ BISD 9S/187, immediately following the list.

⁴⁵¹ See paragraph 80 of US Second Written Submission.

⁴⁵² See Appellate Body in *United States - Measure Affecting Imports of Woven Wool Shirts and Blouses from India*, (WT/DS33/AB/R of 25 April 1997) “... we do not consider that Article 3.2 of the *DSU* is meant to encourage either panels or the Appellate Body to “make law” by clarifying existing provisions of the *WTO Agreement* outside the context of resolving a particular dispute”.

4.945 Thus the European Communities' position is that the FSC subsidies are contrary to Article 3.1(a) of the SCM Agreement without any need to refer to the Illustrative List. However it is not at all afraid of the Illustrative List, nor its footnote 59 since these simply confirm the conclusion.

4.946 It is perhaps useful to look at Item (e) again. After hearing all this argument from the United States there is a danger of forgetting how clearly it prohibits the FSC subsidies. It brings under the prohibition:

“The full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.”

4.947 It is worth dwelling on Item (e) an instant since a footnote is only supposed to *explain* a provision not *contradict* it – as the United States seeks to do. The European Communities examined each element of Item (e) in its First Written Submission⁴⁵³ and having not seen any response from the United States presumes that it is accepted that they apply on their face to the FSC scheme.

The First and Last Sentences of Footnote 59 to Item (e)

4.948 It is important for the United States case to establish that footnote 59 does not explain Item (e) but “explicitly narrows”⁴⁵⁴ its scope. For this reason it briefly mentions the last and first sentences of footnote 59 (in that order). The last sentence states that:

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

4.949 This last sentence of footnote 59 may well guide the interpretation of Item (e) in a manner that is narrower than an alternative interpretation that might prevail in its absence.

4.950 The United States also mentions the first sentence of footnote 59 which states that:

“Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected.”

4.951 Again this is arguably narrowing the scope of Item (e). (Not contradicting, narrowing.)

4.952 However, the United States is not relying on either of these sentences to defend the FSC scheme and nor could it for a number of reasons. For example, the FSC scheme is not designed to reduce double taxation and there is no deferral of tax or interest charge in the FSC scheme.

4.953 The fact that the first and last sentences of footnote 59 might narrow Item (e) (a matter the Panel does *not* need to decide) does not show that the other sentences do so. The European Communities will now show that the sentences on which the United States is relying do not narrow Item (e).

The Second Sentence of Footnote 59 to Item (e)

4.954 The United States relies on the second and third sentences of footnote 59 (and the fourth sentence as regards its preliminary objection).

4.955 The second sentence states:

⁴⁵³ Paragraphs 157 to 162 of the European Communities' First Written Submission.

⁴⁵⁴ Paragraph 66 of the US Second Written Submission.

“The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length.”

4.956 For the European Communities, the second sentence of footnote 59 merely confirms the European Communities position based on the other provisions of the SCM Agreement that the export contingent derogation which the FSC scheme contained from its arm's length pricing rules can and should be considered an export subsidy.

4.957 The United States claims that this sentence “reinforces” the “qualifying nature of footnote 59”. The European Communities considers that the explanation the United States gives of its meaning does not reflect any “narrowing” of Item (e). On the contrary.

4.958 The United States considers that the second sentence:

“protects against WTO Members conferring an impermissible tax advantage on domestic-source income by allowing their exporting enterprises to shift income to tax-advantaged, related foreign enterprises. This could occur if taxing authorities allowed higher-taxed “exporting enterprises” to undervalue prices in relation to lower-taxed “foreign buyers.” Artificially shifting income in this way would result in a tax savings only if the related foreign company was taxed at a lower rate or not at all.”⁴⁵⁵

4.959 The European Communities for once does not disagree. Actually this is describing exactly what the administrative pricing rules of the FSC scheme do.

4.960 The United States seeks to achieve its desired “controlling legal standard” by reasoning that

“In fact, the sentence is relevant and has meaning only if WTO Members are permitted to tax *foreign-source income* to a lesser extent than domestic-source income or to exempt foreign-source income from tax altogether. If WTO Members are not free to do so, there would be no need for the drafters of the SCM Agreement to have included this provision. In such a circumstance, paragraph (e) would ban any tax advantage conferred on the *income of foreign entities* taking part in *export transactions*.”⁴⁵⁶

4.961 This is another example of false logic.

4.962 This piece of reasoning confuses very different concepts. *Foreign source income* and *income from export transactions* are different notions and may not be used interchangeably as the United States does here and in many other parts of its submission. It may be that income from export transactions will in many cases be foreign source income. In other cases however it will be domestic source income. It may also be that a part of an entity's foreign source income is derived from export activities. There are however many other sources of foreign source income (e.g. foreign manufacturing). The two concepts simply do not have the same content.

4.963 It does not follow from the fact that foreign source income may be treated differently than domestic source income that income from export activities may be baptised in all cases foreign source and exempted from taxation. That is effectively what the United States is doing by assimilating income from export transactions with foreign source income. If this were so the door would be wide open for tax-based export subsidies as the European Communities demonstrated with its question 8 discussed a moment ago.

⁴⁵⁵ Paragraph 67 of the US Second Written Submission.

⁴⁵⁶ Paragraph 68 of the US Second Written Submission.

4.964 The real explanation for the second sentence of footnote 59 is that there are a multiplicity of taxing jurisdictions around the world and some tax rates are lower than others. Indeed that is the main reason why transfer pricing rules exist and the United States in particular has such a well developed set of them. That is also why this sentence was considered necessary. It is not a declaration that Members are free not to tax foreign source income. It goes without saying that WTO Members may do this, just as they are free not to tax any income at all, provided that they do not grant exemptions which give rise to export subsidies.

4.965 The truth is that the second sentence of footnote 59 *widens* the prohibition of Item (e) by making clear that the authorisation of non-arm's length pricing rules may be considered an export subsidy.

4.966 The United States candidly admits that the special administrative pricing rules of the FSC scheme will not correctly allocate profit between the persons involved (the FSC and its related supplier) but claims that this is not its purpose and it is not referring to the kind of rules set out in Section 482 IRC or the OECD Guidelines but to the allocation of income between economic functions. According to the United States the FSC and its related supplier should not really be regarded as separate⁴⁵⁷ and that allocating all "income attributable to distributor functions" to the FSC is just a convenient device for taking advantage of a pretended WTO right.

4.967 However, it is plain from the text of the second sentence of footnote 59 that it is referring to the need for prices for goods in export transactions between exporting enterprises and foreign buyers under their or the same control *to be those that would be charged between independent persons acting at arm's length*. It is nowhere referring to the allocation of income between "*economic processes*." It refers to allocating income between persons.

4.968 Thus the reason for footnote 59 adopting the "arm's length" rule is to approximate as far as possible the conditions which would have prevailed in the absence of the privileged relationship between buyer and seller. As discussed above, however, the United States calls on the Panel not to regard the FSC and its related supplier as separate. In fact, the only thing the FSC legislation does is to create a fictitious allocation of income (on the basis of predetermined formulaic criteria) regardless of the processes actually performed by a FSC. It is therefore incompatible with the second sentence of footnote 59 and therefore a prohibited export subsidy under Item (e) and Article 3.1(a).

The Third Sentence of Footnote 59 and the de minimis Arguments

4.969 We come now to the third sentence of footnote 59. The United States does not mention this as narrowing Item (e) but rather tries to erect it into a burden of proof hurdle for the European Communities requiring the European Communities to prove that the FSC subsidies give rise to a "significant" saving of tax.

4.970 The European Communities has already set out its view of the third sentence to footnote 59 at length in its Second Written Submission and will be brief today. The third sentence only refers to the right to draw attention to such practices and the word "significant" is simply designed to avoid Members from invoking individual cases of minor importance.

4.971 The prohibition on export subsidies is absolute. There is no *de minimis* rule.

4.972 In any event, the FSC subsidies are significant at US\$2 billion per year and the relevant effect of the FSC scheme for companies is that they save 15-30 per cent of the tax charge on export transactions.⁴⁵⁸

Conclusion

⁴⁵⁷ Paragraph 109 of the US First Written Submission.

⁴⁵⁸ See paragraphs 36 and 138 of the European Communities' Second Written Submission.

4.973 The European Communities has shown above that the United States is entirely wrong to argue that footnote 59 narrows the terms of Item (e) in any manner relevant to the FSC scheme. On the contrary it simply confirms the correctness of the European Communities' categorisation of the FSC special administrative pricing rules as a prohibited export subsidy.

4.974 The European Communities would add that when the third sentence of footnote 59 refers to administrative and other practices it is not referring to laws but to de facto subsidisation, notably through administrative practices. It is not providing a derogation for non-conforming legislative measures. The addition of the word "administrative" to describe the special pricing rules is a cosmetic device seeking to take advantage of the Tokyo Round SCM Agreement.

The **United States** further responds in its Oral Statement at the Second Meeting of the Panel as follows:

4.975 In particular, we would like to use this opportunity to summarize for the Panel the numerous deficiencies in the European Communities' case that preclude a decision in the European Communities' favour. The European Communities' failings are both procedural and substantive. Perhaps most troubling, the European Communities has attempted to skate by on an overly simplistic theory of the case. The European Communities, in effect, has done nothing more than point out what is plain for all to see – namely, that the FSC is a tax exemption which pertains to exports. According to the European Communities, all such measures are necessarily prohibited export subsidies – irrespective of any exceptions or limitations built into the SCM Agreement or the AA. By asking the Panel to declare a measure to be a subsidy simply because the measure is specific, the European Communities is asking the Panel to overlook the language and structure of these agreements. In addition, the European Communities is asking the Panel to ignore the unique history that led to the enactment of the FSC.

4.976 Notwithstanding the many assertions made and questions raised thus far in this dispute, there are three principal issues confronting this Panel:

- (1) a threshold question of whether this case is ripe for decision on the merits or whether, instead, it should be dismissed or deferred;
- (2) whether the SCM Agreement and the AA incorporate or are otherwise consistent with the fundamental principle that countries are free not to tax income generated from economic processes outside of their territories without running afoul of WTO subsidy disciplines; and
- (3) if so, whether the WTO prohibits the use of rules of administrative convenience in allocating income attributable to foreign economic processes and whether the European Communities has met its burden of proving that the FSC administrative pricing rules contravene the arm's length principle of footnote 59 *and* result in a "significant" saving of taxes on income earned from activities taking place within the territory of the United States.

Dismiss or Defer?

4.977 With respect to the first question, the only point the United States will make here is that this case involves complicated tax provisions that are, in turn, tied to structural considerations that underlie the US tax system. Any decision in this case is likely to have far-reaching repercussions, not only for the US tax system but also for the tax systems of most, if not all, WTO Members. These features of this case make the satisfaction of procedural and evidentiary requirements even more important than they otherwise might be in a typical WTO case.

4.978 The significance of clearly defining and joining the issues, and of presenting well-documented, pertinent evidence, is further underscored by footnote 59 of the SCM Agreement. That unique provision specifically admonishes Members that disputes involving technical tax issues of transfer pricing should first be taken up in bilateral channels or a multilateral forum that is specialized in dealing with such issues. Not only should such a requirement be enforced in this case, but its existence also highlights the importance of having factual and legal issues carefully articulated, well developed, and supported by relevant, credible evidence.

4.979 The European Communities, though, chose to sidestep this route. Instead, the European Communities has attempted to incorporate the rules of one such tax forum – the OECD – into these proceedings. Ironically, the letter cited by the European Communities purportedly to demonstrate why it is appropriate to look to the OECD Guidelines in this case – a 1979 letter from the General Counsel of the Office of the US Trade Representative – actually belies this contention. *See* Exhibit EC-28. This letter, which was sent during the pendency of the Tokyo Round negotiations, identifies the difficulties associated with fashioning rules to address non-arm's-length practices that could amount to export subsidies. The letter notes the need for detailed rules in this area and suggests that the Illustrative List of Export Subsidies should be amended to include an interpretative note stating that the OECD Guidelines may be used to interpret paragraph (e). Of course, no such note was ever incorporated into the Illustrative List. Unlike Article 3 of the Agreement on the Application of Sanitary and Phytosanitary Measures, Article 2 of the Agreement on Technical Barriers to Trade, or even item (k) of the Illustrative List of Export Subsidies, item (e) and footnote 59 do *not* incorporate by reference external international standards, but instead require Members to resort to international mechanisms that deal with transfer pricing matters before invoking WTO dispute settlement.

4.980 Nonetheless, the European Communities has attempted to rely upon the OECD Guidelines because it has been utterly incapable of defining the arm's-length principle for purposes of the SCM Agreement without resort to extrinsic rules. Regrettably, instead of following the sound procedures the drafters of the SCM Agreement established and raising its claims in a forum dedicated to resolving such issues, the European Communities has attempted to take a short cut that ill-serves the WTO and does little to provide the Panel with a sound basis for resolving this dispute.

4.981 For these reasons, and for the reasons set forth in prior United States submissions, the first issue for this Panel to decide is whether this case is positioned to allow for an informed decision on the merits or whether, as the United States has urged, the explicit direction provided in footnote 59 for precisely this type of case should be followed.

The Tax Exemption Issue

4.982 If the Panel decides not to dismiss or defer this case in its entirety, the first and most important issue that the Panel must address is the tax exemption issue. More specifically, the issue is whether WTO subsidy rules leave Members free to tax, or not to tax, income generated from economic activities, including transactions involving exported goods, that occur outside of their territories. (For ease of reference, we identify such income throughout this statement as “foreign-source income.”) If the Panel reaches any part of the merits of this case, it must resolve this fundamental issue.

4.983 Therefore, the United States believes that the first priority among the substantive issues before this Panel is whether the principle on which the United States and other WTO Members have relied since 1981 remains valid. The resolution of this issue necessarily affects the analysis and resolution of the remaining issues in this dispute.

Article 1 of the SCM Agreement Incorporates the Principle that Foreign-Source Income Need Not Be Taxed

4.984 The European Communities, of course, argues that the Panel should begin its analysis with the general provisions of Article 1. In the view of the United States, the result when ones starts with

Article 1 is the same as when one starts with item (e) of the Illustrative List and footnote 59 – the exemption from tax of foreign-source income is not, in itself, a subsidy or an export subsidy. As the United States demonstrated in its second submission, when Article 1.1(a)(1)(ii) is interpreted in light of the 1981 Council Decision and footnote 59, it is clear that such an exemption does not constitute the foregoing of revenue that is “otherwise due.”

4.985 With respect to the status of the Council Decision, the European Communities has sought to muddy the waters on this issue, so let me restate for the Panel the United States position. The principal United States position is that the 1981 Council Decision is a “decision” within the meaning of paragraph 1(b)(iv) of the introductory language to GATT 1994. As such, the Council Decision, which interprets Article XVI:4 of GATT 1947, is part of GATT 1994. GATT Article XVI:4, in turn, constitutes part of the context of Article 1 of the SCM Agreement, as demonstrated by the text of the SCM Agreement itself and Appellate Body jurisprudence.

4.986 The European Communities contests that the 1981 Council Decision is a decision within the meaning of paragraph 1(b)(iv), and refers the Panel to paragraphs 45-52 of the European Communities' oral statement at the first meeting of the Panel. However, insofar as paragraph 1(b)(iv) is concerned, that portion of the oral statement simply recites the now well-known statement by the Appellate Body in the *Japan Liquor* case that adopted panel reports *in themselves* do not constitute “decisions” for purposes of paragraph 1(b)(iv).

4.987 The United States has responded to this argument, but it bears repeating that the United States is not asserting that it is the panel reports in the *Tax Legislation Cases* that constitute “decisions” under paragraph 1(b)(iv). If that were the case, then the FSC would be an export subsidy, because those reports found that the exemption of foreign-source income from tax constituted an export subsidy and that is what the FSC does. Instead, it is the *Council Decision*, which reversed the panel and which adopted a principle different from that relied on by the panel, that falls under paragraph 1(b)(iv) and, thus, has become part of GATT 1994.

4.988 The European Communities also argues that, even if the Council Decision does fall under paragraph 1(b)(iv), it is of no relevance to this case. According to the European Communities: “A decision taken in relation to Article XVI:4 of GATT 1947 cannot therefore assist in the interpretation of the [SCM Agreement].” Here, the European Communities is simply wrong. The text of the SCM Agreement and Appellate Body jurisprudence support the proposition that GATT Article XVI constitutes part of the context of the SCM Agreement, and, as such, must be taken into account when interpreting the SCM Agreement. In addition, as recognized by the panel in the *Indonesia Autos* case, established principles of public international law require a panel, to the extent possible, to interpret GATT 1994 and another Multilateral Agreement in a manner that avoids, rather than creates, a conflict between the two. Here, the European Communities is asking the Panel to create a conflict between GATT Article XVI and the SCM Agreement by ignoring the Council Decision, notwithstanding the fact that it is possible – indeed, desirable – to arrive at a harmonious interpretation of the two agreements.

4.989 Turning from the status of the Council Decision to its contents, the European Communities continues to maintain that what the Council meant to say was that only exporting countries *with territorial tax systems* need not subject foreign-source income to taxation without running afoul of GATT subsidies rules. Of course, the Council Decision does not contain any such limitation, and the European Communities has yet to explain exactly how the text of the Council Decision supports its interpretation.

4.990 The European Communities tries to muddy the waters even more by suggesting that the United States arguments are somehow inconsistent with the United States position that neither the WTO nor the SCM Agreement requires Members to adopt a particular tax system. To the contrary, the United States position in this case is thoroughly consistent. To reiterate, the United States view is that neither the WTO, nor the GATT before it, requires the maintenance of a particular tax system. In light of this, it is impossible to conclude that the GATT Council in 1981 or the Uruguay Round

negotiators in the 1990's contemplated rules under which only some countries with a particular type of tax system could exempt foreign-source income from tax and thereby favor exports over domestic sales.

4.991 The European Communities also has attempted to diminish the significance of the Council Decision by asserting that the concept of “foreign economic processes” is too vague to constitute a workable standard. As demonstrated by the United States in its second submission, the concept is not difficult to grasp – the “foreign” character of an economic process is determined principally by where the process is performed. Moreover, because it was EC member States, backed by the European Communities itself, that proposed the concept in 1981, this particular argument of the European Communities has no credibility whatsoever.

4.992 The European Communities also argues that the United States interpretation of Article 1.1(a)(1)(ii) is inconsistent with the interpretation taken by the United States under its own countervailing duty law. The European Communities cites a single countervailing duty determination from 1991, but does not attach the determination as an exhibit or explain what this determination allegedly says.

4.993 However, the countervailing duty regulations of the US Department of Commerce demonstrate that there is no inconsistency in the United States position. Attached as US Exhibit 25 are relevant pages from Commerce’s Notice of Final Rule containing the agency’s substantive countervailing duty regulations. Commerce’s regulation on direct tax measures is contained in Section 351.509 (page 65,411), and this regulation is explained in the preamble to the regulations. In the preamble, on page 65,376, Commerce states that it would not consider a foreign tax measure that meets the criteria of the Council Decision to be an export subsidy.

4.994 Yet another new European Communities argument relates to the tax expenditure list published by the US Department of the Treasury. In identifying the tax expenditure list as an authoritative source for the designation of FSC exempt income as “revenue foregone,” the European Communities reflects its ignorance of the purpose of that list, as well as its inability to articulate a standard that would be broadly applicable for purposes of the SCM Agreement.

4.995 Under United States law and practice, the term “tax expenditure” has a somewhat arbitrary definition. Tax expenditures are defined by the Congressional Budget Act of 1974 (Public Law 93-344) as “revenue losses attributable to provisions of Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability.” The Act also requires that a list of tax expenditures be included in the budget of the US Government.

4.996 However, the Act does not specify the baseline tax law against which special provisions or preferential tax rates can be compared. Therefore, identifying actual tax expenditures is a matter of judgment, and there is no theoretically correct baseline for measuring tax expenditures. For example, the Congressional Joint Committee on Taxation and the Executive Branch use different baselines and, therefore, sometimes disagree on whether or not a particular provision of the tax law is a tax expenditure. The Joint Committee uses a “normal” tax structure for the baseline. The normal tax structure is a comprehensive tax on income, where income is defined as the sum of consumption, taxes and the changes in net wealth in a given period of time. Beginning in 1983, the Executive Branch has used the “reference law” for the baseline. Reference law is a set of generally applicable, statutory income tax rules for measuring taxable income.

4.997 There are a number of differences between the two baselines, however. For example, under the Congressional normal tax baseline, tax expenditures arise because not all corporate income is taxed at the top corporate tax rate, because capital gains can be taxed at a rate lower than ordinary income, because capital equipment placed in service before January 1, 1997 can benefit from accelerated depreciation rules, and because the US tax on income of controlled corporations generally can be deferred until the income is repatriated to the United States. However, none of these

provisions is a tax expenditure under the Executive Branch's reference law baseline. Therefore, there is no national standard listing of tax expenditures.

4.998 Moreover, neither the Congressional nor the Treasury concept is designed to isolate measures representing "revenue foregone" within the meaning of the SCM Agreement. The Treasury listing includes such broadly based items as tax deductions for charitable donations and credits for child care. The breadth of the tax expenditure list demonstrates that it cannot be considered as a list of trade subsidies.

4.999 Indeed, if the United States were to institute a full exemption system covering all foreign-source income, the cost of that exemption would quite likely be on Congress' and/or Treasury's list of tax expenditures. However, based on the European Communities' arguments in this case, that item would probably not draw an European Communities challenge as "revenue foregone."

4.1000 In addition, exemptions and credits for foreign income show up on some EC member State expenditure lists. For example, in the OECD document entitled "Tax Expenditures: Recent Experiences" (OECD 1996), of which the European Communities provided only a few pages as an exhibit, Belgium admitted that exempting foreign-source income might be a tax expenditure. *See* US Exhibit 26, p. 34.

4.1001 A review of the OECD document in its entirety strengthens the point that tax expenditure lists are not a reliable basis for identifying "revenue foregone" under the SCM Agreement. A key point made early in the OECD report is that "countries' practices in presenting tax expenditure accounts vary substantially." US Exhibit 26, p. 9. Another key point made in the report is that, even taking into account the various country definitions of a "tax expenditure," "classifying statutory fiscal provisions as either part of the norm or an exception is difficult." US Exhibit 26, p. 10.

4.1002 More fundamental, however, is the fact that the SCM Agreement, when interpreted in light of the Council Decision, provides that countries may, but need not, tax foreign-source income. In light of that, the fact that a country chooses to identify the consequences of exercising this WTO-permissible choice in the form of a "tax expenditure" does not transform the exercise of that choice into a prohibited subsidy.

4.1003 In summary, the European Communities simply is wrong when it contends that the 1981 Council Decision has no relevance to this case and that Article 1 of the SCM Agreement does not incorporate the principle that Members are free to refrain from taxing foreign-source income without running afoul of WTO subsidy rules. It simply cannot be correct to hold now that the central premise of the Council Decision was vacated by the SCM Agreement without any statement in the text indicating that this was a purposeful design on the part of the drafters.

Article 3.1(a) of the SCM Agreement Also Incorporates the Principle that Foreign-Source Income Need Not Be Taxed

4.1004 Thus far we have been talking about Article 1 of the SCM Agreement and the fact that the FSC tax exemption does not constitute the foregoing of revenue that is "otherwise due." However, the United States continues to believe that the proper way to approach this issue is by beginning with the provisions of the SCM Agreement that most specifically deal with an income tax measure such as the FSC – Article 3.1(a), item (e) of the Illustrative List and footnote 59. As explained by the United States in its prior submissions, item (e) interprets the general provisions of Article 1 and Article 3.1(a), and footnote 59 further qualifies the coverage of item (e).

4.1005 The arm's length pricing language of footnote 59 would be largely bereft of meaning if the Panel were to conclude that the SCM Agreement requires foreign-source income to be taxed to the same extent as domestic-source income. Under such an interpretation, the use of non-arm's length pricing between related parties would not result in any tax savings, because all income would be taxed, regardless of whether more or less was allocated to the foreign entity. Thus, the arm's length

pricing language of footnote 59 is relevant only if WTO Members may treat the foreign portion of income derived from export transactions differently or more favorably than domestic-source income from the same transactions. This result is confirmed when the 1981 Council Decision is taken into account, the Council Decision also forming part of the context of Article 3.1(a), item (e) and footnote 59.

4.1006 The arguments in the European Communities' second submission regarding footnote 59 lack merit. First, the European Communities states, at paragraph 127, that a footnote can "explain" a provision but cannot "contradict" it. The European Communities offers no citation for this proposition, and the United States is not even sure what the European Communities means. In the view of the United States, regardless of the verb one uses, footnote 59 affects the meaning of item (e). In this regard, the United States also notes that there are other instances in the SCM Agreement where footnotes qualify the meaning of the text. An obvious example is footnote 5, which, as discussed in prior United States submissions, provides that a measure cannot constitute a prohibited subsidy under Article 3.1(b) if the measure is referred to in the Illustrative List as not constituting an export subsidy. Clearly, footnote 5 modifies the scope of Article 3.1(b).

4.1007 Another example is footnote 15, which appears to provide that the rebuttable presumption of serious prejudice for subsidies in excess of 5 per cent *ad valorem* does not apply in the case of civil aircraft, notwithstanding the text of Article 6.1(a). Is the European Communities seriously contending that Article 6.1(a) applies to civil aircraft because footnote 15 cannot, in the European Communities' words, "contradict" Article 6.1(a)? If so, my authorities will be *extremely* interested to learn of this change in the European Communities' interpretation of the SCM Agreement and the fact that the European Communities now believes that the rebuttable presumption in Article 6.1(a) applies to Airbus subsidies.

4.1008 The European Communities also cites the Rivers letter in connection with footnote 59. The United States is grateful to the European Communities for having submitted this particular exhibit, because it clarifies several things. First, in explaining the need for an arm's length principle in item (e), Mr. Rivers states that "enterprises may employ pricing practices which result in the attribution of excessive amounts of income to entities taxable in low or no-tax 'haven' jurisdictions. This shields income from export-related activity from taxation as effectively as does an exemption system." In so stating, Mr. Rivers was acknowledging that income shifted "offshore" in this manner could properly be exempted from tax without running afoul of GATT export subsidy rules, and that the only method of dealing with this – short of declaring that foreign-source income had to be taxed – was to establish an arm's length principle that would regulate the manner in which income could be treated as foreign-source income.

4.1009 Another interesting aspect of the letter is that, as previously noted, Mr. Rivers proposed an interpretative note that would have provided a basis for interpreting item (e) of the Illustrative List in light of whatever transfer pricing guidelines emanated from the OECD, at least in the case of OECD members. Again, such an interpretative note was not adopted, indicating that the drafters rejected the notion that OECD rules would govern for purposes of the arm's length principle in what is now footnote 59.

4.1010 The European Communities also attempts to minimize the significance of footnote 59 by citing the deletion in the footnote of two transitional references to the DISC contained in a predecessor provision, footnote 2 of the Tokyo Round Subsidies Code. Although the European Communities previously has acknowledged that item (e) was not the subject of negotiations during the Uruguay Round, the European Communities claims, at paragraph 51 of its second submission, that the deletion of these transitional provisions "indicates an intention not to continue any exemption for or tolerance of the DISC/FSC." This statement is a *non sequitur*. The referenced transitional provisions were eliminated because the DISC dispute had been resolved and the DISC itself had been eliminated. In particular, the deleted paragraph in footnote 2 referring to "measures incompatible with the provisions of paragraph (e)" could not have been referring to the "DISC/FSC", as claimed by

the European Communities, because the FSC did not even exist when the paragraph was drafted and entered into force.

4.1011 Finally, the European Communities continues to maintain that the Illustrative List does not set forth standards for determining what is and is not an export subsidy. In the view of the United States, the Illustrative List, in conjunction with footnote 5 and the “including” language of Article 3.1(a), evidences an intent on the part of the drafters to provide guidance as to how Members could structure assistance programmes in an acceptable manner without running afoul of WTO subsidy rules. Rather than repeat our arguments, the United States simply refers the Panel to paragraphs 74-80 of the Second US Submission.

Summary

4.1012 In summary, the United States believes that whether one starts with the specific provisions of Article 3.1(a), item (e) and footnote 59, or the general provisions of Article 1, the conclusion is the same – Members may exempt foreign-source income from tax without running afoul of the subsidy prohibitions of the SCM Agreement. Therefore, the FSC tax exemption in itself is not a subsidy or an export subsidy. Once the Panel reaches this conclusion, the Panel must proceed to resolve issues that all deal with questions of implementation; namely, whether the FSC system properly exempts foreign-source income from tax.

"Foreign" Economic Processes

4.1013 The first implementation issue the Panel must address is whether the economic activities that the FSC exempts from tax are foreign, as opposed to domestic. In its second submission, the European Communities has made three arguments.

4.1014 First, the European Communities argues that FSCs located in certain US territories are not “foreign,” even though those territories are not part of the metropolitan United States, are outside of US customs territory, and are outside of the US tax system. According to the European Communities, “the term ‘foreign’ must have some objective meaning.”⁴⁵⁹ The United States already has responded to this particular argument, and notes here only that “territory” is widely used throughout the GATT to mean “customs territory,” and that “customs territory” was the precise concept advocated by the European defendants in the *Tax Legislation Cases* when they proposed what became the 1981 Council Decision. The United States cannot understand, nor has the European Communities explained, how this concept has lost its “objectivity” since the time when its member States first proposed it.

4.1015 A ruling against the United States on this particular issue would invalidate the FSC system only to the extent that FSCs are located in US territories. However, because numerous FSCs are not located in US territories, this would not relieve the Panel from its duty to consider the other issues raised by the parties.

4.1016 A second European Communities argument is that because a FSC can subcontract activities to its related domestic supplier, this means that those activities are conducted in the United States. Here, there seems to be agreement between the European Communities and the United States that the “foreignness” of an activity is determined by where the activity is performed. However, the European Communities asserts, without any evidentiary support, that the fact that activities can be subcontracted means that those activities are performed in the United States. This is another European Communities *non sequitur*. The mere fact that a FSC may subcontract an activity to its parent – or to an independent agent, for that matter – does not mean that the activity is performed in the United States.

4.1017 In this regard, US Question #29 asked the European Communities to identify the precise portions of the First EC Submission and of any submissions made by the European Communities during the first meeting of the Panel that contain evidence supporting the European Communities'

⁴⁵⁹ Second EC Submission, paragraph 94.

assertion that the economic processes attributed to a FSC take place in the United States. The United States invites the Panel to look closely at the European Communities' answer to this question. In the view of the United States, this answer amounts to an admission by the European Communities that it has submitted *no* evidence to the Panel that supports its assertion that the FSC system actually exempts from tax income derived from economic processes occurring in the United States. This is a subject to which we will return when we discuss the FSC administrative pricing rules.

4.1018 A third argument that the European Communities makes for the first time in its second submission is that the FSC rules allegedly depart from the normal rules of the United States with respect to the determination of what constitutes “foreign-source income.” In particular, the European Communities points to Section 921(a) of the US Internal Revenue Code, which designates all FSC exempt foreign trade income as foreign-source not-effectively connected income.

4.1019 The European Communities' argument has no force. The United States does have rules for determining foreign-source income in appropriate contexts. However, one of these contexts – the application of the foreign tax credit – is irrelevant because FSC exempt foreign trade income is not eligible for double taxation relief under the foreign tax credit provisions. A FSC is eligible for double taxation relief only through the partial exemption itself, which is equivalent to the double taxation relief available under a territorial tax system.

4.1020 Moreover, the statutory treatment of FSC exempt income as “foreign-source not-effectively connected income” is consistent with the treatment of certain other foreign sales under United States sourcing rules. For example, a foreign company's income from a transaction consisting of a sale to a foreign customer and attributed to a United States office will be treated as foreign-source if a foreign office materially participated in the sale.

4.1021 Because of the principles applicable to foreign sales by nonresidents, it could be argued that absent Section 921(a), all income from FSC export transactions (at least in the case of a buy-sell FSC) would qualify for treatment as foreign-source, not-effectively connected income. It was the intention of Congress that the income exempted under the FSC system correlate to the anticipated level of foreign activity. Therefore, Congress limited the exemption by treating only 15/23 (65 per cent) of the income as exempt, which was done by providing that only exempt foreign trade income is foreign-source income and not-effectively connected income under Section 921(d) of the Internal Revenue Code. Most other FSC income is treated as non-exempt, US-source income that is effectively connected with a United States business under Section 921(d).

The FSC Administrative Pricing Rules

4.1022 Having established that the economic processes that the FSC seeks to exempt are foreign, the next set of implementation issues relate to whether the FSC administrative pricing rules properly allocate income between domestic and foreign economic processes in accordance with the standard set forth in footnote 59.

Significant Saving of Direct Taxes in Export Transactions

4.1023 The Panel could simplify its task greatly by addressing first an issue that appears last in the relevant text of footnote 59 – namely, the issue of whether the FSC administrative pricing rules result in a significant saving of direct taxes in export transactions. Even assuming for purposes of argument that the European Communities is correct with respect to all of its other contentions concerning the FSC administrative pricing rules, under the plain text of footnote 59, those rules do not give rise to an export subsidy unless they misallocate domestic-source income in a manner that gives rise to a significant tax saving in export transactions.

4.1024 As the United States previously has explained, the total tax saving generated by the FSC system is 0.93 per cent *ad valorem*. Because a portion of this tax saving reflects the exemption from tax of foreign-source income – income that properly may be exempted under the SCM Agreement –

the tax saving attributable to the exemption of domestic-source income, if any, must be some smaller figure. While the European Communities does not appear to take issue with the fact that the tax saving attributable to the exemption of domestic-source income is smaller than 0.93 per cent, it has not provided the Panel with any evidence as to what the relevant figure is, notwithstanding the fact that as the complainant in this case, the European Communities bears the burden of proof.

4.1025 Thus, the only empirical evidence before the Panel that is relevant to this issue is the 0.93 per cent figure itself and US Exhibit 21. In the view of the United States, the 0.93 per cent figure alone represents a tax saving that is not “significant” within the meaning of footnote 59, because this is less than the 1 per cent *de minimis* standard used in the SCM Agreement for countervailing duty purposes. In this regard, the United States is not, as claimed by the European Communities, arguing that there is a general *de minimis* standard applicable to all potential export subsidies. Instead, the United States is arguing: (1) in the case of income tax measures, the text of footnote 59 provides for a “significant tax saving” test insofar as transfer pricing is concerned; and (2) a tax saving that is *de minimis* for countervailing duty purposes cannot be considered as “significant.” Again, it is important to keep in mind that the tax saving, if any, attributable to the FSC administrative pricing rules is less than 0.93 per cent.

4.1026 With respect to US Exhibit 21, the information contained therein does not permit an estimated calculation of any improper tax saving attributable to the FSC administrative pricing rules. However, US Exhibit 21 does show that for the firms surveyed there was, in the aggregate, more foreign economic activity than required to justify the roughly 15 per cent tax exemption provided by the FSC. This suggests that even if some domestic-source income is included in exempt FSC income under the FSC administrative pricing rules, the amount of any tax saving is likely to be minuscule in the aggregate, and by no stretch of the imagination can be considered “significant.”

Administrative or Other Practices

4.1027 Should the Panel choose to deal with the FSC administrative pricing rules in a different order, then the first issue the Panel has to resolve is whether the SCM Agreement precludes a Member from using administrative rules of convenience, such as the FSC administrative pricing rules, at all.

4.1028 In the view of the United States, footnote 59 expressly contemplates that Members may use “administrative or other practices.” Even if these practices contravene the arm’s length principle, they are acceptable if they do not result in a “significant saving of direct taxes in export transactions.” Thus, footnote 59 contemplates that Members may rely on income allocation practices designed to approximate arm’s length results in the aggregate.

Arm's Length Results

4.1029 Assuming that administrative rules of convenience, such as the FSC administrative pricing rules, are permitted by the SCM Agreement, the Panel must determine whether the FSC administrative pricing rules generate results that, in the aggregate, are consistent with the arm’s length principle of footnote 59. This issue brings us back to the first defect in the European Communities' case. By raising its arm’s length claims about the FSC administrative pricing rules before this Panel rather than before an international body with more fully developed rules on transfer pricing, the European Communities has been compelled to resort to extrinsic texts in order to meet its burden of proof. Specifically, the European Communities has argued that the FSC administrative pricing rules violate the arm’s length principle of footnote 59 because they are purportedly inconsistent with the OECD Guidelines and Section 482 of the US Internal Revenue Code. However, nothing in the SCM Agreement suggests that these standards are applicable or even relevant.

4.1030 The European Communities has failed to provide a proper interpretation of arm’s length as that term is used in footnote 59. In fact, the European Communities has been unable to articulate what the arm’s length principle of footnote 59 means, the range of values it considers to be within that principle, and what range of values would not be within that principle. It would seem elementary that

the European Communities should be obligated to first identify the bounds of the arm's length principle before it can be said to have met its burden of proving that the FSC administrative pricing rules somehow achieve results that fall outside of it.

4.1031 Other than pointing to the OECD Guidelines and Section 482, the European Communities only argues that the FSC rules violate the arm's length principle because they result in more income being allocated to FSCs than their own direct activities would justify. According to the European Communities, unless FSCs themselves perform economic functions commensurate with their share of income from covered export transactions, the administrative pricing rules necessarily violate the arm's-length principle.

4.1032 The European Communities' entity-to-entity comparison might have force in other contexts, but not with regard to the FSC. FSCs are specifically designed to conform to the 1981 Council Decision. The purpose of the FSC statute is to create a mechanism for properly segregating the foreign aspect of export transactions, primarily the sales and distribution functions, from the domestic aspect, which is largely manufacturing.

4.1033 The administrative pricing rules allow a limited exemption to income that is attributable to foreign activities. Because the FSC is obligated to take responsibility and pay for the distributor functions, it does not matter whether the FSC, its related supplier, or a third-party performs them. If a FSC uses administrative pricing rules, it must always be the party that contracts for the services in question to be performed. Under this system, the FSC is properly credited with activities that occur outside the United States, and the tax exemption conferred under the rules corresponds to income derived from these activities.

4.1034 The FSC rules are consistent with footnote 59. They afford taxpayers and the taxing authority with alternatives to Section 482 that are more flexible and less burdensome, but nonetheless correlate to the income that may properly be attributed to the distribution and sales function in qualified export transactions. So long as the FSC rules, in the aggregate, exempt the proportion of income in export transactions that is attributable to foreign economic processes – and do not permit a tax savings for domestic-source income that is "significant" – they cannot be said to create a prohibited export subsidy.

4.1035 For its part, the European Communities has not supplied the Panel with any evidence demonstrating that the administrative pricing rules allow for a tax saving – let alone a "significant" tax saving – on domestic-source income earned in export transactions. Instead, the European Communities has argued that the FSC does not properly provide a tax exemption for foreign-source income because (a) FSCs may contract out their sales and distribution functions to their related United States suppliers and (b) FSCs may be incorporated in the Virgin Islands. For reasons that we previously have explained, neither of these arguments has merit.

4.1036 While the European Communities has failed to adduce evidence demonstrating that the FSC results in any tax savings on domestic-source income, the United States has supplied the Panel with empirical data in US Exhibits 20 and 21, which demonstrate that the FSC administrative pricing rules reach an overall result consistent with the arm's length principle and the principle that countries need not tax income earned outside their territorial borders. Specifically, the economic studies discussed in Exhibit 20 show that the FSC administrative pricing rules reflect an appropriate allocation of income between the FSC, which performs or pays for all sales and distribution activities, and the parent company, which is responsible for production activities. The survey discussed in Exhibit 21 shows that a cross-section of the largest United States exporting companies that use the FSC are exempted on a percentage of income that correlates overall with the level of economic activities involved in their FSC transactions which occur outside United States territory.

4.1037 As its legislative history clearly indicates, the FSC was designed by Congress specifically to comply with the principles of the 1981 Council Decision. Because neither the FSC in general, nor the FSC administrative pricing rules in particular, were designed to favor specific industries or products,

the pricing rules could not be tailored to reflect the manner in which specific products might be sold or specific industries might operate. On the other hand, any rule applied to all FSCs but modelled on the operations of a specific industry or product would have been inequitable and inflexible to an unacceptable degree.

4.1038 Consequently, Congress provided choices in I.R.C. Sections 924(d) and (e) that permit each FSC to adapt the tests for foreign economic processes to their own particular industry or market conditions. The requirements of Sections 924(d) and (e) ensure that FSCs must perform at least some key sales and distribution functions outside the United States. The survey results in Exhibit 21 show that the level of foreign economic activity actually involved in the FSC transactions of major exporters correlates favorably with the exemption level for FSC income. Thus, the FSC rules appear to be successful in carrying out Congress's intention of applying the criteria articulated in the 1981 Council Decision.

4.1039 In summary, the FSC administrative pricing rules constitute acceptable "administrative or other practices" that do not contravene the arm's length principle and that do not result in a significant saving of direct taxes in export transactions.

European Tax Systems

4.1040 The United States feels compelled to comment on the discussion in the European Communities second submission of the tax system of its member States. As the Panel knows, the United States contends that the results of the FSC tax exemption do not differ substantively from the treatment accorded exports under the tax systems of various EC member States. Apparently recognizing the force of this point, the European Communities spent a considerable amount of time in its second submission, especially in its Annex 2, attempting to deny the pro-export bias of the tax systems of its own member States.

4.1041 To reiterate, the United States position is that territorial exemption systems operate to favor export sales because they permit sales activities to be moved outside the home country and thereby benefit from lower tax rates in another jurisdiction. To demonstrate this point, let us consider the following hypothetical. Company C is taxed by its home country, Country C, at the full rate on commissions related to domestic sales of products manufactured and sold in the home country. However, Company C is not taxed at all by Country Z – or is taxed at a lower rate – on its commissions relating to sales of the same types of products made to foreign customers through a branch of Company C operating in Country Z, "Foreign Branch C." Assume the same commission of 100 for distribution functions incurred in both domestic and export transactions.

4.1042 Now let us consider what would happen under several European tax systems. If Country C is considered to be the Netherlands, the tax on the commission with respect to domestic sales conducted through a domestic branch would be 35, the commission being taxed at the full Dutch rate of 35 per cent. However, suppose that Country Z is the Netherlands Antilles and distribution activities are conducted through Foreign Branch C. Because the Netherlands Antilles has an income tax on commissions of 3 per cent, the Netherlands would not tax the commission based on its formalistic "subject to tax" test. The net result is that the tax on the commission incurred in the export transaction is only 3. As compared to the tax on the domestic transaction of 35, the result is an increased net income to Company C in the export transaction of 32.

4.1043 Turning to France, the example becomes slightly more complicated. In the case of a domestic transaction, the commission of 100 would be taxed at the full French tax rate of 40 per cent, resulting in a tax of 40. In the case of distribution activities conducted through Foreign Branch C, the outcome depends on whether Country Z is a country with which France has a tax treaty. Assuming that Country Z is not a treaty country, the 100 commission earned by Foreign Branch C is not taxed by France if Country Z's tax rate is such that the commission earned in Country Z is subject to tax by Country Z at two-thirds of the French corporate tax rate; *i.e.*, at 26.66 per cent. Assuming that

Country Z is Panama, which has a tax rate of 30 per cent, the commission of 100 on distribution activities is not taxed by France.

4.1044 Assuming that Country Z is a treaty country, there is no French income tax on the commission of 100 earned by Foreign Branch C. Assume also that Country Z is Ireland, which has a tax rate of 10 per cent.

4.1045 Under the French tax system, the net increase in income to Company C from using Foreign Branch C is as follows. For export sales conducted through Country Z/Panama, the increase is 10 (a Panama tax of 30 on the export transaction as compared to a French tax of 40 on the domestic transaction). For export sales conducted through Country Z/Ireland, the tax saving is 30 (an Irish tax of 10 on the export transaction as compared to a French tax of 40 on the domestic transaction).

4.1046 Turning to Belgium, again the analysis depends on whether the export transaction goes through a treaty or a non-treaty country. Because Belgium has a tax rate of 40.17 per cent, the tax on the commission of 100 in a domestic transaction would be 40.17. Assuming that Country Z is not a treaty country, the 100 commission earned by Foreign Branch C is taxed by Belgium at 25 per cent of the normal rate (*i.e.*, 10.04 per cent), provided that the commission is “subject to tax” in Country Z. Assuming that Country Z is Barbados, which has a tax rate of 2.5 per cent on an external company with an International Business Company licence, the combined Belgium/Barbados tax on Foreign Branch C’s commission of 100 is 12.54 per cent.

4.1047 In the case of a treaty country, Belgium imposes no income tax. Assuming again that Country Z is Ireland, the tax on Foreign Branch C’s commission would be 10.

4.1048 Thus, under the Belgian tax system, the net increase in income to Company C from using Foreign Branch C is as follows. For export sales conducted through Country Z/Barbados, the increase is 27.63 (a combined Belgium/Barbados tax of 12.54 on the export transaction as compared to a Belgian tax of 40.17 on the domestic transaction). For export sales conducted through Country Z/Ireland, the tax saving is 30.17 (an Irish tax of 10 on the export transaction as compared to a Belgian tax of 40.17 on the domestic transaction).

4.1049 Finally, let us consider Germany. Because Germany has a tax rate of 40 per cent, a tax of 40 would be imposed on the commission of 100 earned in a domestic transaction. However, Germany imposes no income tax on distribution activities conducted through a foreign branch in a treaty country. Thus, assuming again that Country Z is Ireland, the tax on the commission of 100 earned by Foreign Branch C would be 10. For export sales conducted through Country Z/Ireland, the tax saving is 30 (an Irish tax of 10 on the export transaction as compared to a German tax of 40 on the domestic transaction).

4.1050 Thus, notwithstanding the European Communities’ protestations to the contrary, the territorial or territorial-type tax systems of its member States provide a tax savings for distribution activities conducted through a foreign branch, a tax savings that is not available under the United States worldwide tax system.

4.1051 More generally, the European Communities notes that the tax systems of the United States and the European Communities member States share common objectives; namely, raising revenue, avoiding double taxation, and preventing tax avoidance. While the United States agrees that virtually all national tax systems are designed to achieve these and other objectives in one form or another, this fact is irrelevant to the key issue in this case; namely, that the tax systems of many EC member States exempt foreign-source income in export transactions from tax, or tax it at a lower rate, and that the FSC merely attempts to emulate this treatment.

4.1052 The European Communities rejects “the United States suggestion that any of its Member States exempts income from tax havens, such as Barbados and the US Virgin Islands.” Of course, anyone with any knowledge of European tax systems knows that this statement is inaccurate. In

several EC member States, it is possible to obtain a tax exemption from various tax havens, including Barbados. For example, Germany specifically includes Barbados on a list of developing countries from which certain dividend income is eligible for an exemption from German tax. US Exhibit 27. Also regarding Barbados, foreign branch profits of Dutch and Belgian companies would be eligible for an exemption (in the case of the Netherlands) and a significantly reduced tax rate (in the case of Belgium). The above examples only scratch the surface of the possibilities known to tax authorities and tax planners internationally for reducing European corporate taxes through tax haven transactions.

4.1053 The European Communities refuses to even concede a proven fact – That there are countries that do not tax foreign-source income of companies. European Communities countries that partially exempt foreign-source income include Belgium, France, the Netherlands, and Germany (by treaty). An even greater number of European Communities countries have participation exemptions under which income of foreign subsidiaries is repatriated to domestic parent companies tax-free. Contrary to what the European Communities asserts in its Annex 2, the United States believes that, notwithstanding anti-abuse rules, EC member States with participation exemptions generally permit the tax-free repatriation of foreign subsidiary sales income (even, in some cases, where the income is taxed abroad at a lower rate or not actually taxed at all).

4.1054 The European Communities contends that an exemption from tax for foreign-source income does not necessarily provide any advantage to European Communities exporters. Here, the European Communities implies that providing a foreign tax credit is the equivalent of providing an exemption. However, the two approaches are not equivalent. A foreign tax credit reduces home country tax by the amount of the creditable foreign tax. An exemption, on the other hand, eliminates home country tax on exempt income, often without regard to the extent of foreign tax imposed on the income. As the rate of tax may differ in the foreign jurisdiction, an exemption system is not simply aimed at eliminating double taxation, and the US foreign tax credit provisions do not achieve the effect of an exemption system.

4.1055 Finally, the European Communities appears to admit that an exemption system produces more favorable results for foreign-source income than for domestic-source income, and that this may lead to the imposition of higher taxes on domestic-source income. However, this appears to be merely a roundabout way of saying that export transactions are treated more favorably than domestic transactions in an exemption system, a proposition with which the United States wholeheartedly agrees.

4.1056 In summary, the statement by the European Communities that the tax systems of its member States ensure that income is subject to tax at a level similar to that applicable in the member State concerned simply is incorrect as a general proposition.

The **European Communities** argues as follows in response to questions from the Panel following the Second Meeting of the Panel:

4.1057 The European Communities has always understood the phrase “revenue that is otherwise due is forgone” as meaning that there is only a financial contribution and therefore a subsidy where an exemption or exclusion from taxation is not based on neutral and objective criteria, i.e. the exemption or exclusion is special or programmatic.⁴⁶⁰ As the European Communities has explained, this corresponds to the practice of both the European Communities and the United States in countervailing duty cases.^{461,462}

⁴⁶⁰ See paragraphs 72-83 of the European Communities’s Second Written Submission and 78-93 of the European Communities’s Oral Statement to the Second Meeting of the Panel. The European Communities noted that the terms “special” and “programmatic” are those used by the US in its contribution to the OECD Report on Tax Expenditures in Exhibit EC-25.

⁴⁶¹ See paragraph 80 of the European Communities’s Second Written Submission and 91-93 of the European Communities’s Oral Statement to the Second Meeting of the Panel referring to Exhibit EC-33.

4.1058 The United States' contribution to the OECD Report on Tax Expenditures provides criteria for determining where there is "revenue that is otherwise due is forgone" and therefore a financial contribution arising out of a tax measure⁴⁶³, which the European Communities is willing to adopt for the purpose of further explaining to the Panel its approach. The first is that "absent that special provision, the tax laws provided general rules to enable a taxpayer to determine his income tax due and payable". The second criterion would be that "*it is necessary that the special provision apply to a sufficiently narrow class of transactions or transactors to permit the specification of a programme objective that could be administered on the direct spending side of the budget with appropriate funds*". Lastly, the report states that one of the categories that have been labelled as tax expenditures "would consist of deviations from general rules of the existing tax system that could be measured and evaluated in a manner comparable to the measurement and evaluation of subsidy and transfer programmes on the outlay side of the budget".⁴⁶⁴

4.1059 The exemption from taxation of income arising out of economic activities occurring abroad (known in the tax field as "foreign source income") is not revenue forgone which is otherwise due and therefore a financial contribution under this test. It is a category of income which is defined in broad, neutral and objective terms and is applicable to all types of foreign source income and does not serve any special programmatic function. If the 1981 Understanding is considered relevant in this case, it constitutes clear confirmation of the fact that the exemption or exclusion from taxation of income from economic activities occurring abroad is not a measure by which "revenue that is otherwise due is forgone".

4.1060 The partial exemption from tax of income arising out of export activities with no equivalent exemption for similar income deriving from domestic transactions or for income deriving from equivalent foreign transactions on the other hand would come within the scope of "revenue that is otherwise due is forgone" and therefore a financial contribution under this test since it is a narrow "special or programmatic" exemption. Also, for the reasons that the European Communities has developed at length in its submissions⁴⁶⁵, it is not covered by any reasonable interpretation of the 1981 Understanding.

4.1061 The narrow, special and programmatic nature of the FSC scheme is clear from its terms and its design. It is expressly limited to income deriving from the export of United States "export property" and designed to promote exports. It is even expressly described by the United States as a "tax incentive for United States exporters," for example, in the title to the Department of Commerce document in Exhibit EC-3.⁴⁶⁶

⁴⁶² Paragraphs 4.1057-4.1064 reflect the European Communities' response to the following question from the Panel: The European Communities has stated, in its response to question 5 from the United States, that "the European Communities' position is simply that WTO Members are not prevented by the SCM Agreement from not taxing foreign source income if this is done on a general basis." In explaining its view of "revenue . . . otherwise due", the European Communities has further stated (paragraph 78 to its rebuttal) that "[w]hat is important is that there must be a deviation from or exemption to the generally applied rate or basis for collection for there to be a subsidy." (emphasis in original) Is it the view of the European Communities that the exemption of all foreign source income from taxation would not represent the foregoing of "revenue . . . otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement? Please explain in detail the legal basis for your view.

⁴⁶³ See Chapter III on page 108 of the document.

⁴⁶⁴ See last paragraph of Chapter III on page 109 of the document.

⁴⁶⁵ See paragraphs 53-55 of the European Communities's Oral Statement to the First Meeting of the Panel, 65-70 of the European Communities's 2nd Submission and 55-60 of the European Communities's Oral Statement to the Second Meeting of the Panel. The terms "special" and "programmatic" are those used by the US in its contribution to the OECD Report on Tax Expenditures in Exhibit EC-25.

⁴⁶⁶ The US describes the FSC scheme as a "programme" throughout the Treasury Reports in Exhibits EC-4 and EC-5.

4.1062 Other interpretations of the phrase “revenue that is otherwise due is forgone” can be developed, but the European Communities finds the one it proposes and the United States and the European Communities use in their countervailing duty practice to be the most reasonable one.

4.1063 First, the phrase could be interpreted as covering any revenue forgone compared with what would have been collected in the absence of the measure which is being complained against. This would be a more formalistic interpretation of Article 1.1 of the SCM Agreement which would simply rely on the measure under consideration being identified as an exemption or derogation from the rest of the legislation. An argument in favour of this interpretation would be that the more limited test which the European Communities is proposing involves a consideration of the nature of the exemption and may be considered to be importing a notion similar to that of specificity in Article 2 of the SCM Agreement into Article 1 of the SCM Agreement. This approach would clearly lead to the FSC as well as many other tax measures being considered subsidies for the purpose of Article 1 of the SCM Agreement. *Bona fide* tax measures (e.g. lower tax rates for SMEs) would, however, escape the disciplines of the SCM Agreement because they would not be “specific” within the meaning of Article 2 of the SCM Agreement. The FSC scheme would not escape because it is clearly contingent upon export performance and local content, and therefore specific by virtue of Article 2.3 of the SCM Agreement. The European Communities has not proposed this possible interpretation of the phrase “revenue that is otherwise due is forgone” since it considers that substance should prevail over form in the interpretation of the SCM Agreement and the more purposive and less formalistic approach proposed above is therefore more appropriate.

4.1064 Second, there is the interpretation of the United States which brings some extraneous notion of what Members have the right to tax or not to tax into the phrase “otherwise due”. The United States argues that revenue is not “otherwise due” if a Member has a *right not* to tax it under some rule of the WTO (and does not consider it relevant whether it would normally be taxed under that Member’s general rules). As the European Communities has explained most recently in paragraphs 84 to 85 of its Statement to the Second Meeting of the Panel, such a proposition cannot be correct. WTO Members have the right not to tax any income at all and the United States logic would lead to the conclusion that it could exempt a particular company or industrial sector from tax as it pleases. Indeed Article 1.1(a)(1)(ii) of the SCM Agreement and Item (e) could never apply.

4.1065 In conclusion, the European Communities submits that from all the above proposals, the one which better corresponds to the true meaning and purpose of Article 1.1(a)(1)(ii) is the approach given at the beginning of this response.

4.1066 The European Communities would first note that for the necessary assumption for this question is not just that the 1981 Understanding is relevant to the ASCM but that it is in particular relevant to Article 1 and the definition of a subsidy. The US has argued that it is relevant for the interpretation of footnote 59 to Item (e) in the Illustrative List to Article 3.1 and this does not of course make it relevant for Article 1.⁴⁶⁷

4.1067 However, making the assumption for the purposes of answering the question, the European Communities would observe that the phrase “*should not be regarded as export activities in terms of Article XVI:4 of the General Agreement*” is simply recalling that foreign activities and export activities are different notions and should not be confused. The purpose of this phrase in the 1981 Understanding is to clarify that countries (applying a territorial tax system) which choose to exempt

⁴⁶⁷ Paragraphs 4.1066-4.1067 reflect the European Communities' response to the following question from the Panel: The 1981 GATT Council decision states that, "in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country *and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement.*" Assuming – without prejudice to the parties' views on this issue – that the 1981 understanding is relevant to interpretation of the SCM Agreement, please comment on the significance, if any, of the highlighted language in terms of the concept of revenue "otherwise due" in Article 1 of the SCM Agreement.

income from foreign economic activities, do not provide an exemption for export activities which would be prohibited under Article XVI:4 of the GATT, because foreign activities and export activities are two separate notions, contrary to what the United States implies. An exemption for foreign source income is not prohibited because it is not specific to export activities. Moreover export activities are not necessarily foreign. Although these two positions derive directly from the 1981 Understanding and abide with the spirit of the WTO regarding subsidies, the United States is trying to extract from the 1981 Decision exactly the opposite; namely that an exemption specific to export activities is not prohibited, and that export activities are always foreign, even when FSCs perform virtually no foreign activities.

4.1068 The European Communities position as was stated at the second Panel meeting is that subsidies should abide with the requirements of Article 3.1(a) and (b) ASCM so as not to be prohibited under the ASCM. Tax exemptions give rise to prohibited subsidies only when they are contingent *in law* or *in fact*, whether solely or as one of a number of other factors (cumulative or alternative), on exports or local content. Differentiation among types of income (such as dividends, royalties, interest etc.) is acceptable as long as it is not contingent on export performance or local content. The European Communities cannot speculate on what would the US tax system look like if all, or some, of the above changes were introduced. It notes, however, that the FSC scheme could not simply be made available to entities, such as these described in the question, or this would be meaningless, considering that the entire FSC scheme is built around the notion of "export property".⁴⁶⁸

4.1069 The European Communities has explained its general position on the meaning of "otherwise due". For the purposes of determining whether there is revenue forgone "otherwise due", the baseline is not what countries allegedly have the right to do under WTO rules but what they have chosen to do.⁴⁶⁹

4.1070 In case the Panel is interested in a more detailed explanation of how "revenue that is otherwise due is forgone" arises under the FSC scheme, the European Communities will now illustrate its position by explaining further the details of the FSC exemptions and derogations. For this purpose, the European Communities will analyse which rules would be applicable in the absence of the FSC⁴⁷⁰ scheme for the same type of activities. Two comparable situations will be examined:

- (a) A United States corporation which handles its own export sales directly.
- (b) A foreign corporation (which is not a FSC) organised in a typical FSC location, which handles its United States parent's export sales.

4.1071 For situation (a) things are relatively easy. The United States company will be taxed on its worldwide income including all income from export sales at the currently applicable United States corporate tax rate. Part of its export sales income will be characterised as domestic and part foreign source income. This will not change, however, the way this income will be taxed. Thus there will be no exemption or deduction for foreign source income attributable to export sales. Therefore, for a given export transaction carried by the United States company directly there will be a 15 per cent or higher increase in its taxable income compared to the same transaction carried out through a FSC.

⁴⁶⁸ Paragraph 4.1068 reflects the European Communities' response to the following question from the Panel: Given the European Communities' view on the lack of consistency of the FSC with Article 3.1(a) of the SCM Agreement, would this view be modified if the FSC were also available to entities: (a) involved in importation of goods into the United States; (b) operating overseas in economic activities other than exportation from or importation into the United States; (c) both.

⁴⁶⁹ Paragraphs 4.1069-4.1082 reflect the European Communities' response to the following question from the Panel: Please provide further explanation regarding your view of the criteria to be applied in determining whether revenue foregone is "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.

⁴⁷⁰ The analysis may be done either on the basis of a FSC not benefiting from the special exemptions, absent the special FSC rules; or on the basis of a non-FSC entity performing FSC-type activities.

4.1072 Under situation (b), a “foreign export corporation”⁴⁷¹ (which is not a FSC) is involved. For this situation the analysis will be made on the basis of the standard rules which would be applicable absent the special exemptions of the FSC scheme as defined in the European Communities' Statement to the Second Meeting of the Panel paragraph 9. Each exemption and the special administrative pricing rules will be analysed separately.

4.1073 First, the special formulaic source rules. Absent the formulaic source rules of IRC Sections 921 and 923(a), the IRC standard source rules of Sections 861 et seq. would apply, which have been structured to determine the source of income based on factual evidence and which cover all types of income, including export income.

4.1074 In the case of a foreign export corporation conducting its business in the way that FSCs are entitled to do and employing its parent company to carry out the export sale, Sections 864(c)(4)(B)(iii)⁴⁷² and 865(e)(2) would apply. These provide that:

Section 864(c)(4)(B)(iii):

“Income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual or a foreign corporation if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable and such income, gain, or loss—

...

(iii) is derived from the sale or exchange (outside the United States) through such office or other fixed place of business of personal property described in Section 1221(1), except that this clause shall not apply if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in such sale.”

Section 865(e)(2):

“(A) IN GENERAL.- Notwithstanding any other provisions of this part, if a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business shall be sourced in the United States. The preceding sentence shall not apply for purposes of Section 971 (defining export trade corporation).

(B) EXCEPTION.- Subparagraph (A) shall not apply to any sale of inventory property which is sold for use, disposition, or consumption outside the United States if an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale.”

4.1075 The premises of the parent corporation will be “an office or other fixed place of business within the United States” (the FSC parent definitely qualifies as such under Section 864(c)(5) IRC) and the foreign export corporation has no *material* participation in such a sale (because assuming

⁴⁷¹ For the purposes of this analysis a “foreign export corporation” is defined as a subsidiary of a US manufacturing company incorporated in a typical FSC low-tax or no-tax jurisdiction, which handles its US parent’s export sales performing the same type of activities as a FSC. In other words, it is defined as a FSC which does not qualify for the special exemptions and the special pricing rules.

⁴⁷² Text contained in Exhibit EC-1 and referred to at paragraph 65 of the European Communities' First Written Submission.

financial and legal responsibility can hardly be considered a material participation). Therefore, under Section 864(c)(4)(B)(iii) IRC, the sale income would be considered as effectively connected with a United States trade or business, and under Section 865(e)(2) the sale income would be considered sourced in the United States. Under both circumstances, however all FSC income would be taxed in the United States. The FSC scheme has need of special source rules to function since otherwise all the income would be subject to tax in the United States.

4.1076 Consequently, although the usual United States position may be that the source of income from an activity depends on where the activity is performed, the European Communities notes that the generally applicable United States rule in these cases (i.e. which would be applicable if not for the special FSC exception) is that whenever a foreign company derives income from any sale of inventory property outside the United States through an office or a fixed place of business without that foreign company materially participating in the transaction, this income is taxed in the United States and that irrespective of where the activities of the office or a fixed place of business are performed.

4.1077 Second, the exception from the Subpart F rules.⁴⁷³ The foreign export corporation in this comparison would fall within the “controlled foreign corporation” definition of Section 957(a) IRC, and its earnings will constitute “foreign base company sales income” as defined in Section 954(d) IRC, which will have to be included in the taxable income of the United States parent corporation as a constructive dividend under Section 951(a) IRC. This means that the benefit of being taxed at zero or near zero levels in its country of incorporation will be lost because the same income will be taxed at current United States tax rates in the hands of the parent of the foreign export corporation. If the special exception from the Subpart F rules of Sections 951(e) and 954(d) and (e) did not exist, the FSC would receive the same treatment.

4.1078 Third, the 100 per cent deduction for dividends received from Foreign Trade Income under IRC Section 245(c). Under standard US tax rules there is no exemption allowed for dividends received from foreign source income of foreign subsidiaries. The United States parent may only receive a tax credit for foreign taxes paid abroad as a relief from double taxation. In the case of the foreign export corporation, however, there would be no (or almost no) foreign taxes to credit since it would be incorporated in a tax haven as most FSCs are.

4.1079 Fourth, the special pricing rules. The standard rules of Section 482 would apply to the foreign export corporation, which provide for an allocation of profits based on activities actually performed by the related entities. The determination of profits under Section 482 is always subject to re-allocation by the tax authorities and there are no safe harbours. Furthermore separate mechanisms apply for different types of industries and there are no catch-all rules such as the so-called “administrative pricing rules”. Thus a foreign export corporation that subcontracts all its activities back to its parent would only receive a transfer price equal to the parent’s costs of performing these activities. Under the special pricing rules of Sections 925(a)(1) and (2), however, the FSC that subcontracts all its activities back to its parent receives a transfer price equal to the parent’s costs of performing these activities **plus** an amount which will allow the FSC to derive income equal to the 23 per cent of the combined taxable income, or 1.83 per cent of the foreign trading gross receipts.

⁴⁷³ In footnote 56 of its second written submission, the US alleges that the Subpart F anti-deferral rules, are an exception to the general US system of deferral, and therefore since the FSC scheme provides for an exception to this exception the FSC follows the general rule. This argument however is erroneous because the US anti-deferral regimes have a wide scope of application and may not be considered as an exception in the FSC field of activities. In fact one of the major targets of the controlled foreign corporations provisions of Subpart F rules was the tax savings that could be realised under prior law by handling international trade activities through a foreign corporation incorporated in a tax haven country. As the European Communities stated in paragraph 96 of its Statement to the Second Meeting of the Panel, the Subpart F rules are not an “exception” in the sense of exemption; they are part of the US system of raising tax revenue – they do not result in the forgoing of revenue. It is the FSC scheme which is the exemption since it exempts revenue from this regime of taxation and therefore revenue is forgone which is otherwise due.

4.1080 Under the different methods prescribed by regulations under Section 482, the most appropriate for a foreign export corporation would be the resale price method described in Treas. Reg. 1.482-3(c). The resale price method is used in situations “involving the purchase and resale of tangible property in which the reseller [*i.e.*, the foreign export corporation] has not added substantial value to the tangible goods by physically altering the goods before resale.” Under the resale price method, the proper, arm’s-length transfer price between the related supplier and the foreign export corporation would be calculated by starting with the price actually charged by the foreign export corporation to its unrelated overseas customers and then subtracting an “appropriate gross profit.” The “appropriate gross profit” must be determined by reference to completely uncontrolled transactions – *i.e.*, transactions in which the reseller purchases the goods involved from an unrelated party and then resells them to another unrelated party. The uncontrolled transaction must be as comparable as possible to the controlled transaction, and the regulations direct that the factors to be considered in determining comparability include the “functions performed” by the reseller and the “risks borne” by the reseller.⁴⁷⁴ Given that the “functions performed” and the “risks borne” by a foreign export corporation are typically relatively minor, one would generally expect that the “appropriate gross profit” allowable for the foreign export corporation under normal arm’s-length pricing rules would be relatively small. Again, these considerations play no role in the administrative pricing rules under Section 925 IRC.

4.1081 Although it is not easy to determine to what extent the outcome of the special pricing rules varies from the outcome of the Section 482 rules, as this is different in every individual transaction, it is obvious that the special pricing rules produce transfer prices which are different from these under Section 482, since they are an optional and are used by most FSCs. If the Section 482 rule gave a more favourable result in any case, the FSC could use it.

4.1082 In conclusion, it is clear from the above analysis that the existence of the FSC scheme leads to the foregoing of “revenue ... otherwise due”, since absent the FSC rules, more tax would be payable for the same activities.

4.1083 The European Communities has explained that the “administrative” pricing rules constitute a separate prohibited subsidy under the SCM Agreement. The “administrative” pricing rules constitute a specific part of the FSC scheme separate from the other exemptions. Even if all the other special exemptions available to FSCs were abolished, the special pricing rules alone would provide a benefit for US exports. They would give rise to an independent violation of the SCM Agreement. First they constitute a subsidy since they confer a benefit by allocating to the FSC more income than may be attributable to the FSC minimal activities and participation in the transaction. Even assuming that all the FSC tax exemptions were abolished, this could still give rise to revenue forgone since the combined income of the FSC and its parent could still benefit from lower effective taxation than under the general US transfer pricing rules contained in Section 482 IRC (as explained above). Thus government revenue is foregone that would otherwise be due. In addition this subsidy is prohibited under Article 3 since it is contingent on export performance and the use of domestic over imported goods. Furthermore, the special pricing rules violate the arm’s length pricing requirement of footnote 59, although this does not necessarily need to be proved since the pricing rules violate Articles 3 and 1 even without the invocation of footnote 59.⁴⁷⁵

4.1084 One of the basic arguments the United States is making in the attempt to justify the FSC scheme under the SCM Agreement is that exempt foreign trade income is attributable to foreign activities or processes and therefore may not be taxed under the 1981 Understanding.⁴⁷⁶ The

⁴⁷⁴ See Treas. Reg. 1.482-3(c).

⁴⁷⁵ Paragraph 4.1083 reflects the European Communities' response to the following question from the Panel: Is the European Communities arguing that the special administrative pricing rules have a separate legal existence such that, even in the absence of the exemptions, they would be capable of giving rise to an independent violation of the SCM Agreement?

⁴⁷⁶ See *i.e.* paragraphs 12, 43-51, and 64-66 of the US Oral Statement to the Second Meeting of the Panel.

United States is likely to argue that these activities (or processes) whether performed by the FSC, or its related supplier, or an independent agent regardless of their residence, are foreign because they have to take place (partly) outside the United States.^{477,478}

4.1085 The European Communities submits that the FSCs' (or their subcontractors') activities are not foreign and that following the Regulations prescribed by the IRS these foreign economic processes tests are easily circumvented by FSCs by simply maintaining a mailbox and a bank account in the FSC's location of incorporation.

4.1086 Under IRC Section 924(d)(1)(A), the *foreign sales activities test* is satisfied if:

“such corporation [the FSC] (or any person acting under a contract with such corporation) has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction”

4.1087 As a general rule the location of any activity is determined by the place where the activity is initiated by the FSC and not by the location of any person transmitting instructions to the FSC.⁴⁷⁹ The “solicitation” and “negotiation” outside the United States requirements are satisfied by a communication by mail if the mail is deposited in a mailbox outside the United States.⁴⁸⁰ The “making of a contract” outside the United States requirement is satisfied if a written confirmation confirming the acceptance of an order, or confirming variable contract terms or specifying additional contract, is also sent through a mailbox outside the United States.⁴⁸¹ Once the FSC has participated outside the United States in an activity that constitutes one of the three foreign sales activities as described above, any prior or subsequent activity of the FSC will be disregarded.⁴⁸² The regulations explicitly provide that the disclosure of the identity of a FSC as a separate entity in the performance of the foreign sales activities is not required.⁴⁸³ All three forms of sales activities may be performed by the FSC or any other person under contract on behalf of the FSC.⁴⁸⁴

Under IRC Section 924(d)(1)(B) the *foreign costs test* is satisfied if:

“the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed 50 per cent of the total direct costs attributable to the transaction.”

Under IRC Section 924(e):

“The activities referred to in subsection (d) are-

- (1) advertising and sales promotion,
- (2) the processing of customer orders and the arranging for delivery of the export property,

⁴⁷⁷ See US first written submission, paragraph 50-51;

⁴⁷⁸ Paragraphs 4.1084-4.1094 reflect the European Communities' comment on the following question to the United States from the Panel: Let us assume that a FSC sub-contracts all foreign distribution and sales functions in connection with FSC transactions to its parent company and pays for them. In such circumstances, would the income generated by such transactions be considered foreign source income or domestic source income for fiscal purposes? In what proportion?

⁴⁷⁹ Reg.1.924(d)-1(a).

⁴⁸⁰ Reg.1.924(d)-1(c)(2) and (3).

⁴⁸¹ Reg.1.924(d)-1(c)(4).

⁴⁸² Reg.1.924(d)-1(c)(1).

⁴⁸³ Reg.1.924(d)-1(a).

⁴⁸⁴ Reg.1.924(d)-1(a).

- (3) transportation from the time of acquisition by the FSC (or, in the case of a commission relationship, from the beginning of such relationship for such transaction) to the delivery to the customer,
- (4) the determination and transmittal of final invoice or statement of account and the receipt of payment, and
- (5) the assumption of credit risk.⁴⁸⁵

4.1088 Again the disclosure of the identity of the FSC as a separate entity is not required in the performance of this test, and also these activities may be performed by the FSC or any other person under contract on behalf of the FSC.⁴⁸⁶

4.1089 With respect to the advertising and sales promotion costs requirement, generally, the location of advertising is the place to which the advertising is transmitted (even if initiated within the United States).⁴⁸⁷ Thus the advertising costs requirement may be fulfilled by taking out an advertisement in a foreign trade journal which includes all the export products marketed by it. Although the foreign direct costs allocated to each export transaction will be minimal, this fact will not prevent the FSC from meeting this test.⁴⁸⁸

4.1090 With respect to the processing of customer orders and arranging for delivery costs, this requirement may be satisfied by assuming the costs of communicating (telephone, telegram, or mail) from an office outside the United States the delivery or other details of the customer's orders to the related supplier, or carrier, or customer.⁴⁸⁹ Thus this requirement is fulfilled by simply having the FSC send a letter or make a telephone call, even when the related supplier, or carrier, or customer has independent knowledge of the order and requirements for delivery, and the communication is redundant.⁴⁹⁰

4.1091 With respect to the transportation costs, this requirement is satisfied by considering the FSC or its related supplier responsible for the property if it has title, bears the risk of loss, or insures the property during shipment. Once again the FSC may fulfil this requirement by simply holding the title over the goods and bearing the risk of loss, which may easily be arranged by its parent, without performing any foreign activity.⁴⁹¹

4.1092 With respect to the determination and transmittal of final invoice or statement of account costs, this requirement may be satisfied if the FSC undertakes the assembly of a final invoice or statement of account and the forwarding of that document to the customer from a location outside the United States.⁴⁹² "Assembly" is defined as folding of documents (where applicable), filling envelopes, and addressing envelopes. "Forwarding" is defined as mailing or delivery.⁴⁹³ Seldom have US tax principles been so clearly defined: fold it, stuff it, mail it, and the foreign cost requirement is fulfilled. With respect to the receipt of payment, the only thing the FSC has to do is receive a payment from the customer or the related supplier, in a foreign bank account (not even the principal bank account) equal to at least 1.83 per cent of the gross receipts associated with the transaction.⁴⁹⁴

⁴⁸⁵ Under IRC sec.925(c) a FSC must perform all of the activities described in section 924(e), in order to qualify for the use of the special pricing rules.

⁴⁸⁶ Reg.1.924(d)-1(a).

⁴⁸⁷ Reg.1.924(e)-1(a)(1)(iii)(A).

⁴⁸⁸ Reg.1.924(e)-1(a)(1)(i) and (v).

⁴⁸⁹ Reg.1.924(e)-1(b)(iv).

⁴⁹⁰ Reg.1.924(e)-1(b)(1) and (2).

⁴⁹¹ Reg.1.924(e)-1(c)(1) and (4).

⁴⁹² Reg.1.924(e)-1(d)(1)(i)(A) and (iii).

⁴⁹³ Reg.1.924(e)-1(d)(1)(i)(D).

⁴⁹⁴ Reg.1.924(e)-1(d)(2)(i), (ii) and (iii).

4.1093 With respect to the assumption of credit risk costs, this requirement is met if the FSC bears the economic risk of non-payment with respect to a transaction.⁴⁹⁵ This cost is by definition foreign since the “location of the activity of assumption of credit risk is the location of the customer or obligor whose payment is at risk”⁴⁹⁶, and the FSC does not need to do anything abroad to satisfy it.

4.1094 It is therefore clear that the above mentioned tests which, the United States alleges demonstrate the foreignness of the FSC activities, are easily fulfilled, or better circumvented, through a number of regulations that the European Communities has indicated in its First Written Submission as constituting part of the FSC scheme. In fact FSCs may satisfy the foreign economic processes requirements by maintaining a mailbox, through which mail is sent and received, and a bank account, where money is deposited and paid out in the FSC location of incorporation. The amount of activities a FSC, or a person operating under contract on behalf of the FSC, has to perform is minimal and when it comes down to foreign activities are almost zero. As demonstrated by these regulations the only thing most FSCs have to do is send and receive letters and manage a bank account. Therefore the allegation that the FSC tax exemption is permissible because FSCs have substantial foreign economic activities is totally absurd. The amount of tax exemption, provided through the formulaic source and pricing rules, that FSCs receive in no way corresponds to their minimal foreign activities.

The **United States** argues as follows in response to questions from the Panel following the Second Meeting of the Panel:

4.1095 The Panel’s question reveals the flaws underlying the European Communities' arguments with respect to Article 1 of the SCM Agreement. In order to cast the FSC as a subsidy while at the same time excluding its own territorial tax systems from the scope of that term, the European Communities has cobbled together a theory that contorts Article 1.1(a)(1)(ii) almost beyond recognition. The problem for the European Communities is that it can achieve the result it seeks only by interjecting concepts into that provision which simply are not there. Moreover, while the European Communities has asserted that its interpretation of Article 1.1(a)(1)(ii) is simple and straightforward, it has been unable to respond to the most basic questions concerning that interpretation. At both meetings of the Panel, whenever the Panel or the United States attempted to probe the implications of the European Communities' interpretation, the European Communities begged off by claiming that the questions were not easy to answer. However, if the European Communities' interpretation is as simple and straightforward as the European Communities claims it to be, why does the European Communities have such difficulty in answering basic questions about that interpretation?⁴⁹⁷

4.1096 As the Panel noted in its question, the European Communities first claims that exempting foreign-source income from taxation does not constitute a subsidy provided that it is done “on a general basis.” However, the concept of general or specific application of a measure is simply not a part of Article 1. Not only does the language of Article 1.1(a)(1)(ii) make no reference to the breadth of application of a measure, but Article 1.2 makes clear that “[a] subsidy as defined in paragraph 1 is subject to parts II, III or V of the Agreement” only “if such a subsidy is specific in accordance with the provisions of Article 2.” Article 1.2 makes clear that the question of general or specific application of a measure is reached under Article 2 only following an initial determination that a measure is a subsidy under Article 1.

⁴⁹⁵ Reg.1.924(e)-1(e)(1).

⁴⁹⁶ Reg.1.924(e)-1(e)(3).

⁴⁹⁷ Paragraphs 4.1095-4.1099 reflect the United States' comment on the following question to the European Communities from the Panel: The European Communities has stated, in its response to question 5 from the United States, that "the European Communities' position is simply that WTO Members are not prevented by the SCM Agreement from not taxing foreign source income if this is done on a general basis." In explaining its view of "revenue . . . otherwise due", the European Communities has further stated (paragraph 78 to its rebuttal) that "[w]hat is important is that there must be a deviation from or exemption to the generally applied rate or basis for collection for there to be a subsidy." (emphasis in original) Is it the view of the European Communities that the exemption of all foreign source income from taxation would not represent the foregoing of "revenue . . . otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement? Please explain in detail the legal basis for your view.

4.1097 Alternatively, in contending that tax exemptions for foreign-source income are not subsidies only if they are provided “on a general basis,” the European Communities appears to be arguing that such a practice is a subsidy only if it is limited to exports. If so, then the European Communities is confusing Article 1 with Article 3. The existence of an export contingency is relevant only where a measure is a subsidy. If a measure is not a subsidy, it is immaterial whether or not it is contingent on exports.

4.1098 More importantly, the mere existence of an exception to otherwise applicable tax provisions cannot, in and of itself, establish the existence of a subsidy where foreign-source income is at issue. The European Communities' argument might have some merit in other contexts, but not here. Whether foreign-source income is exempted because a tax system does not extend to it, or because a provision directly states that it is not subject to taxation, the economic result is the same.

4.1099 These considerable deficiencies in the European Communities' position are attributable to the fact that the European Communities is, in effect, asking the Panel to reduce Article 1.1(a)(1)(ii) to nothing more than a rule instructing WTO Members on how to draft tax exemptions for foreign-source income so as not to have them labelled a subsidy. If the European Communities has its way, a Member would confer a “subsidy” if it exempted foreign-source income from taxation through an overt measure, but the very same practice would not be a subsidy if it were achieved indirectly or by omission. Such an outcome would fly in the face of the WTO's many rules and principles promoting transparency in laws affecting international trade. Proper interpretation under public international law surely precludes reaching such an absurd result. With respect to the meaning of the GATT Council's decision, the Council made two important points. First, GATT Article XVI:4 does not oblige countries to tax foreign-source income (including income derived from an export transaction), and the failure to tax such income is not a subsidy or otherwise problematic under GATT subsidies disciplines. This derives from the language of the Council's decision, which states that “in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be taxed.” In so stating, the Council rejected the finding of the panel in the *Tax Legislation Cases* that a decision not to tax foreign-source income constituted the foregoing of revenue.⁴⁹⁸

4.1100 The second important point is that for purposes of Article XVI:4, foreign economic processes, including those related to export transactions, are not export activities in the sense of that Article and a decision not to tax income derived from them does not constitute an export subsidy. This follows from the portion of the decision which states that “economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement.”

4.1101 It is easy to see the connection between the first point and Article 1 of the SCM Agreement. In declaring that income derived from foreign economic processes need not be taxed, the GATT Council made plain that a decision not to tax such income is entirely appropriate and that no consequences under international trade rules should flow from a country's decision not to do so. Likewise, the connection between the second point and Article 3 of the SCM Agreement is clear. If foreign economic processes are not export activities, then no export contingency can be said to exist.

⁴⁹⁸ Paragraphs 4.1099-4.1102 reflect the United States' comment on the following question from the Panel: The 1981 GATT Council decision states that, “in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement.” Assuming – without prejudice to the parties' views on this issue – that the 1981 understanding is relevant to the interpretation of the SCM Agreement, please comment on the significance, if any, of the highlighted language in terms of the concept of revenue “otherwise due” in Article 1 of the SCM Agreement.

4.1102 At the same time, the second point is also relevant to the “otherwise due” language of Article 1. In deeming foreign economic processes not to be export activities, the GATT Council was saying that foreign economic processes connected to export transactions are wholly foreign and, accordingly, tax exemptions for income derived from them are entirely outside the scope of the GATT subsidy disciplines. In so providing, the GATT Council was drawing a distinct, bright line at the borders of taxing nations. Insofar as subsidies rules are concerned, the Council took the position that an exporting country’s obligation to tax export income in the same manner as income from domestic sales stops at the country’s border. Where income is attributable to economic activities occurring outside a taxing country’s borders, such income is unrelated to that country in the eyes of the GATT (and, now, the WTO), and a decision not to tax such income cannot be said to be a financial contribution from that country under SCM Agreement Article 1.

4.1103 In the context of an obligation arising out of an international agreement, one obvious criterion is whether there has ever been a decision or ruling under the same or a related agreement that a particular tax practice constituted foregoing revenue that was “otherwise due.” If so, that would be an appropriate criterion in determining the meaning of those terms. In this instance, of course, precisely that has occurred. In 1981, the GATT Council essentially decided that the failure to tax foreign-source income did not constitute the foregoing of revenue, and the Council’s decision forms part of the context for interpreting Article 1.1(a)(1)(ii). As discussed in the response to Question 3, that decision answered the point now at issue on two, equally dispositive grounds. Moreover, as discussed in the response to Oral Question 15, that decision is part of GATT 1994.⁴⁹⁹

4.1104 Another criterion would be the desirability of avoiding results that exalt form over substance. As discussed above in connection with Question 2, outcomes should not differ depending upon whether a Member chooses (a) to exempt a category of income from tax, or (b) not to tax the income in the first place.

4.1105 Yet another criterion to consider is the need to have clear rules so that Members are in a position to know what is and what is not permitted by the SCM Agreement. The need for clear rules is particularly important where, as in this case, trade rules interact with the complex realm of international taxation. In the absence of clear rules, it becomes extremely difficult in this context to determine when revenue foregone is “otherwise due.”

4.1106 The 1981 Decision provides just such a clear rule. The Council’s declaration that foreign source income need not be taxed was tantamount to declaring that tax on foreign source income is not “otherwise due.” The desirability of such a clear rule is demonstrated by a few examples that illustrate the arbitrary results achieved when one relies on domestic law as a basis for determining when foreign source income is “otherwise due”.

4.1107 Example One: This example illustrates the difficulty of distinguishing a “baseline” rule from an “exception” under exemption systems.

As discussed in paragraphs 180 and 181 of the Second US Submission, under the Dutch income tax system, for resident companies, both Dutch-source income and income derived from sources outside the Netherlands are subject to taxation. In other words, corporate income tax is levied on worldwide income. However, in the case of income earned abroad by a Dutch company, a company fulfilling the requirements under Dutch tax law is entitled to relief that has the effect of exempting foreign income from Dutch tax.

As described in footnote 116 of the Second US Submission, under the French income tax system, which is based on the principle of territoriality, the income tax law

⁴⁹⁹ Paragraphs 4.1103-4.1114 reflect the United States' response to the following question from the Panel: Please provide further explanation regarding your view of the criteria to be applied in determining whether revenue foregone is "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.

generally is not applicable beyond French territorial limits. There are, however, exceptions, such as tax consolidation and special but temporary foreign investment tax incentives. In addition, as discussed in Example Two, below, there also is an exception providing for the taxation of certain “low-taxed income”.

4.1108 When viewed together, the Dutch and French systems are similar in that both provide certain exemptions for foreign-source income. However, if the tax laws of each system are viewed in isolation, the Dutch system might be considered as resulting in the foregoing of revenue that is otherwise due, because the exemption for foreign-source income might be viewed as an exception from the basic principle of worldwide taxation of Dutch companies. The French system, on the other hand, might not be considered as resulting in the foregoing of revenue that is otherwise due, because an exemption might be viewed as the basic rule, with the taxation of foreign-source income being the exception.

4.1109 Example Two: This example indicates the difficulty of distinguishing the “baseline rule” from the “exception” under a tax system with anti-abuse rules and exceptions to these rules.

As described in Example One, above, as a general rule, profits earned in foreign branches and foreign subsidiaries are not taxed by France. However, this exemption is subject to a limitation. Under this limitation, France imposes its full corporate income tax on the income of a foreign branch or foreign subsidiary where the income is earned in a jurisdiction that imposes a tax of less than 2/3 of the French tax. *See* Second US Oral Statement, paragraph 73. This low-taxed income limitation is also subject to exceptions, including, for example, where the low-taxed income is exempt under an income tax treaty.

4.1110 In attempting to distinguish between the baseline and the deviation in Example Two, one possible approach is to consider the French general exemption as the baseline rule and the low-taxed-income exception as a deviation from the baseline rule. Viewed in that light, any exception that would exempt low-taxed income would simply represent an application of the fundamental rule – the exemption from tax of foreign-source income – and would not constitute the foregoing of revenue that is “otherwise due.”

4.1111 Under a different approach, however, the fundamental rule could be viewed as the rule under which low-taxed foreign-source income is taxed by France. Under this approach, any exception that would exempt low-taxed foreign-source income could be viewed as the foregoing of revenue that is “otherwise due.” However, it appears completely arbitrary to consider the taxation of certain low-tax income as part of the baseline and then not to consider any exceptions under that provision as also part of the baseline.

4.1112 Example Three: This example illustrates the arbitrariness of arriving at different results depending on the manner in which anti-abuse rules are formulated.

The income tax systems of Denmark and the United States operate under the same general rule that the domestic taxation of the foreign income of foreign subsidiaries is deferred until the income is repatriated to domestic shareholders in the form of dividends. Denmark has a controlled foreign corporation (CFC) regime that requires the current taxation of only low-taxed passive income of foreign subsidiaries.⁵⁰⁰ The United States has a broader CFC regime, which requires the current taxation of low-taxed passive income, but also the current taxation of certain active foreign income, subject to various exceptions. However, the US CFC regime also has some limitations.

⁵⁰⁰ *Studies in Taxation of Foreign Source Income: Controlled Foreign Company Legislation*, Organisation for Economic Co-operation and Development (OECD 1996), p. 55.

4.1113 The effect of the United States limiting provisions is to make the scope of its CFC regime narrower, but not as narrow as Denmark's CFC regime. Because the norm of both countries is deferral, it would be arbitrary to declare the United States anti-deferral CFC regime to be the United States baseline while at the same time declaring Denmark's baseline to be deferral simply because the United States "exception" – its CFC regime – is not as narrow as Denmark's.

4.1114 In this regard, the European Communities has emphasised that the United States rules for FSCs are part of the Administration's tax expenditure list.⁵⁰¹ However, the fact that a provision regarding the non-taxation of foreign-source income is listed in a country's tax expenditure list is not dispositive of whether there is foregone revenue that is "otherwise due." First, for all the reasons set forth in the Oral Statement of the United States at the Second Meeting of the Panel, a country's tax expenditure list is not determinative for purposes of the SCM Agreement, regardless of whether a country uses "reference" law, "normal" law, or both. Second, if the rule under the SCM Agreement were that a country's tax expenditure list is determinative, a country could easily manipulate the rule by simply redefining its expenditure list. In addition, there would be no consistency from country to country in the absence of a single definition of tax expenditure applied by all authorities in all jurisdictions. For the sake of fairness and consistency, a clear, transparent test is needed under the SCM Agreement. The core principle of the 1981 Decision that "foreign source income need not be taxed" translates into a clear test that "tax on foreign source income is not otherwise due" within the meaning of Article 1.1(a)(1)(ii).

4.1115 Footnote 59 is directly relevant to the FSC administrative pricing rules, which were designed specifically to comply with fundamental principles of both US tax law and GATT law, as articulated in the 1981 Council Decision and in what is now footnote 59. The language of footnote 59 must be read in context. It narrows the scope of item (e) of the Illustrative List by implicitly recognizing that a Member may exempt foreign-source income from tax.⁵⁰²

4.1116 As a factual matter, export transactions normally involve a domestic seller and a foreign buyer. Where those entities are not related, the arm's length principle would ordinarily be observed simply as a result of market forces. Where those entities are related, footnote 59 reaffirms that the arm's length principle applies to transactions between those entities, as well. The second sentence of footnote 59 rests on the assumption that the income of a foreign entity need not be taxed to the same extent as income earned by a domestic exporter. Otherwise, in the context of item (e), it would not matter whether exporting companies observed arm's length pricing in their dealings with related foreign buyers, because deviations from the arm's length principle would not result in any saving of taxes. All of the income, regardless of how it might be allocated between the domestic exporter and the related foreign buyer, would have to be taxed.

4.1117 Because a country need not tax foreign-source income, an excessively low transfer price from the domestic seller to the foreign related buyer could result in an improper reduction of taxes. The seller would be subject to tax on a lesser amount of profit than should properly be attributed to its domestic activities. The foreign related buyer would earn too much profit on its foreign activities in reselling the goods, and all of that profit could be exempt from taxation by the home country.

4.1118 Under the third sentence of footnote 59, if this deviation from the arm's length principle were too great, it could lead to a significant saving of taxes and result in WTO Members' bringing that deviation to the home country's attention in a proper forum. When read together, it is apparent that the second and third sentences of footnote 59 are intended to ensure that taxes on income from domestic activities are not improperly exempted to a significant degree due to the manipulation of

⁵⁰¹ See the Second EC Submission, paragraph 84 - 90.

⁵⁰² Paragraphs 4.1115-4.1122 reflect the United States' response to the following question from the Panel: The second sentence of footnote 59 appears to address the issue of arm's length pricing between *entities*. The United States has explained that FSC special administrative pricing rules are intended to allocate profit arising from foreign and domestic economic *activities*. In light of this fact, please explain why footnote 59 is relevant to the FSC's special administrative pricing rules.

transfer prices on sales of goods between related entities so as to shift profits from an entity in the home country (which would be taxable) to an entity in a foreign country (which could be exempt).

4.1119 Although the language of the second sentence of footnote 59 is specifically directed to a situation similar to that of buy-sell FSCs, where there are sales of export goods among affiliated entities, the concerns raised in the preceding paragraph apply equally to commission transactions, in which a foreign entity engages in commercial activities but does not actually take title to exported goods. The improper allocation of fees in this situation could also lead to the exemption of income derived from domestic economic processes. To avoid such a loophole, footnote 59 must be interpreted as permitting an analogous allocation of income between domestic and foreign economic processes for related party transactions involving the payment of a commission, such as in the case of a commission FSC.

4.1120 The FSC transfer pricing rules in I.R.C. Section 925(a) are written in much the same terms and with much the same purpose as footnote 59. Because a FSC must be a foreign entity, and because some of its income is exempted from US taxation, the transfer pricing rules must properly allocate the income from FSC transactions between FSCs and their related entities. Section 925(a) provides rules for the allocation of income to FSCs by reference to the transfer price of eligible property in sales from the related entities to the FSCs.

4.1121 The link between footnote 59, the administrative pricing rules in Section 925(a), and the allocation of profits to foreign economic activities is that FSCs are allocated a portion of the profits from FSC transactions that correlates to the income attributable to foreign distribution and sales activities. The European Communities claims that this allocation is improper because footnote 59 allegedly requires an analysis based on the activities performed by the FSC with its own personnel. However, the text of footnote 59 does not call for such an approach. To the contrary, it is not inconsistent with the arm's length principle of footnote 59 to allocate income attributable to foreign distribution and sales activities to FSCs, because FSCs are required to perform, or pay for, all of those activities if they use the administrative pricing rules. Indeed, US Exhibit 20 demonstrates that the allocation of profits to FSCs falls within appropriate arm's length ranges for entities performing, or paying for, distribution and sales activities.

4.1122 In sales to customers outside the United States, such activities are foreign because they will of necessity occur predominantly outside the United States. Thus, the allocation of profits to FSCs under Section 925(a) reflects primarily an allocation between income attributable to foreign and to domestic activities. By imposing income tax directly on a substantial percentage of FSC income, the United States ensures that the portion of income exempted from tax will not deviate significantly from the portion of income attributable to foreign economic activities undertaken in connection with FSC sales. US Exhibit 21 provides some empirical evidence of the correlation between foreign economic activities and the amount exempted. No significant saving of direct taxes on domestic economic activities has occurred, and the principles of footnote 59 have been respected. The European Communities has not shown otherwise.

4.1123 The European Communities must speak for itself on this question, because the United States believes that the FSC as presently constituted is in full compliance with the SCM Agreement.⁵⁰³

4.1124 However, the United States notes that the Panel's question identifies a fundamental defect in the European Communities' arguments concerning Article 3.1(a). The European Communities asserts that what is relevant in the present dispute is how the United States taxes the three categories of foreign-source income referred to above. Assuming for purposes of argument that the

⁵⁰³ Paragraphs 4.1123-4.1124 reflect the United States' comment on the following question to the European Communities from the Panel: Given the European Communities' view on the lack of consistency of the FSC with Article 3.1(a) of the SCM Agreement, would this view be modified if the FSC were also available to entities: (a) involved in importation of goods into the United States; (b) operating overseas in economic activities other than exportation from or importation into the United States; (c) both.

European Communities assertion is correct, then the European Communities' case must fail *because the US tax system does, in fact, exempt these categories of foreign-source income from tax*. It should not matter whether the United States creates the exemption in one all-inclusive provision or in multiple, separate provisions, and the fact that US tax laws may appear different from, or more complex than, the laws of territorial tax systems is beside the point.

4.1125 To the extent that the term “foreign distribution and sales activities” in Question 7 refers to distribution and sales activities conducted outside the territory of the United States, all income attributable to those activities would be income attributable to foreign economic processes. It would make no difference whether the activities were conducted by the FSC directly, by the parent company under a sub-contract from the FSC, or by an independent third party under a sub-contract from the FSC, because the geographical location of the activities would still be outside the United States. For example, a sale of goods of substantial value to foreign customers will generally require sales representatives to meet with those customers at the customers’ home (i.e., foreign) offices. Such meetings will be foreign sales activities, whether the sales representatives are employed by a FSC, its US parent, or an independent third party.⁵⁰⁴

4.1126 The fact that activities are performed by the related supplier on behalf of the FSC and paid for by the FSC does not transmute foreign economic processes into domestic economic processes. For example, if a FSC contracts the negotiation function to its related supplier and the related supplier uses employees of a controlled foreign corporation or an independent agent to perform these activities abroad, does this make the activity a domestic economic process as the European Communities contends? The mere association of a domestic entity with a foreign economic process does not change that process into a domestic one.

4.1127 In its submissions, the United States has generally used the term “foreign-source income” as a shorthand expression for the longer formulation used by the GATT Council in its 1981 Decision. “Foreign-source income” also has a specific technical meaning in US tax law, as reflected in Section 921(a) with respect to the character of FSC exempt foreign trade income. In the foreign corporation context, the meaning of the term relates normally to whether a foreign corporation will be subject to US tax. In this regard, the US tax treatment of sales by foreign corporations of inventory property for use, disposition or consumption outside the United States (as required for FSC treatment) is ordinarily more generous than the treatment accorded to FSCs. Under fundamental US tax principles, income from sales by foreign corporations to foreign customers normally would be considered foreign-source income and would be exempt from taxation by the United States.

4.1128 Indeed, except for FSCs, foreign corporations are virtually never subject to US taxation directly on their foreign-source income. Under I.R.C. Sections 864 and 865(e)(2)(B), even if an office of the foreign corporation in the United States takes an active role in such a sale, the income would not be taxed by the United States, so long as a foreign office has also participated materially in the sales activities. Thus, if a French corporation used a branch office, or the office of a subsidiary, in New York to assist in selling goods to customers in Latin America, and the head office in France also participated materially in the sales activities, the United States would exempt that French corporation from taxation on those sales – even though some of the activity giving rise to the profits from the sales clearly occurred in the United States.

4.1129 Because the European Communities has confused matters with its belated and superficial discussion of sourcing rules, the United States offers the following brief analysis of the manner in which the general source rules under US income tax law would apply to the income of a foreign corporation, such as a FSC. Depending upon whether one is considering a commission FSC or a buy-

⁵⁰⁴ Paragraphs 4.1125-4.1130 reflect the United States' response to the following question from the Panel: Let us assume that a FSC sub-contracts all foreign distribution and sales functions in connection with FSC transactions to its parent company and pays for them. In such circumstances, would the income generated by such transactions be considered foreign source income or domestic source income for fiscal purposes? In what proportion?

sell FSC, FSCs earn either commission income (income from services) or sales income. Regarding income from services, the general US source rules would source that income where the services are performed. In the case of sales income, where the sale is for use, disposition or consumption abroad, and a foreign office materially participates in the sale, the general source rules would source the income as foreign. In this regard, US Exhibit 21 provides evidence that, on an aggregate basis, the FSC income that is exempted from tax arises out of foreign activity, thereby corroborating that the partial exemption for qualifying FSC income is consistent with the results that would be obtained under the general source rules for foreign corporations.

4.1130 The statutory requirements that FSCs perform certain foreign economic processes are generally designed to ensure that FSCs participate materially in every sale for which they may earn exempt foreign trade income, even when much of the sales activity has been conducted through sub-contract by the US parent company (in effect, a US office of the FSC). Thus, the treatment of FSC income from foreign distribution and sales activities is fundamentally consistent with US rules for sourcing income of this kind. The FSC treatment is less generous than the general rule because the United States designed the FSC to comply with the requirements articulated in the 1981 Council Decision. By imposing income tax directly on a substantial percentage of FSC income – as opposed to exempting all FSC income – the United States has ensured that the portion of income exempted from tax will not deviate significantly from the portion of income attributable to foreign economic activities undertaken in connection with FSC sales. US Exhibit 21 provides empirical evidence of the correlation between foreign economic activities and the amount exempted.

4.1131 For its part, the United States cannot see how the FSC administrative pricing rules can be capable of giving rise to an independent violation of the SCM Agreement “in the absence of the exemptions.” The existence of the FSC tax exemption is a necessary predicate to the application of the administrative pricing rules. If the exemption did not exist, the pricing rules would be superfluous and have no effect. Indeed, the United States believes that the European Communities has advanced this peculiar position in order to obfuscate the fact that a necessary predicate of the arm’s length principle in footnote 59 is that foreign-source income may properly be exempted from tax without running afoul of the export subsidy prohibition in the SCM Agreement.⁵⁰⁵

4.1132 The United States has explained that there is only one way that the FSC administrative pricing rules could be deemed to be inconsistent with Article 3.1(a) of the SCM Agreement. This would be the case only if the European Communities could demonstrate that, by contravening the arm’s length principle of footnote 59, the rules exempt *domestic*-source income from taxation and do so to a “significant” extent. The European Communities, of course, has not supplied the Panel with any evidence to this effect because it has failed to recognize the controlling legal principle applicable to its Article 3.1(a) claims. In contrast, the United States has supplied the Panel with evidence, in particular US Exhibits 20 and 21, which indicates that the FSC administrative pricing rules are consistent with the results in transactions between independent manufacturers and distributors, that the rules properly exempt foreign-source income earned in FSC transactions overall, and that if any saving of taxes on domestic-source income does occur, such saving is not “significant.”

4.1133 Thus, as a purely theoretical matter, the FSC administrative pricing rules could give rise to an “independent violation” only in the event that the Panel concludes that (a) the FSC tax exemption is permissible (because foreign-source income need not be taxed), and (b) the administrative pricing rules nonetheless result in domestic-source income escaping taxation to a “significant” extent. Because the European Communities has not met its burden of proof on these critical points, the Panel should reject the European Communities' claims regarding the administrative pricing rules.

⁵⁰⁵ Paragraphs 4.1131-4.1133 reflect the United States' comment on the following question to the European Communities from the Panel: Is the European Communities arguing that the special administrative pricing rules have a separate legal existence such that, even in the absence of the exemptions, they would be capable of giving rise to an independent violation of the SCM Agreement?

4.1134 At the outset, the United States notes that the phrase “range of tolerance” was used by the European Communities, not the United States. The United States referred to the “arm’s length range.” First US Submission, paragraph 115, note 97. The European Communities has admitted that adjustments to related party transfer prices need only “deliver a sufficiently close approximation to arm’s length in a . . . wide variety of cases over time.”⁵⁰⁶ The European Communities even conceded that the arm’s length principle is satisfied as long as the results of a particular measure are within an accepted “range of tolerance.”^{507,508}

4.1135 The United States would admit that in individual cases the results under the FSC administrative pricing rules may differ from the results that would obtain under Section 482 of the Internal Revenue Code. However, footnote 59 does not require a Member to do the type of full-blown functional analysis that might be required under Section 482. As stated in the Second US Submission, particularly in paragraphs 102-103, the FSC administrative pricing rules embody methods that have validity and stability in the aggregate, notwithstanding variances that may occur in individual cases. The administrative pricing rules do this in a manner that affords administrative ease to both taxpayers and tax administrators. As previously explained to the Panel, given the need to maintain the confidentiality of taxpayer information under the laws of most countries, including the laws of the United States, assessing the consistency of a Member’s transfer pricing practices in the aggregate is the most appropriate approach under footnote 59, and is likely the approach that the drafters contemplated.

4.1136 In this regard, the question raised in this dispute is whether the results generated by the FSC administrative pricing rules depart from the arm’s length principle of footnote 59. To reiterate, the European Communities has yet to identify for the Panel what the arm’s length principle of footnote 59 contemplates, and its arguments on this issue present a constantly moving target.⁵⁰⁹ Instead, the European Communities merely alleges that whatever the standard in footnote 59 may be, the FSC administrative pricing rules fail to meet it. In the view of the United States, it is incumbent upon the European Communities, as the complainant, to identify what the relevant standard is under footnote 59 and then provide evidence demonstrating that the FSC administrative pricing rules fail to generate results within the “range of tolerance” established by that standard. Until the European Communities has done so, it has failed to satisfy its burden of proof, and it does not fall to the United States to demonstrate why the FSC administrative pricing rules conform to an as-yet-to-be-defined standard.

4.1137 Regarding the second part of the Panel’s question, the United States believes that the appropriate question to ask is whether the FSC administrative pricing rules, in the aggregate, systematically misallocate domestic-source income to FSCs. The only empirical evidence the Panel has in this case are US Exhibits 20 and 21. US Exhibit 20, which is based on public data that was freely available to the European Communities, demonstrates that the FSC allocation percentages are well within the range of the profit breakdowns between manufacturers and independent distributors. As for US Exhibit 21, it suggests that, in the aggregate, the allocation of income between related US parents and FSCs appropriately reflects the amount of foreign economic activity performed by FSCs or for which FSCs are responsible.

4.1138 At the outset, the United States should make clear that it does not view footnote 59 as an “exception” to item (e). Instead, it is part of item (e), just as the European Communities presumably views footnote 15 of the SCM Agreement as part of Article 6.1(a). The United States also does not disagree with the proposition that footnote 59 explains the scope of item (e). Instead, the

⁵⁰⁶ First EC Submission, paragraph 80, *quoted at* Second US Submission, paragraph 114.

⁵⁰⁷ *Ibid.*, paragraph 86, *quoted at* Second US Submission, paragraph 114.

⁵⁰⁸ Paragraphs 4.1134-4.1137 reflect the United States’ comment on the following question from the Panel: The United States believes that the FSC administrative pricing rules in the aggregate are within the “range of tolerance.” Would the United States admit that, in individual cases, the FSC administrative pricing rules may depart from an arm’s length result? What is the tolerable range or “range of tolerance” ?

⁵⁰⁹ For example, the European Communities seems to have abandoned its initial assertion that the OECD Guidelines should provide the standard for footnote 59.

United States disagreement with the European Communities relates to the manner in which footnote 59 explains that scope.⁵¹⁰

4.1139 Having said that, the United States sees nothing in footnote 59 that would shift the burden of proof from the European Communities to the United States, and at the second meeting of the Panel, the European Communities appeared to share this view. As a general matter, the Appellate Body has made clear that the complainant bears the burden of presenting a *prima facie* case of a violation. See, e.g., *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India* (“Wool Shirts”), WT/DS33/AB/R, Report of the Appellate Body adopted 25 April 1997, p. 16. The assignment of this burden is not avoided by describing a provision as an “exception.” *EC – Measures Affecting Meat and Meat Products* (“EC Hormones”), WT/DS26/AB/R, WT/DS48/AB/R, Report of the Appellate Body adopted 16 January 1998, paragraph 104. The assignment of the burden of proof may shift where a defending Member invokes a provision that is in the nature of an affirmative defense, such as GATT Article XX. *Wool Shirts*, p. 16. However, footnote 59 lacks the characteristics of an affirmative defense.

4.1140 Insofar as the interpretation of the meaning of footnote 59 is concerned, even if the footnote were characterized as an “exception,” this would not warrant a different method of treaty interpretation. This point was made clear by the Appellate Body in the *European Communities Hormones* case, paragraph 104, in which the Appellate Body stated as follows:

[M]erely characterizing a treaty provision as an “exception” does not by itself justify a “stricter” or “narrower” interpretation of that provision than would be warranted by examination of the ordinary meaning of the actual treaty words, viewed in context and in the light of the treaty’s object and purpose, or, in other words, by applying the normal rules of treaty interpretation.

4.1141 As previously explained in the First US Submission, paragraph 113, and the Second US Submission, paragraph 136-138, footnote 59 calls for the use of an aggregate approach. The European Communities has dismissed the US analysis by essentially asserting that it is wrong to focus on the choice of words used by the drafters of the SCM Agreement, a rather remarkable proposition in light of Article 31 of the *Vienna Convention on the Law of Treaties*.⁵¹¹

4.1142 An additional textual justification for an aggregate approach is the use of the phrase “administrative or other *practices*” in footnote 59. (emphasis added). Under footnote 59, it is the practice that must contravene the arm’s length principle *and* result in a significant saving of direct taxes in export transactions. “Practice” is defined as follows:

1a The habitual doing or carrying on of something; usual or customary action or performance; action as opp. to profession, theory, knowledge, etc. b. A custom; a habit; a habitual action. c. *Law* An established method of legal procedure.

As can be seen from this definition, a “practice” involves more than an isolated act, but instead connotes actions that are taken repeatedly. As such, any evaluation of a practice calls for an aggregate

⁵¹⁰ Paragraphs 4.1138-4.1140 reflect the United States’ comment on the following question from the Panel: The United States says that footnote 59 of the Subsidies Agreement narrows the scope of item (e) of the Illustrative List. The European Communities says that footnote 59 explains the scope of item (e). What would be the logical implication of the interpretation of footnote 59 with respect to the burden of proof if footnote 59 is characterized as an “exception” to item (e)? In other words, who bears the burden of proof that the FSC administrative pricing rules do or do not satisfy the requirements of footnote 59? Also, how would the characterization of footnote 59 affect the interpretation of that footnote?

⁵¹¹ Paragraphs 4.1141-4.1147 reflect the United States’ comment on the following question from the Panel: Regarding the concept of “aggregate”, what base should one use for assessing what is or is not a “significant” tax saving? Put differently, how does one measure a “significant” tax saving? At the aggregate level? At the company level?

assessment. This conclusion is reinforced by the use in footnote 59 of the plural form “transactions” rather than the singular form “transaction.”

4.1143 Moreover, while the European Communities has conceded that nothing in the SCM Agreement precludes the use of simplified methods for applying the arm’s length principle⁵¹², interpreting footnote 59 as requiring the use of a transaction-specific approach would have the effect of prohibiting the use of rules of administrative convenience with respect to transfer pricing. This is because rules of administrative convenience, by their very nature, are less precise than more rigorous, less administratively convenient rules, and inevitably will generate results in individual cases that may differ from the results obtained under more precise rules. Thus, the reasonableness of rules of convenience can be fairly assessed only on the basis of the results generated in the aggregate.

4.1144 Finally, the United States would like to take this opportunity to comment on the European Communities’ assertion that the third sentence of footnote 59 does not apply to the FSC administrative pricing rules because those rules are statutory rather than non-statutory. This assertion is not supported by the text of the third sentence, it would generate absurd results if accepted, and it is contradicted by the European Communities’ own evidence (Exhibit EC-28) regarding the purpose of footnote 59.

4.1145 With respect to the text, the third sentence refers to “administrative or *other* practices”. A practice reflected in a statute easily can be categorized as an “other” practice. To hold otherwise would lead to the absurd result that a practice could be deemed permissible under footnote 59 if it were articulated in non-statutory form, but the very same practice would be prohibited if it were articulated in statutory form.

4.1146 Moreover, the “Rivers Letter”, which the European Communities has offered as a relevant source for purposes of interpreting footnote 59, advocated GATT regulation of both “statutory law” and “administrative practices” relating to transfer pricing. Exhibit EC-28, page 2. In light of this objective, it is more reasonable to conclude that the ultimate language used – “other practices” – was intended to embrace transfer pricing methods embodied in statutory form.

4.1147 The United States has suggested a useful way to measure whether or not the FSC provides a “significant saving” of direct taxes within the meaning of footnote 59. *See* First US Submission, paragraphs 137 - 147. In summary, the FSC overall provides an *ad valorem* benefit of under 1 per cent, and any saving accorded by the FSC administrative pricing rules is even less. Whatever the quantum for “significance” may be, a tax measure that provides only *de minimis* benefits under the rules of the SCM Agreement cannot be considered as conferring a significant tax saving.

4.1148 Whether evaluated at the aggregate or at the company level, it is possible, and indeed required by footnote 59, for these matters to be dealt with under tax treaties or other appropriate mechanisms. The issues raised by the European Communities are the types of issues that competent tax authorities and the OECD are equipped to address. *See* US Request for Preliminary Findings.⁵¹³

4.1149 The FSC administrative pricing rules do not require a traditional resource-intensive and company- and transaction-specific transfer pricing evaluation. Nevertheless, the US Internal Revenue Service enforces all of the legal requirements with respect to FSC qualifications and income allocations, and corrects misallocations *ex post*, by litigation if necessary. *See* US Exhibits 18 and 19. Because a FSC is required to perform or pay for activities for which it is being allocated a portion of

⁵¹² *See* Second EC Submission, Annex EC-1, page 17 (answer to US Question #39).

⁵¹³ Paragraph 4.1148 reflects the United States’ comment on the following question from the Panel: If you take the view that matters could be evaluated at the company level, would it be possible to deal with that under tax treaties or other appropriate mechanisms?

the profit under the administrative pricing rules, the level of allocation is designed to, and normally will, fall within the range of values that are considered to be arm's length. *See* US Exhibit 20.⁵¹⁴

4.1150 With respect to the first two questions, the 1981 Council Decision resolves the issue of payment to an agent by establishing a rule under which the income generated from a process may be exempted from tax if that process took place outside the territorial limits of the exporting country. Thus, in the context of this case, if a FSC pays an agent to perform a process (whether the agent is related to, or independent from, the FSC), the income generated from that process may be exempted from tax if the process is performed outside of the United States. For example, a sales meeting at the premises of a foreign customer is a foreign process, regardless of whether the sales representatives are employed directly by a FSC, are employees of the US parent for which the FSC reimburses the parent, or are independent agents retained by the FSC.⁵¹⁵

4.1151 With respect to the term "processes", one definition of "process" is as follows:

4. A thing that goes on or is carried on; a continuous series of actions, events, or changes; a course of action, a procedure; *esp.* a continuous and regular action or succession of actions occurring or performed in a definitive manner; a systematic series of actions or operations directed to some end, as in manufacturing, printing, photography, etc. *The New Shorter Oxford English Dictionary* (1993).

In the view of the United States, the functions performed by a FSC – "distribution" and "sales" – fall within this definition of "process." *See also* Second US Submission, paragraph 86, which discusses the definition of "economic" and "process".

4.1152 With respect to "activity", one definition of this term is as follows: "4. An active force or operation; an occupation, a pursuit. b. In *pl.* Things that a person, animal or group chooses to do." *The New Shorter Oxford English Dictionary* (1993). Thus, while they may not be synonyms, there certainly is an overlap in the definitions of "process" and "activity". In the view of the United States, sales and distribution – the things that a FSC does – can be described both as "processes" and "activities".

4.1153 With respect to "location", this refers to where the "process" or "activity" is performed. A "process" or "activity" is "foreign" if it is performed outside the territory of the exporting country. The United States refers the Panel to the Second US Submission, paragraph 91-93, wherein the United States addressed this point. Here, the United States simply will reiterate that its position regarding the "foreignness" of an economic process is exactly the same position as advocated by the European Communities and its member States at the time of the 1981 Council Decision.

⁵¹⁴ Paragraph 4.1149 reflects the United States' comment on the following question from the Panel: In its Oral Statement at the Second Meeting of the Panel, 16 March 1999, at paragraph 31, the European Communities states as follows:

It is also important to note that under Section 482, the IRS maintains the possibility to correct misallocations ex post. This is not the case under the administrative pricing rules which provide for a fixed allocation of common profit to the FSC irrespective of their actual activities. No ex post correction mechanism exists if the FSC activity has been close to zero.

What are the views of the United States concerning this statement? Is the assessment by IRS auditors qualitative or quantitative regarding the amount of activity of a FSC?

⁵¹⁵ Paragraphs 4.1150-4.1153 reflect the United States' comment on the following question from the Panel: Does the 1981 Council Decision resolve the issue of payment to an agent? Please reconcile the US answer with the reference to "processes located outside the territorial limits? What are "processes"? Are "processes" the same as "activities"? What is meant by "location"? Does this refer to where something is performed or where it occurs?

4.1154 Under the plain meaning of the 1981 Council Decision, the relevant question is where the activity is performed, not who performs it. This is the standard that the European Communities and its member States proposed to the Council and that the Council adopted. *See* Second US Submission, paragraph 91-93.⁵¹⁶

4.1155 In the view of the United States, when one cuts through all of the smoke generated by the European Communities, it is apparent that the European Communities' complaint is that the FSC system allegedly has the potential to exempt domestic-source income from tax. This can be seen from the European Communities' answer to US Question #29 posed at the first meeting of the Panel. Question #29 read as follows:

In paragraph 65 of the European Communities' Oral Statement, and on many occasions during the European Communities' extemporaneous remarks at the Panel meeting, the European Communities asserted that the economic processes attributed to the FSC take place in the United States. Please identify the precise portions of the First EC Submission and of any submissions made by the European Communities during the first meeting of the Panel that contain evidence supporting this assertion.⁵¹⁷

4.1156 The European Communities answer was as follows:

The European Communities merely stated that the FSC scheme *allows* the economic processes which an FSC is supposed to perform to be subcontracted back to the related supplier and therefore to take place in the United States and that FSC legislation allows a standard formulaic tax exemption regardless of the amount of work actually performed by an FSC.⁵¹⁸

4.1157 In the view of the United States, the only reasonable interpretation of this answer is that the European Communities' complaint is based on the allegation that the FSC system "allows" the exemption of domestic-source income, not that the FSC system actually exempts such income. Certainly, the European Communities' answer to US Question #29 demonstrates that the European Communities has presented *no* evidence that the FSC system actually exempts any domestic-source income from tax.

4.1158 In view of the plain text of footnote 59, the "potential" to exempt from tax domestic-source income is insufficient to constitute a violation. Footnote 59 requires that a practice, such as the FSC administrative pricing rules, "result in a significant saving of direct taxes in export transactions." (Emphasis added). Assuming, as the United States does, that foreign-source income may properly be exempted from tax, the quoted language means that the European Communities must do something more than allege that the exemption of domestic-source income is possible. Instead, it must demonstrate that such an exemption actually happens and that the frequency and amount of such exemption are sufficiently large to constitute a significant saving of direct taxes in export transactions.⁵¹⁹

4.1159 The United States submits that these are excellent questions that the European Communities has yet to adequately answer. With respect to the first question, the United States simply notes that at the time of the 1981 Council Decision, the position of the European Communities and its member

⁵¹⁶ Paragraph 4.1154 reflects the United States' comment on the following question from the Panel: How can the United States defend under the plain meaning of the 1981 Council Decision the fact that a FSC is financially responsible for an activity performed by an agent or parent? How can that be an economic process located abroad?

⁵¹⁷ Paragraphs 4.1155-4.1157 reflect the United States' comment on the following question from the Panel: Is the European Communities complaining that the FSC system exempts from tax domestic-source income or that it has the potential to do so?

⁵¹⁸ Second EC Submission, Annex EC-1, page 14 (emphasis in original).

⁵¹⁹ Paragraph 4.1158 reflects the United States' comment on the following question from the Panel: If there merely is a potential to exempt from tax domestic-source income, is that enough to constitute a violation?

States was that export activities ceased at the customs border of the exporting country. *See* Second US Submission, paragraph 143-144. With respect to the second question, under the principle articulated in the 1981 Council Decision, the cited activities would not constitute export activities. Nothing in the SCM Agreement requires a different conclusion.⁵²⁰

4.1160 The United States refers the Panel to its answer to Oral Question #6 of the Panel, above. In the view of the United States, foreign economic processes, within the meaning of the 1981 Council Decision, include all economic processes that take place abroad, including manufacturing.⁵²¹

4.1161 The Panel asked a number of questions concerning the method by which the 1981 Council Decision was adopted and whether it qualifies as a “decision” under paragraph 1(b)(iv) of the incorporation clause of GATT 1994. In particular, the Panel inquired as to the nature of the debate in the Council meeting of 7-8 December 1981, recorded as C/M/154, which the European Communities tabled as Exhibit EC-32 and referred to in paragraphs 36-59 of its Second Oral Statement of 16 March 1999.⁵²²

4.1162 The Council Decision adopted the reports of the four *Tax Legislation Cases*, together with the understanding “that with respect to these cases, and in general,” foreign economic processes “(including transactions involving exported goods)” “need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement” Following the adoption of the reports, the Council Chairman then stated that “the Council’s decision and understanding” does not require parties adhering to Article XVI:4 to tax “the profits on transactions beyond their borders,” and stated that the decision does not modify the existing GATT rules in Article XVI, nor does it affect the Tokyo Round Subsidies Code or rights and obligations under the General Agreement.

4.1163 The European Communities argues in paragraph 48 of its Second Oral Statement that the Council Decision cannot constitute joint action under Article XXV of GATT 1947, and, hence, is not a “decision” under Article XVI:1 of the Marrakesh Agreement, nor an “other decision” under paragraph 1(b)(iv) of GATT 1994, because it does not change the meaning of GATT Article XVI:4. However, a “decision” is not limited to actions that “change” the meaning of a provision. An action that clarifies or restates the meaning of a provision equally qualifies as a decision. As stated in the Second US Submission, paragraph 54, note 35, the Council Decision merely reiterated, in general terms, the existing understanding of the CONTRACTING PARTIES that Article XVI:4 does not require countries to tax the profits derived from activities taking place outside their borders, including transactions involving exported goods. This restatement by the Council constituted joint action by the CONTRACTING PARTIES under Article XXV:1, because the Council was empowered to act on behalf of the CONTRACTING PARTIES. *See* Second US Submission, paragraph 55-56.

4.1164 Moreover, the Council Decision was, in fact, adopted by the CONTRACTING PARTIES themselves. In GATT Doc. No. L/5414 (12 November 1982) (*Council of Representatives: Report on Work since the Thirty-Seventh Session*), the Council reported to the Thirty-Eighth Session of the CONTRACTING PARTIES on matters considered since the Thirty-Seventh Session. The report included 33 subjects, the *Tax Legislation Cases* constituting subject number 15(e). The first page of the report stated as follows: “Adoption of this report, which summarizes the action taken by the Council, will constitute approval by the CONTRACTING PARTIES of that action.”

⁵²⁰ Paragraph 4.1159 reflects the United States’ comment on the following question from the Panel: Why would economic activities going beyond exports ever be considered as export subsidies? Would export activities include income earned by a foreign subsidiary selling in a foreign market or manufacturing abroad?

⁵²¹ Paragraph 4.1160 reflects the United States’ comment on the following question from the Panel: Do foreign economic processes include all foreign economic processes, including manufacturing?

⁵²² Paragraphs 4.1161-4.1182 reflect the United States’ comment on the following question from the Panel: Explain the relevance of the 1981 Council Decision to this dispute.

4.1165 With two exceptions, the Thirty-Eighth Session of the CONTRACTING PARTIES then proceeded to adopt the Council Report. GATT Doc. No. SR.38/1 (15 December 1982), page 10. The exceptions involved subject 1(a) (Progress reports of the Preparatory Committee on preparations for the Ministerial meeting) and subject 13 (trade restrictions affecting Argentina applied for non-economic reasons). *Id.* Thus, while the CONTRACTING PARTIES were free to reject the 1981 Council Decision, they chose instead to affirmatively adopt it.

4.1166 The Panel inquired as to the significance of the intervention by the Brazilian delegate to the Council meeting to the effect that the Decision was cryptic and that he would prefer to separate the adoption of panel reports and general interpretations. Despite any reservations the Brazilian delegate may have had following the adoption of the Council Decision, it is clear that the Council Decision constituted a general interpretation of GATT 1947, and was recognized as such by the participants at the Council meeting. Its status as a general interpretation is reinforced by the subsequent intervention of the delegate from Chile, who stated that, “[h]e shared the concern expressed by the Brazilian delegation, and considered that it *would have been* more appropriate to adopt an understanding with a judicial approach rather than a legislative one, *as the present case seemed to be.*” (Emphasis added). To use the European Communities' terminology, the Chilean delegate correctly perceived the Council as engaging in a “rulemaking” activity.

4.1167 The subsequent colloquy between the United States, the European Communities and Canada, cited at paragraphs 54-57 of the European Communities' Second Oral Statement referred solely to the interpretation the United States made at that time as to the consistency of the DISC with the Council Decision and, as such, is irrelevant to divining the overall meaning of the Council Decision in the context of the present dispute or to its status as a general statement extending beyond the four cases at issue.

4.1168 However, discussions by the GATT Council concerning the DISC subsequent to the adoption of the Council Decision indicate that the Council members considered the Decision to be a substantive “decision” by the Council, and not merely the routine adoption of a panel report. The European Communities and other Contracting Parties considered the Decision normative and, rightly or wrongly, criticized the DISC legislation for not being consistent with it.

4.1169 For example, at the 29-30 June 1982 meeting of the Council, the European Communities representative stated:

We have examined these contentions [by the United States]. In our view the United States continues to argue as if the DISC system was no different in form from the other practices examined by the panel. In fact they are substantially different; and the impact of the December decision will vary, depending on the relevance of its content to the different practices concerned. One important difference is that the Panel report on DISC does not mention the taxation of “export activities” outside the United States whereas this is crucial in the other cases examined.

The Community submits that the essential qualification adopted by the Council last December - relating to export activities outside the territory of the exporting country - has no significance when applied to the DISC case. Its clear intent was to establish that the activities of foreign located branches or subsidiaries or other foreign located establishments in connection with the export of goods were not within the terms of Article XVI:4.

The DISC system does not, according to our information, apply to export activities outside the territory of the United State [*sic*]. Unless the United States contests this, it is clear that the effect of the December decisions is to remove the basis upon which certain European tax practices were found by the panels to be, in some cases, not in accordance with Article XVI:4 - and it was for this reason that the EEC and member

States had proposed the formula; it does not in any way modify the essential basis for the Panel's finding in relation to the DISC.

To conclude on this point: the Panel report on DISC is not based on an incorrect judicial basis. It is based on the provisions of Article XVI:4 - which we are all agreed have not been modified. *The legal interpretation of last December* has not vitiated the Panel's approach, since it applies to a situation which does not occur in the DISC case. Consequently it is our view that DISC is the only practice which remains inconsistent with GATT. (C/M/159, pages 6-7, reprinted in full as C/W/391, pages 2-3; underscoring in original; italics added).

4.1170 In a similar vein, the representative of Australia stated that:

The adoption of the Panel Report had in no way qualified the findings of the [DISC] Panel, the December 1981 qualification having been limited to clarifying the position in regard to the taxation of goods arising from economic processes located and incorporated outside the territorial limits of the exporting country. C/M/159, page 11.

4.1171 In addition, at the 21 July 1982 meeting of the Council, C/M/160, the European Communities tabled a resolution, reprinted as C/W/392, that contained a specific reference to the Council Decision:

Recalling that [the DISC] Panel Report had been adopted in December 1981, *together with a decision* on the tax treatment of certain export activities in relation to Article XVI:4 (L/5271) (Emphasis added).

4.1172 These references, which are only a small sampling of the statements made following the December 1981 Council meeting, make clear that members of the Council, including the European Communities, considered the 1981 Council Decision to be an authoritative interpretation concerning the taxation of foreign economic processes.

4.1173 That the Council Decision as a whole constituted joint action under Article XXV:1 is supported by the *Analytical Index to the GATT: Guide to GATT Law and Practice* (1995), Volume 2 at 875-876, footnote 13, where, in a discussion of examples of joint action under Article XXV, the following reference appears: "E.g., Council adoption of four Panel Reports on tax legislation subject to the understanding in L/5271 (28S/114)." Because the 1981 Council Decision also adopted the four panel reports, the Council Decision also constituted a decision under Article XXIII.⁵²³

4.1174 Part of the European Communities attack on the 1981 Council Decision appears to be based on the notion that the GATT 1994 incorporation clause was intended only to incorporate "big", for lack of a better word, decisions made under GATT 1947. At the second meeting of the Panel, the European Communities suggested that because paragraphs 1(b)(i) through (iii) refer to protocols relating to tariff concessions, protocols of accession, and waivers, a "decision" must be of similar magnitude in order to fall under paragraph 1(b)(iv).

4.1175 This contention is simply wrong. The obligations of Contracting Parties under GATT 1947 consisted not only of the obligations created by the text of GATT 1947 itself, but also of obligations based on forty-seven years of decisions, protocols and other legal instruments which formed a legally-enforceable regime. In the view of the United States, the Uruguay Round negotiators did not intend to discard this *acquis*, and the European Communities has offered no evidence that they did. To the

⁵²³ Even if that portion of the Council Decision dealing with the adoption of the four *Tax Legislation Cases* were considered to be solely a decision pursuant to Article XXIII of GATT 1947, the remaining portion of the Council Decision, which re-affirmed a general rule that income derived from foreign economic processes need not be taxed by the exporting country and that foreign economic processes should not be regarded as export activities under Article XVI:4, would constitute joint action by the CONTRACTING PARTIES pursuant to Article XXV:1.

contrary, paragraph 1(b)(iv) and Article XVI:1 of the WTO Agreement demonstrate that the negotiators sought continuity between the old regime and the new, using the general interpretative note in Annex 1A to resolve any conflicts between the two regimes. Indeed, because of time limitations, the negotiators gave up the attempt to revise the text of the GATT to reflect this *acquis*, and chose to rely instead on the incorporation clause.

4.1176 It would take a book to document all of the different decisions and legal instruments that would be affected if the GATT 1947 *acquis* were discarded, as the European Communities suggests. The United States offers only a few examples here. On 29 January 1980, the GATT Council adopted *Guidelines for Decisions Under Article II:6(a) of the General Agreement*, L/4938, BISD 27S/28, dealing with the adjustment of specific duties in light of exchange rate changes. Is this decision no longer valid because it is not, for example, of the same magnitude as a protocol of accession? Members with specific duty regimes no doubt would be surprised to learn that, in the European Communities' view, they no longer can rely on these guidelines.

4.1177 On 26 November 1986, the CONTRACTING PARTIES approved a report on *Procedures for Future Appointment of the Director-General*, L/6099, BISD 33S/55, that resulted in an approved statement regarding appointment procedures. It is the understanding of the United States that many Members, including the United States, take the position that these procedures apply to the pending selection of the next Director-General of the WTO. Are these Members wrong to rely on this statement because it is not of the same magnitude as a decision on a waiver?

4.1178 Unless the Panel is prepared to relegate these and myriad other decisions and legal instruments to what the European Communities has called the "misty history" of GATT 1947, then it must accept that the 1981 Council Decision has been incorporated into GATT 1994.

4.1179 At bottom, the European Communities' arguments concerning the status of the 1981 Council Decision amount to the mere assertion that the Council Decision does not fall under paragraph 1(b)(iv) because it was generated at the end of a process that began under the dispute settlement provisions of GATT Article XXIII. However, whether the process began as part of a dispute settlement panel or a working party has no bearing on the nature of the Council's action at the end of the process. If the Council had merely been acting in an adjudicative mode, it could have refrained from adopting the panel reports in the *Tax Legislation Cases*. Alternatively, it could have adopted one or more reports, such as the DISC report, and refrained from adopting others. Instead, however, it issued a decision that, by its express terms, was not limited to the cases before it, but that was intended to apply "in general", as was understood by the GATT membership at the time, including the European Communities.

4.1180 Although the United States is firmly of the view that the Council Decision is carried over to GATT 1994, by virtue of Article 1(b)(iv), and to the WTO generally by Article XVI:1 of the Marrakesh Agreement, should the Panel decide otherwise, the United States calls to the attention of the Panel the statement of the Appellate Body in *Japan - Alcoholic Beverages* at 14, with respect to adopted GATT 1947 panel reports. The Appellate Body stated that while such reports are not legally binding on future panels they "are an important part of the GATT *acquis*. They are often considered by subsequent panels. They create legitimate expectations among WTO Members, and, therefore should be taken into account where they are relevant to any dispute."

4.1181 In the present dispute, the above considerations would be even more important with respect to the Council Decision than would a normal adopted panel report. The Council Decision interpreted GATT Article XVI:4 both generally, and in a dispute between the same parties arising from legislation that was the predecessor of the legislation that is at issue in the present dispute. Moreover, as stated throughout the US presentations, the United States relied heavily upon the Council Decision in crafting the FSC in a manner that was intended to eliminate the criticisms aimed at the DISC. Finally, the Council Decision constitutes the *only* clear guidance available to the Panel as to how the exemption from tax of foreign-source income should be treated for purposes of WTO subsidy rules.

4.1182 Thus, even if the Council Decision were found not to be legally incorporated into the WTO and GATT 1994, the United States considers that the reasoning expressed in the Council Decision should be considered as highly authoritative in interpreting Articles 1 and 3 of the SCM Agreement and item (e) and footnote 59 of the Illustrative List of Export Subsidies.

4.1183 In the view of the United States, there is no conflict between GATT Article XVI:4, as interpreted by the Council Decision, and the SCM Agreement. The Council interpreted Article XVI:4 as meaning that the exemption from tax of economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities. In so doing, the Council essentially reversed the finding of the panel in the *Tax Legislation Cases* that the failure to tax foreign-source income earned as part of an export transaction constituted the foregoing of revenue by the countries in question.⁵²⁴

4.1184 There is no conflict between the principle articulated by the Council and the SCM Agreement. Inherent in footnote 59 is the notion that foreign-source income earned as part of an export transaction need not be taxed without violating the export subsidy prohibition in the SCM Agreement. *See* First US Submission, paragraph 89-91. Similarly, the language in Article 1.1(a)(1)(ii) regarding foregone revenue that is “otherwise due” is not self-defining and does not on its face conflict with the principle articulated by the Council. *Put differently, the principle that “foreign-source income need not be taxed” can be restated as the principle that tax on foreign-source income is not “otherwise due.”*

4.1185 As previously explained by the United States, the text of the SCM Agreement demonstrates that Article XVI constitutes part of the context of the SCM Agreement. Therefore, decisions interpreting Article XVI, such as the 1981 Council Decision, are relevant to an interpretation of the SCM Agreement. *See, e.g.,* Second US Submission, paragraph 28-32. This conclusion is reinforced by the panel and Appellate Body decisions in the *Desiccated Coconut* case, which support the proposition that the subsidy provisions of the GATT and the SCM Agreement should not be interpreted in isolation from each other. *Id.*, paragraph 33-35.⁵²⁵ In addition, because there is a presumption in public international law against the existence of conflicts, the Panel must, to the extent possible, interpret Article XVI and the SCM Agreement so as to avoid a conflict. *See* Second US Submission, paragraph 37.

⁵²⁴ Paragraphs 4.1183-4.1185 reflect the United States' comment on the following question from the Panel: Is there any conflict between the 1981 Council Decision and the SCM Agreement?

⁵²⁵ In this regard, in its Second Oral Statement, paragraph 72, the European Communities misstates the US argument regarding the relevance of the Council Decision and the relevance of the decisions in the *Desiccated Coconut* case. As a review of the US submissions in this dispute make clear, the United States is *not* arguing that Article XVI:4, as interpreted by the Council Decision, prevails over the SCM Agreement. Instead, the United States is arguing that Article XVI:4, as interpreted, constitutes part of the context for interpreting ambiguous language in the SCM Agreement.

In the same paragraph, the European Communities also misconstrues the holding of the panel and the Appellate Body in the *Desiccated Coconut* case. Neither the panel nor the Appellate Body ruled that the SCM Agreement “prevailed” over GATT Article VI. Instead, both bodies found that Article VI could not be applied independently of the SCM Agreement. Indeed, the Appellate Body, after duly noting that the SCM Agreement would prevail in the event of a conflict with Article VI, stated as follows:

This does not mean, however, that the other goods agreements in Annex 1A, such as the *SCM Agreement*, supersede the GATT 1994. As the Panel has said:

... The question for consideration is not whether the SCM Agreement supersedes Article VI of GATT 1994. Rather, it is whether Article VI creates rules which are separate and distinct from those of the SCM Agreement, and which can be applied without reference to that Agreement, or whether Article VI of GATT 1994 and the SCM Agreement represent an inseparable package of rights and disciplines that must be considered in conjunction.

Brazil - Measures Affecting Desiccated Coconut, WT/DS22/AB/R, Report of the Appellate Body adopted 20 March 1997, page 15 (footnote omitted).

4.1186 Perhaps more than any of the other questions posed by the Panel and the parties in this case, this question goes to the heart of the matter, because it highlights the “form over substance” nature of the European Communities arguments.⁵²⁶

4.1187 Although the SCM Agreement lacks a preamble or any other statement of its objectives, it is possible to glean those objectives, particularly with respect to the export subsidy prohibition, from the practices described in the Illustrative List. Item (c) refers to internal transport and freight charges on export shipments on terms more favorable than for domestic shipments. Item (d) refers to the provision of products or services for use in the production of exported goods on terms or conditions more favorable than for use in the production of goods for domestic consumption. Item (f) refers to the allowance of special deductions directly related to exports or export performance over and above those granted in respect to production for domestic consumption. Items (g) and (h) both deal generally with indirect tax breaks that give favorable treatment to exported goods as opposed to goods sold for domestic consumption.

4.1188 Based on these examples, it seems fair to say that the objective of the export subsidy prohibition in the SCM Agreement is to prevent the artificial stimulation of exports – one that is unrelated to economic efficiency and comparative advantage – by precluding the preferential treatment of goods sold for export as compared to goods sold for domestic consumption. This raises the question of how that objective should be achieved in the context of the taxation of foreign-source income.

4.1189 Although the discussion of tax regimes that has taken place in this dispute is by no means exhaustive, we have seen that under the regimes of many countries, exports of goods are treated more favorably than domestic sales of goods for income tax purposes. The United States has described how the tax regimes of the Netherlands, France, Belgium, and Germany allow a firm to pay less tax on an export transaction than it would on a comparable domestic transaction. Second US Oral Statement, paragraph 70-80. The ability to reduce taxes in this way is something that is known to every European tax planner. In a similar manner, the FSC regime results in a lower tax on export transactions as compared to comparable domestic transactions.

4.1190 If one were starting from scratch and if one considered the objectives of the SCM Agreement in isolation from anything else, one perhaps might conclude that each of these regimes should be declared to be an export subsidy because each allows income from export sales to bear less of a tax than income from comparable domestic transactions. Moreover, the European tax regimes (or similar regimes of other WTO Members, for that matter) could not be excused on the grounds that other types of foreign-source income may not be taxed, because the SCM Agreement is not concerned with, for example, how Members tax income from import transactions, passive income from overseas investments, or income earned from manufacturing abroad. As indicated above, the SCM Agreement focuses on the favorable treatment of export sales, as compared to domestic sales, of goods. The tax benefits accorded to exports under the European tax regimes are contingent upon export performance within the meaning of Article 3.1(a) and item (e) because a producer of goods must export in order to obtain the tax benefits. In many cases, the export contingency is implicit in the way the various tax systems operate. For example, in transactions involving the distribution of goods, tax exemptions (whether by statute or treaty) under various European tax systems effectively apply only to income related to distribution activities carried out abroad through foreign branches or subsidiaries and *not* to income from distribution through domestic activities.

⁵²⁶ Paragraphs 4.1186-4.1196 reflect the United States' comment on the following question from the Panel: The United States takes the view that any foreign-source income does not have to be taxed. The European Communities, in answering US Question #22, says that it is impermissible for the FSC system to exempt foreign-source income based upon the fact of exportation. Which view is more consistent with the basic objective of the SCM Agreement, particularly with respect to the prohibition concerning export subsidies? Put differently, if one were writing a new SCM Agreement, how would foreign-source income be treated?

4.1191 However, this purist approach founders on the fact that most, if not all, countries tax foreign-source income differently than they do domestic-source income. More specifically, while the methods differ among countries, most, if not all countries, tax foreign-source income less extensively than they do domestic-source income, and in some cases they may not tax foreign-source income at all. For example, some countries, including several in Europe, exempt some or all foreign branch income of *domestic* companies. An overwhelming number of countries, including the United States, generally defer the taxation of undistributed foreign income of foreign subsidiaries. Furthermore, the deferral of income tax over time may amount to a tax exemption, and some countries, including several in Europe, combine the deferral of tax on undistributed earnings with a specific exemption for foreign subsidiary earnings when distributed as dividends.

4.1192 Thus, a purist approach to export subsidies runs into an inevitable structural conflict arising at the intersection of tax regimes and subsidy rules; namely, that the purist approach would result in the classification of most – perhaps even all – tax regimes in the world as prohibited export subsidies. Needless to say, this is not the sort of result that is likely to be reflected in the legal rules of a multilateral organization as large as the WTO.

4.1193 The history of the *Tax Legislation Cases* is informative in this regard. The panel in those cases found that the European tax regimes in question constituted export subsidies because exports were taxed less heavily than comparable domestic transactions. *See* Second US Submission, paragraph 23-24. From the standpoint of economics and the objectives that currently are reflected in the SCM Agreement, the panel's conclusions were not unsound or irrational. However, if the panel's findings had been allowed to stand, countries would have faced the unacceptable choice of either (a) reconfiguring their tax regimes so as to tax foreign-source and domestic-source income identically; or (b) accept the consequence of having their tax regimes declared to be export subsidies. Faced with this structural conflict between tax regimes and subsidy rules, the GATT membership overturned the panel's findings. Rejecting a purist approach, the Council interpreted GATT Article XVI:4 as allowing countries to exempt foreign-source income from tax, even if this allowed exports to bear a lower tax burden than comparable domestic transactions.⁵²⁷

4.1194 What all of this means in the context of this case is that, from the standpoint of the objectives of the export subsidy prohibition in the SCM Agreement, the FSC is no more or no less objectionable than the tax regimes of other Members that result in export transactions bearing a lower tax burden than comparable domestic transactions. While a purist approach might warrant declaring the FSC and these other regimes to be export subsidies, the Council decided to reject such an approach in 1981, and there is no indication in the SCM Agreement that the Uruguay Round negotiators chose to revisit or alter that decision.

4.1195 The difference between the United States and the European Communities is that, notwithstanding the absence of any intent on the part of the negotiators to repeal the 1981 Council Decision, the European Communities is using this dispute as a vehicle for doing so. However, if the European Communities indeed wished to rewrite history, it should have sought to do so through negotiations. Instead, it chose not even to pursue the issue in that venue.

4.1196 Finally, given the fact that we are talking about the objectives of the SCM Agreement, the United States submits that another objective is symmetry of obligations. Although, as noted, the SCM Agreement lacks a preamble or statement of objectives, the preamble to the *Marrakesh Agreement Establishing the World Trade Organization* refers to “*reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the*

⁵²⁷ This reluctance of the Council to meddle in international tax policy is echoed in Article XIV(d) of the General Agreement on Trade in Services (GATS), which provides a set of exceptions to the GATS national treatment requirement with respect to measures “aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members.” (Footnote omitted). Although Article XIV(d) relates to national treatment, it nonetheless is indicative of a healthy caution on the part of the negotiators against embroiling the WTO in transnational tax issues.

elimination of discriminatory treatment in international trade relations" (Emphasis added). Thus, whatever principles the Panel ultimately chooses to rely on in fulfilling the task assigned to it, those principles must not result in the treatment of some Members more favorably than others based upon whether the Member has a worldwide or territorial tax system. The exemption from tax of foreign-source income earned in export transactions must either be a subsidy in all cases or a subsidy in none.

4.1197 The phrase "whether solely or as one of several other conditions" suggests that if the Panel concludes that the exemption of foreign-source income constitutes revenue foregone that is "otherwise due," then the tax regimes of many, if not all Members – including European Members – will be transformed into export subsidies. As discussed above, territorial or territorial-type systems allow for foreign-source income earned in export transactions to bear less of a tax burden than domestic-source income earned in comparable domestic transactions. The fact that these tax systems may tax other types of foreign-source income more favorably than comparable domestic-source income is irrelevant to an export subsidy analysis, because the SCM Agreement does not require that the export contingency be the "sole" contingency.⁵²⁸

4.1198 To the best of US knowledge, the authorities responsible for administering the US countervailing duty law have never knowingly found a tax measure that exempts foreign-source income from tax, such as the FSC, to be countervailable.⁵²⁹ As explained in paragraph 23 of the Second United States Oral Statement, and as demonstrated in US Exhibit 25, the US Department of Commerce recently has clarified that a measure that exempts foreign-source income from tax would not constitute an export subsidy for purposes of the US countervailing duty law. The reference in US Exhibit 25 to "other relevant WTO rules" was meant to refer to the arm's length principle of footnote 59 and the 1981 Council Decision.⁵³⁰

4.1199 The European Communities has claimed that the language in the Commerce regulations referring to foreign-source income was added solely for purposes of this dispute. This is partially true. Until the European Communities initiated this dispute, it never had been seriously contemplated that the exemption of foreign-source income from tax – provided that the allocation of income did not contravene the arm's length pricing principle of footnote 59 and the Council Decision – was objectionable. The European Communities having raised the issue, it became important for the Commerce Department to clarify its position on the matter.

4.1200 The United States does not believe that the phrase has any special meaning.⁵³¹ However, the United States notes that this phrase was construed by the panel in the *Desiccated Coconut* case. Although the United States quoted the relevant portion of the panel report in paragraph 33 of the Second US Submission, for the convenience of the Panel, the United States will reproduce the quote here. The panel stated as follows:

For example, Article 1.1 of the SCM Agreement contains a definition of "subsidy" and Article 16.1 of the SCM Agreement contains a definition of "domestic industry" both of which are "for purposes of this Agreement". However, the terms "subsidy" and "domestic industry" are used both in Article VI of GATT 1994 and the SCM Agreement. If the term "this Agreement" were interpreted *strictu sensu* to mean the

⁵²⁸ Paragraph 4.1197 reflects the United States' comment on the following question from the Panel: What does the word "solely" refer to in Articles 3.1(a) and 3.1(b) of the SCM Agreement with respect to the coverage of economic activities?

⁵²⁹ The United States says "knowingly" because it is possible that in the near 100-year history of the US countervailing duty law, the responsible authorities may have countervailed a tax measure based on a misunderstanding as to the type of income exempted from tax by the measure.

⁵³⁰ Paragraphs 4.1198-4.1199 reflect the United States' comment on the following question from the Panel: Has the United States or the European Communities investigated a measure like the FSC under domestic countervailing duty procedures?

⁵³¹ Paragraphs 4.1200-4.1201 reflect the United States' comment on the following question from the Panel: In Article 1.1 of the SCM Agreement, does the phrase "For purposes of this Agreement" have any special meaning?

SCM Agreement, then the definitions of these key terms in the SCM Agreement would be inapplicable to the same terms as used in Article VI of GATT 1994. Such a result could not have been intended.⁵³²

4.1201 Thus, the panel rejected the notion that the phrase “For purposes of this Agreement” should be used as a basis for interpreting Article VI and the SCM Agreement in isolation from each other. For the reasons articulated by the *Desiccated Coconut* panel and the Appellate Body, this Panel should seek a harmonious interpretation of Article XVI and the SCM Agreement.

C. WHETHER FSC MEASURES ARE SUBSIDIES CONTINGENT UPON USE OF DOMESTIC OVER IMPORTED GOODS WITHIN THE MEANING OF ARTICLE 3.1(B) OF THE SCM AGREEMENT

The **European Communities** argues in its First Submission as follows:

4.1202 As explained, both the tax exemptions and the availability of the special administrative pricing rules under the FSC scheme are limited to income from the export of products “not more than 50 per cent of the fair market value of which is attributable to articles imported into the United States” (see the definition of “export property” in Section 927(a) of the IRC).

4.1203 In order to qualify for the benefit of the FSC scheme and therefore the FSC subsidies (both the tax exemptions and the availability of the special administrative pricing rules), the manufacturer must ensure that “not more than 50 per cent of the fair market value of which is attributable to articles imported into the United States” and must therefore give preference to United States over imported goods when producing the “export property.”

4.1204 FSC subsidies are therefore both contingent in law upon the use of domestic over imported goods and contrary to Article 3.1(b) of the SCM Agreement.

The **United States** responds in its First Submission as follows:

4.1205 The European Communities argues that the FSC violates Article 3.1(b) of the SCM Agreement because the FSC tax exemption applies to income from export transactions involving products “not more than 50 per cent of the fair market value of which is attributable to articles imported into the United States.”⁵³³ The European Communities' legal conclusion regarding this particular claim is incorrect for several reasons. Moreover, this is an issue that this Panel need not reach.

4.1206 First, the FSC cannot be a prohibited subsidy under Article 3 because it is not a “subsidy” as that term is defined in Article 1. Second, Article 3 expressly provides that any measure that Annex I provides is not an export subsidy cannot be prohibited under any other provision of the SCM Agreement. As established above, the FSC is not an export subsidy under Annex I.

4.1207 However, before addressing these points in more detail, it is important to note that the European Communities' assertion that under the FSC rules a manufacturer “must . . . give preference to United States over imported goods” reflects a misunderstanding of the nature and the effect of the 50 per cent provision.⁵³⁴ First, the 50 per cent requirement applies to the overall *value* of the exported product, not to the domestic versus foreign content of its component parts. In particular, the statutory definition of “export property” provides that “not more than 50 per cent of the *fair market value*” of the property can be attributable to “articles imported into the United States.”⁵³⁵ The fair market value

⁵³² *Brazil - Measures Affecting Desiccated Coconut*, WT/DS22/R, Report of the Panel, as modified by the Appellate Body, adopted 20 March 1997, paragraph 234.

⁵³³ Section 927(a)(1)(C) of the IRC.

⁵³⁴ First EC Submission, paragraph 165.

⁵³⁵ Section 927(a)(1)(C) of the IRC (emphasis added).

is, in turn, defined to be the appraised value of the goods as determined under applicable customs laws and procedures.

4.1208 Therefore, compliance with the 50 per cent requirement takes into account not just the value of “goods” used in producing the finished product, but also every element of value that has contributed to the total market value of the exported product. Thus, value added through manufacturing, assembling, converting, finishing, or otherwise producing the finished product are all included in the calculation. When a significant portion of the value of a finished product is attributable to its intellectual property content, to manufacturing or assembling, or to other non-tangible elements of the product, the “goods” used in manufacturing, whatever their origin, may account for a relatively small proportion of its total value.

4.1209 The practical implications of this rule, properly understood, bear directly on the European Communities' allegations on this point. One implication is that under the 50 per cent rule, a United States exporter may qualify for FSC benefits even if more than 50 per cent of the “goods” used in producing the exported product are imported goods. The reason, of course, is that the value of the non-goods elements of the product, particularly when combined with any US-origin goods, easily meets the 50 per cent of value requirement. Indeed, it is quite possible for a product manufactured or assembled in the United States *entirely from imported goods* to meet the 50 per cent test of the FSC.

4.1210 Second, the practical effect of the 50 per cent rule is further diminished by the principle of origin applicable to components incorporated into products exported from the United States. When, for example, a US exporter sources a component from a United States supplier, that component normally is deemed to be a US-origin good for purposes of the 50 per cent of total value rule. However, the goods from which that component was manufactured may have been primarily, or even entirely, imported goods. In such circumstances, there is no preference for domestic over imported goods because the finished component typically is deemed to be a US-origin good. This same process obviously can occur not only at the level of components, but also at the level of sub-components, sub-sub-components, etc.

4.1211 Third, it also must be recognized that for important exporting industries, the 50 per cent requirement has little or no practical effect. For example, in the agricultural sector that the European Communities targets in this case, the notion of incorporating imported goods into export products is impractical and artificial. Thus, for the agricultural sector, the 50 per cent requirement is largely inapplicable. Likewise, for other industries, such as the chemicals and software industries, the notion of incorporating imported “goods” into products to be exported is commercially impractical.

4.1212 For all of these reasons, the European Communities' characterisation of the 50 per cent requirement is inaccurate and misleading. Nevertheless, as noted above, the Panel does not even have to reach the question of whether these requirements render the FSC tax exemption “contingent . . . upon the use of domestic over imported goods” within the meaning of Article 3.1(b).

4.1213 Article 3.1(b) states in relevant part that “[e]xcept as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited: . . . subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.” However, Article 3.1(a), the export subsidy provision, includes a footnote 5 which states that “Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement.”

4.1214 Accordingly, for a measure to constitute a prohibited subsidy under Article 3, there are four elements to be satisfied, the first two of which are:

- It must be a “subsidy” within the meaning of Article 1;
- It must not be a measure that under Annex I does *not* constitute an export subsidy.

4.1215 The United States has demonstrated above that the FSC is not a subsidy under Article 1 of the SCM Agreement. Because the SCM Agreement and the 1981 Council Decision provide that a Member need not tax income attributable to foreign economic processes, such income does not constitute “revenue that is otherwise due” within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement. Accordingly, the FSC is not a “subsidy” as that term is defined in Article 1. Because Article 3.1 prohibits measures only if they are “subsidies . . . within the meaning of Article 1,” the FSC cannot be violative of Article 3.1(b).

4.1216 An additional reason why the Panel need not reach the question of whether Article 3.1(b) even applies to the FSC is that the European Communities' claim is precluded by footnote 5 of the SCM Agreement. Footnote 5 states that “[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this [Article 3.1(a)]⁵³⁶ or *any other provision of this Agreement*” (emphasis added). According to footnote 5, no prohibition contained anywhere in the SCM Agreement is applicable to measures that are referenced in Annex I as not constituting an export subsidy. As explained above, Annex I, the Illustrative List of Export Subsidies, identifies certain types of measures as being export subsidies and other types of measures as not being export subsidies.

4.1217 A measure does not have to be explicitly listed or identified with particularity in Annex I as not constituting an export subsidy in order to be within the immunity from prohibition conferred by footnote 5. Rather, a measure need only be “referred to” in the Annex. According to *Webster's Third New International Dictionary* (1976), to “refer” means “to think of, regard, or classify under a subsuming principle or with a general group.” Thus, to the extent that a measure can be classified in a general group of measures that, under the standard contained in Annex I, do not constitute export subsidies, it is not subject to any prohibition contained in the SCM Agreement.

4.1218 The FSC meets this standard. As discussed in detail above, footnote 59 and the 1981 Council Decision establish a “subsuming principle” or “general group” that is relevant to the FSC; that is, measures that exempt income attributable to foreign economic processes are not export subsidies if they are based on administrative or other practices that do not contravene the arm's length principle or, if they do contravene such principle, do not result in a significant saving of direct taxes in export transactions. The FSC does not implicate either of these conditions, and thus does not give rise to an export subsidy.

4.1219 Therefore, because the FSC is not an export subsidy pursuant to Annex 1, and because footnote 5 of the SCM Agreement renders the FSC immune from all other prohibitions in the SCM Agreement, it cannot be prohibited under Article 3.1(b).

The European Communities rebuts the United States' response in its Oral Statement at the First Meeting of the Panel as follows:

4.1220 The European Communities explained in its First Written Submission that the violation of Article 3.1(b) follows from the fact that the FSC tax exemptions and the availability of the special administrative pricing rules under the FSC scheme are limited to income from the export of products “not more than 50 per cent of the fair market value of which is attributable to articles imported into the United States” (See the definition of “export property” in Section 927(a) IRC).

4.1221 In order to qualify for the benefit of the FSC scheme and therefore the FSC subsidies (both the tax exemptions and the availability of the special administrative pricing rules), the manufacturer must ensure that “not more than 50 per cent of the fair market value of which is attributable to articles imported into the United States” and must therefore give preference to United States over imported goods when producing the “export property.”

4.1222 The FSC subsidies are therefore both contingent in law upon the use of domestic over imported goods and contrary to Article 3.1(b) of the SCM Agreement.

⁵³⁶ Footnote 5 is attached to Article 3.1(a). Thus, the term “this . . . provision” refers to Article 3.1(a).

4.1223 Apart from arguing that there is no subsidy, the only defence the United States can bring up is that in some cases the actual United States content may be less than 50 per cent since individual components may be made up of some non-US parts. Article 3.1.(b). indicates that the subsidy must be "contingent" upon the use of domestic over imported parts; it does not qualify the prohibition on the basis of actual usage i.e. that if 100 per cent imported parts were used in a particular product, for that particular export the subsidy would not be prohibited. The fact that a producer has to take into account the 50 per cent test in order to meet the conditions for the subsidy forces him to make decisions on the sourcing of parts which would not have been made in the absence of the provision. Furthermore, there is no *de minimis* rule for the application of the prohibition on local content subsidies either.

The **United States** further responds in its Oral Statement at the First Meeting of the Panel as follows:

4.1224 Furthermore, the fact that the FSC is not a subsidy at all means that it cannot be an import-substitution subsidy. By the terms of Article 3.1(b), a measure does not constitute an import-substitution subsidy unless it is first a subsidy.

4.1225 In addition, because footnote 59 provides that tax exemptions for income attributable to foreign economic processes, such as the FSC, do not constitute prohibited export subsidies, the FSC cannot be prohibited under Article 3.1(b). Footnote 5 of the SCM Agreement states that any measure referred to in Annex I as not being an export subsidy is not prohibited by any provision of the SCM Agreement. Footnote 5, when read in conjunction with footnote 59, renders the FSC exempt from any prohibition under Article 3.1(b).

The **United States** further responds in its Second Submission as follows:

4.1226 With respect to the European Communities' allegation that the FSC tax exemption and the FSC administrative pricing rules violate Article 3.1(b) of the SCM Agreement, at the first meeting of the Panel, the European Communities conceded that a measure can violate Article 3.1(b) only if it is a subsidy. As established above and in the First US Submission, because the FSC does not involve the foregoing of revenue that is "otherwise due" within the meaning of Article 1.1(a)(1)(ii), the FSC cannot violate Article 3.1(b).

4.1227 In addition, because the FSC does not, pursuant to footnote 59, constitute an export subsidy under Annex I, the FSC is not prohibited under Article 3.1(b) by virtue of footnote 5 of the SCM Agreement. In the section of its Oral Statement dealing with Article 3.1(b), the European Communities does not address footnote 5 and appears to concede that if a measure is not referred to as constituting an export subsidy under Annex I, footnote 5 precludes the measure being treated as a prohibited subsidy under Article 3.1(b).⁵³⁷

4.1228 The European Communities, however, did mention footnote 5 in connection with its arguments concerning the FSC as an alleged export subsidy, stating that footnote 5 "only relates to measures which are considered not to be export subsidies in the Illustrative List. If it exempted subsidies not expressly prohibited by the Illustrative List, it would be transforming the Illustrative List into an *exhaustive list*, which would be contrary to the expressed intent."⁵³⁸

4.1229 The United States must confess that it finds the above-quoted statement difficult to follow. What the European Communities *seems* to be saying is that even if the FSC does not constitute an export subsidy under the criteria of item (e) and footnote 59 of the Illustrative List, it can still be found to be an export subsidy under some other set of criteria. The United States has addressed this argument above, and simply will reiterate here that: (1) the European Communities' approach to the status of the Illustrative List would render footnote 5 a nullity; and (2) the United States approach to

⁵³⁷ EC Oral Statement, paragraphs 90-93.

⁵³⁸ EC Oral Statement, paragraph 88 (emphasis in original).

the status of the Illustrative List gives meaning to footnote 5 without transforming the List into an exhaustive list.

4.1230 Finally, in its discussion of the FSC 50 per cent fair market value requirement, the European Communities carefully tiptoes around the fact that the FSC statute does not *require* the use of domestic over imported goods. The European Communities states that “[t]he fact that a producer has to take into account the 50 per cent test in order to meet the conditions for the subsidy forces him to make decisions on the sourcing of parts which would not have been made in the absence of the provision.”⁵³⁹

4.1231 Aside from the fact that the European Communities' assertion about what a producer is “forced” to do is unsupported by any evidence, it is questionable whether, in the absence of a requirement that domestic goods be used in favor of imported goods, the effect alleged by the European Communities constitutes the sort of “contingency” required by Article 3.1(b). If it does, then the United States submits that the favorable tax treatment accorded by territorial tax systems to export transactions, as opposed to domestic transactions, equally constitutes a “contingency” for purposes of Article 3.1(a). Because a producer subject to a territorial tax system can pay less taxes if it exports than if it sells domestically, this forces the producer to make decisions which would not have been made if export and domestic transactions bore the same tax burden.

4.1232 As is the case with its claims under Article 3.1(a), the European Communities' inability to demonstrate that the FSC is a subsidy under Article 1 means that it cannot be a prohibited subsidy under Article 3.1(b). In addition, under footnote 5, the FSC is immune from all prohibitions in the SCM Agreement because under footnote 59 a measure such as the FSC is referred to as not being an export subsidy. Finally, the European Communities has failed to demonstrate that the FSC tax exemption is contingent upon the use of domestic over imported goods.

The **European Communities** further rebuts the United States' response in its Oral Statement at the Second Meeting of the Panel as follows:

4.1233 The United States pays little attention to the violation of Article 3.1(b) of the SCM Agreement. The United States repeats that there is no violation of Article 3.1(b) if there is no subsidy and if it benefits from footnote 5. These matters have already been dealt with.

4.1234 The other argument the United States makes⁵⁴⁰ is to question whether the local content effect constitutes the sort of “contingency” required by Article 3.1(b) and that any effect it has is comparable to that resulting from territorial tax systems because, and I quote:

“a producer subject to a territorial tax system can pay less taxes if it exports than if it sells domestically, this forces the producer to make decisions which would not have been made if export and domestic transactions bore the same tax burden.”

4.1235 The United States argument is difficult to follow. As the European Communities explained in its First Written Submission, FSC benefits only apply to the export of “export property” which is defined in Section 927(a) IRC to be property “not more than 50 per cent of the fair market value of which is attributable to articles imported into the United States.” The United States is doubting whether this is “contingency” for the purposes of Article 3.1(b) because there are some cases in which

⁵³⁹ EC Oral Statement, paragraph 93. In the same paragraph, the European Communities distorts the First US Submission when it states that “the only defence the US can bring up is that in some cases the actual US content may be less than 50 per cent since individual components may be made up of some non-US parts.” What the United States said was that because the 50 per cent requirement is based on the “value” of the finished product, that product could consist of 100 per cent imported “goods” and still qualify for the FSC tax exemption. Rather than reiterate here what the United States actually said, the United States refers the Panel to the First US Submission, paragraphs 156-163.

⁵⁴⁰ Paragraph 151 of the US Second Written Submission.

the value added by assembly or manufacture in the United States will already amount to 50 per cent so that the condition is not a constraint.

4.1236 The European Communities considers that where a law sets a restriction on the use of imported materials (as Section 927(a) clearly does) that is a local content contingency and it is irrelevant if in a certain number of cases the restriction has no effect in practice. There is at least local content contingency in all those cases where the non-component or raw material value of the exported goods is less than 50 per cent since it will not then be possible to use 100 per cent imported components or raw materials.

4.1237 The comparison with the effect of territorial tax systems is entirely misconceived and the United States has not identified any legal requirement in such systems relating to the use of domestic products or restricting the use of imported products.

D. WHETHER FSC MEASURES ARE IN VIOLATION OF THE AA

The **European Communities** argues in its First Submission as follows:

Introduction

4.1238 Article 3.1 of the SCM Agreement applies “except as provided in the Agreement on Agriculture”. It is therefore necessary to examine whether the AA allows the provision of FSC subsidies to agricultural products. It will be demonstrated below that it does not and that the FSC scheme also violates Articles 3 and 8 of the AA read in conjunction with its Articles 9.1(d), 10.1, and 10.3 of the AA. The European Communities will present two lines of argument; the first based on the assumption that FSC subsidies fall under Article 9.1 of the AA (specifically Article 9.1(d)) and the second on the assumption that they do not.

4.1239 The European Communities will first discuss the provisions of the AA relevant to both arguments and present the data for the agricultural products to be used as examples.

The Relevant Common Provisions of the AA

4.1240 Article 1(e) of the AA defines “Export subsidies” as:

“subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement”.

4.1241 Article 3 of the AA provides, insofar as relevant for export subsidies, that:

“1. The ... export subsidy commitments in Part IV of each Member's Schedule constitute commitments limiting subsidization...

...

3. Subject to the provisions of paragraphs 2(b) and 4 of Article 9, a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule *in excess of the budgetary outlay and quantity commitment levels specified therein and shall not provide such subsidies in respect of any agricultural product not specified in that Section of its Schedule.*”

(Emphasis added.)

4.1242 Article 8 of the AA provides that:

“Each Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member's Schedule.”

4.1243 Accordingly, export subsidies are not allowed under the AA for agricultural products in excess of the budgetary outlay and quantity commitment levels specified in the relevant Schedule and are not allowed at all for agricultural products not listed in the Schedule.

4.1244 Subsidies which are not allowed under the AA may of course be prohibited under the SCM Agreement. It has been shown above that the FSC subsidies are so prohibited.

4.1245 The AA recognises in Article 10.1 of the AA that there may be some export subsidies that may not be covered by Article 9.1 of the AA. It states that:

“Export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments; nor shall non-commercial transactions be used to circumvent such commitments.”

4.1246 Apart from the non-commercial transactions (i.e. development aid) mentioned in Article 10.1, there is the case of export credits referred to in Article 10.2 of the AA.

4.1247 In view of the difficulty for Members to identify which export transactions are subsidised and which are not, Article 10.3 of the AA reverses the burden of proof and provides that:

“Any Member which claims that any quantity exported in excess of a reduction commitment level is not subsidized must establish that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports in question.”

US Exports of Agricultural Products Benefiting from FSC Subsidies

4.1248 The European Communities has provided in Exhibit EC-16 data on United States exports and European Communities imports of United States wheat, maize, soya beans and cotton for the period 1995 to 1997. These show exports of all these products to the European Communities. For maize, soya beans, and cotton, the United States has included no reduction commitments in its Schedule and so no export subsidies are allowed. For wheat, United States notifications to the Committee on Agriculture show that the quantities of product exported with subsidies were below the commitments.

4.1249 There is nothing in the FSC legislation or elsewhere in United States legislation, which prevents exports of maize, soya beans and cotton from benefiting from the FSC subsidies.

4.1250 The latest figures provided by the United States for FSCs relate to 1992. Table 1 to Exhibit EC-12 shows 27 FSCs active in the export of “grains and soybeans” and 9 for cotton with gross receipts of US\$4.4 and 1.7 million respectively. This demonstrates that FSCs can be and are used for the export of these products. Indeed the FSC legislation contains specific rules designed to facilitate the application of the scheme to agricultural cooperatives (Sections 923(a)(4) and 925(f) of the IRC).

4.1251 Sections 923(a)(4) of the IRC provides that in the case of a FSC owned by a cooperative, the exempt foreign trade income of the FSC is 100 per cent of its foreign trade income (instead of 65 per cent as is normally the case – see Section II.C.8 above).

4.1252 Since the use of FSCs is expanding throughout the United States economy with the use of computer software to maximise the benefits, it is clear that the exports of wheat, maize, soya beans, and cotton for the period 1995 to 1997 mentioned above have benefited to some extent from the FSC subsidies.

4.1253 The European Communities will now explain how the FSC subsidies, whether falling under Article 9.1 of the AA or not, must be considered contrary to the AA..

FSC Subsidies Fall under Article 9.1(d) of the AA

4.1254 Article 9:1 (d) of the AA requires to be scheduled and to be reduced:

“the provision of subsidies to reduce costs of marketing exports of agricultural products (other than widely available export promotion and advisory services) including handling, upgrading and other processing costs, and the costs of international transport and freight.”

4.1255 It may be considered that the FSC scheme falls within this category. By reducing the tax liability arising out of foreign sales, the FSC scheme is reducing the costs of marketing exports. The exception for “widely available export promotion and advisory services” does not apply since the FSC scheme is not a “service” but a tax exemption.

4.1256 Of the four agricultural products being considered, maize, soya beans, and cotton for the period 1995 to 1997 could not be exported with export subsidies at all. Therefore the application of the FSC scheme to them was contrary to the AA.

4.1257 Wheat on the other hand may attract export subsidies under the AA. However, as indicated in the table in Exhibit EC-16, a quantity of up to 20.2 Mio tonnes could in 1995 be exported under the commitment. The United States has notified that only 560 000 tonnes received such subsidies in 1995. In total, the United States exported 32.4 Mio tonnes of wheat in 1995 which means that 31.8 Mio tonnes were claimed to be exported without export subsidies.

4.1258 The United States does not take into account subsidies provided to agricultural products under the FSC scheme for the purpose of compliance with its commitments under the AA.

4.1259 According to Article 10.3 of the AA, it is for the United States to prove that all the maize, soybeans and cotton, and all the wheat in excess of its reduction commitments were exported without the benefit of FSC subsidies. If it does not do so, it must be deemed to have violated Articles 8 and 3.3 of the AA.

FSC Subsidies Do Not Fall under Article 9.1(d) of the AA

4.1260 Even if the FSC scheme subsidy does not fall under Article 9.1(d), this does not prevent it from being contrary to Article 8 of the AA which applies to all export subsidies to agricultural products, whether or not described in Article 9.1 of the AA.

4.1261 The export subsidy commitments in the case of the United States for maize, soya beans, and cotton are zero.

4.1262 Therefore, pursuant to Article 10.3 of the AA, it is for the United States to prove that all the maize, soya beans and cotton and all the wheat in excess of its reduction commitments was exported without the benefit of FSC subsidies. If it does not do so, it must be deemed to have violated Articles 8 and 3.3 of the AA as well as Article 3 of the SCM Agreement in respect of these subsidies.

Conclusion

4.1263 Subject to the United States demonstrating that none of its exports of cotton, maize, or soya beans benefit from the FSC subsidies and that none of its exports of wheat in excess of its reduction commitments do so, it must be held to have violated Articles 3.3 and 8 of the AA.

The **United States** responds in its First Submission as follows:

4.1264 The FSC does not violate United States obligations under the AA for the simple reason that, as demonstrated below, the FSC is not an export subsidy for purposes of that Agreement.

The Export Subsidy Provisions of the AA Must Be Interpreted in Light of Article XVI of GATT 1994 and the SCM Agreement

4.1265 As an initial starting point, one must determine what an “export subsidy” is for purposes of the AA. In this regard, the European Communities has cited two provisions, Article 1(e) and Article 9.1(d) of that Agreement. Article 1(e) is a general definition that provides as follows: “‘export subsidies’ refers to subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement.” Article 9.1(d) is more specific, providing as follows:

1. The following export subsidies are subject to reduction commitments under this Agreement:

...

(d) the provision of subsidies to reduce the costs of marketing exports of agricultural products (other than widely available export promotion and advisory services) including handling, upgrading and other processing costs, and the costs of international transport and freight.

As is obvious from the text, neither of these provisions defines the term “subsidy”. Moreover, no other provision of the AA provides such a definition.

4.1266 Accordingly, as an initial threshold question, the Panel must interpret the term “subsidy” as it is used in the AA. The United States submits that in accomplishing this task, the *VCLT* and Article 21.1 of the AA require the Panel to consider, as part of the context of the treaty provisions in question, relevant provisions of other WTO agreements.⁵⁴¹ In this regard, provisions that clearly are relevant are Article XVI of GATT 1994 and Articles 1 and 3.1(a) and Annex I of the SCM Agreement. Indeed, paragraph (c)(ii) of Article 13 of the AA (the so-called “peace clause”) expressly recognises the linkage between the AA and these provisions.⁵⁴²

4.1267 As an additional aid to interpretation, the Appellate Body also has emphasised Article XVI:1 of the *WTO Agreement*, which provides as follows:

Except as otherwise provided under this Agreement or the Multilateral Trade Agreements, the WTO shall be guided by the decisions, procedures and customary practices followed by the CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947.⁵⁴³

Thus, for example, decisions made and reports issued under Article XVI of GATT 1947 and the Subsidies Code also are relevant to the interpretation of the term “export subsidy” as used in the AA.

4.1268 Finally, paragraph 1(b)(iv) of GATT 1994 provides that GATT 1994 shall consist of “other decisions of the CONTRACTING PARTIES to GATT 1947”

4.1269 Taking these interpretative resources into account, it is obvious that the FSC is not an export subsidy for purposes of the AA.

⁵⁴¹ Article 21.1 provides as follows: “The provisions of GATT 1994 and of other Multilateral Trade Agreements in Annex 1A to the WTO Agreement shall apply subject to the provisions of this Agreement.

⁵⁴² Article 13(c)(ii) provides that during the implementation period, export subsidies in conformity with Part V of the AA shall be exempt from actions based, *inter alia*, on Article XVI of GATT 1994 or Article 3 of the SCM Agreement.

⁵⁴³ *Brazil - Measures Affecting Desiccated Coconut*, WT/DS22/AB/R, Report of the Appellate Body adopted 20 March 1997, at 14.

Given the Absence of any Contrary Indication in the AA, Because the FSC Does Not Constitute a Subsidy for the Purposes of the SCM Agreement or Article XVI of GATT 1994, It Does Not Constitute an Export Subsidy Within the Meaning of Article 1(e) of the AA

4.1270 As demonstrated above, the FSC does not constitute a subsidy, let alone an export subsidy, under the SCM Agreement. Moreover, while the European Communities has not made a claim under Article XVI of GATT 1994, the discussion above demonstrates that the FSC would not constitute a subsidy for purposes of Article XVI. In particular, the FSC is consistent with the terms of the 1981 Council Decision, a decision which, pursuant to paragraph 1(b)(iv) of GATT 1994, constitutes part of GATT 1994, and which, pursuant to Article XVI:1 of the *WTO Agreement*, must guide the WTO.

4.1271 Thus, in light of the fact that the FSC is not a subsidy or an export subsidy for purposes of the SCM Agreement or GATT 1994, and in the absence of anything in the AA that would indicate a contrary result, the FSC cannot be considered an “export subsidy” for purposes of Article 1(e) of the AA.

The FSC Does Not Constitute an Export Subsidy Within the Meaning of Article 9.1(d) of the AA

4.1272 The FSC also does not constitute an export subsidy for purposes of Article 9.1(d) of the AA. There are two criteria that must be satisfied in order for a measure to fall under Article 9.1(d). First, the measure must be an export subsidy. Second, the export subsidy must be provided “to reduce the costs of marketing exports of agricultural products (other than widely available export promotion and advisory services) including handling, upgrading and other processing costs, and the costs of international transport and freight.” The FSC satisfies neither criterion.

4.1273 With respect to the first criterion, as demonstrated above, the FSC is not an export subsidy within the meaning of Article 1(e) of the AA. Thus, even assuming *arguendo* that the FSC is provided to reduce the costs of marketing expenses, etc., it would not be covered by Article 9.1(d).

4.1274 Second, assuming *arguendo* that the FSC is an export subsidy, it is not provided to reduce the costs of marketing expenses, etc. Based on the ordinary meaning of the terms used, the FSC does not reduce marketing expenses. Instead, the FSC statute increases the after-tax net income of a FSC. It does so not by reducing marketing costs but by reducing the tax liability. The costs incurred by a firm for marketing expenses do not change depending upon whether or not the firm files an income tax return as a FSC.⁵⁴⁴

4.1275 In addition, as a contextual matter, an examination of the SCM Agreement reveals that the drafters of the WTO subsidy rules knew how to distinguish between potential tax-related subsidies and other types of subsidies. For example, paragraphs (e) through (h) of the Illustrative List establish specific rules for different types of tax measures. In light of this, it is inconceivable that those same drafters would have intended that tax measures be covered by a provision such as Article 9.1(d) that, by its terms, deals with subsidies provided to reduce marketing expenses and that does not even mention the word “tax”.⁵⁴⁵

4.1276 With respect to the European Communities' claims under the AA, the European Communities' failure to meet its burden of proof is even more manifest. With respect to the European Communities' assertion that the FSC falls under Article 9.1(d), one searches the First EC Submission in vain for any explanation, let alone proof, that the FSC constitutes an export subsidy for

⁵⁴⁴ Indeed, if Article 9.1(d) were construed in the manner suggested by the European Communities, then that provision would apply to rebates of a VAT.

⁵⁴⁵ The European Communities has not alleged that the FSC falls under any other paragraph of Article 9.1 of the AA. However, to complete the analysis, the United States submits that none of those other paragraphs would cover an income tax measure, such as the FSC.

purposes of the AA, one of the prerequisites for an Article 9.1(d) subsidy. In addition, the European Communities' assertion that the FSC "reduce[s] the costs of marketing exports" is untenable in light of the ordinary meaning of the words in Article 9.1(d).

4.1277 Likewise, with respect to its assertion that FSC constitutes an "[e]xport subsid[y] not listed in paragraph 1 of Article 9" within the meaning of Article 10 of the AA, the European Communities has not offered any explanation or evidence as to why the FSC constitutes an export subsidy within the meaning of Article 1(e) of that Agreement. Instead, the European Communities relies on Article 10.3 of the AA in an attempt to avoid its burden of proof. Assuming *arguendo* that Article 10.3 is applicable, at most it shifts the burden to the responding Member to establish that products exported in excess of a reduction commitment level did not take advantage of a particular measure alleged to be a subsidy, or, alternatively, that the measure is not an export subsidy. However, Article 10.3 cannot be construed to shift any evidentiary burden where the exported product either does not appear in Section II, Part IV of the Member's schedule or the quantity reflected in the schedule is zero. Only products listed in Section II along with a specific positive quantity are subject to reduction commitments, and the scope of Article 10.3 is limited expressly to quantities of any product "exported in excess of a reduction commitment." Thus, only in those specific circumstances could Article 10.3 relieve the complaining Member of the obligation to make a *prima facie* case that the measure in question is, in fact, an export subsidy. In the context of this case, this means that if the burden of proof shifts to the United States at all under Article 10.3, it shifts only with respect to wheat, the only agricultural product identified by the European Communities for which the United States has a positive reduction commitment.

4.1278 In any event, the United States has established that the FSC is not an export subsidy for purposes of the AA.

The **European Communities** rebuts the United States' response in its Oral Statement at the First Meeting of the Panel as follows:

Introduction

4.1279 The European Communities has explained in its First Written Submission⁵⁴⁶ that the FSC scheme also violates Articles 3 and 8 of the AA read in conjunction with its Articles 9.1(d), 10.1, and 10.3 AA. The European Communities presented two lines of argument; the first based on the assumption that FSC subsidies fall under Article 9.1(d) of the AA⁵⁴⁷ and the second on the assumption that they do not⁵⁴⁸.

4.1280 Apart from raising a procedural objection⁵⁴⁹, the United States has made a number of arguments in reply.

The United States claim that there is no subsidy within the meaning of the AA

4.1281 The first United States objection is that although many provisions of the AA regulate "export subsidies" and there are definitions of "export subsidies" in Article 1 (e) and 9 of the AA, there is no definition of the term "subsidy".

4.1282 The European Communities assumed and now submits formally that in view of the similarity between Article 1(e) of the AA and Article 3.1(a) of the SCM Agreement, the term used in the AA must have the same meaning as in the SCM Agreement, at least insofar as export subsidies are concerned. One reason for this is that Article 3.1(a) starts off with an exception for the export

⁵⁴⁶ Paragraphs 167-192.

⁵⁴⁷ Paragraphs 183-188.

⁵⁴⁸ Paragraphs 189-191.

⁵⁴⁹ Dealt with separately [].

subsidies allowed by the AA. The terms used in both Agreements must therefore have the same meaning.

4.1283 The United States contends that Article XVI GATT needs to be taken into consideration and that in the light in particular of Article XVI: 1 WTO and paragraph 1(b)(iv) of the language incorporating GATT 1994 into the WTO, “it is obvious that the FSC is not an export subsidy for the purposes of the AA.”⁵⁵⁰

4.1284 This view seems to be based entirely on the reasoning (or rather alleged “controlling legal standard”) that what a Member considers to be a foreign economic process may be exempted from tax at the discretion of the Member which may include export contingency, which the European Communities has already refuted. If the European Communities should be mistaken and there are some additional reasons, it would ask for this to be made clear.

Claim that the FSC does not reduce marketing costs under Article 9.1(d) of the AA

4.1285 Article 9:1 (d) of the AA requires to be scheduled and to be reduced:

“the provision of subsidies to reduce costs of marketing exports of agricultural products (other than widely available export promotion and advisory services) including handling, upgrading and other processing costs, and the costs of international transport and freight.”

4.1286 Apart from repeating that the FSC is not a subsidy, the United States argument is that the FSC scheme reduces tax liability, not marketing costs and that “costs incurred by a firm for marketing expenses do not change depending upon whether or not the firm files an income tax return as a FSC.”⁵⁵¹

4.1287 The European Communities would point out that the FSC scheme, by the United States’ own admission, reduces tax payable on the “income of distributor functions” of an export transaction. In this way the FSC scheme is partially compensating the costs of marketing exports. The United States argument that the subsidy does not reduce costs, just tax liability” cannot be accepted since otherwise a direct grant to companies marketing agricultural products would escape Article 9.1(d) – it could be argued that the grant was not reducing costs, just increasing revenue ! The existence of a subsidy must surely be independent of the means by which it is delivered.

4.1288 The important point is that the FSC subsidies when applied to agricultural products are by their nature related to the distribution or marketing of the products. Marketing means advertising, sales promotion and solicitation and these are all activities which the FSC is required to perform (or be responsible for).⁵⁵²

US rejection of burden of proof that it is not circumventing its commitments under Article 10.3 of the AA

4.1289 As mentioned above, the European Communities brought an alternative claim under the AA for the case that the FSC subsidies should not be considered to fall under Article 9.1(d).

4.1290 Article 10.1 of the AA provides that:

“Export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export

⁵⁵⁰ Paragraphs 170-174 of the US First Written Submission.

⁵⁵¹ Paragraph 179 of the US First Written Submission.

⁵⁵² See Sections 924(e)(1) and 924 (d)(1)(A) IRC.

subsidy commitments; nor shall non-commercial transactions be used to circumvent such commitments.”

4.1291 In view of the difficulty for Members to identify which export transactions are subsidised and which are not, Article 10.3 of the AA reverses the burden of proof and provides that:

“Any Member which claims that any quantity exported in excess of a reduction commitment level is not subsidized must establish that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports in question.”

4.1292 The European Communities therefore claimed that it is for the United States to prove that its agricultural products for which there were reduction commitments were exported without the benefit of FSC subsidies.

4.1293 The European Communities chose four products which the United States has been exporting to the European Communities since 1995 in respect of which it invited the United States to provide the required proof. These are maize, soybeans, and cotton, for which the United States has scheduled no reduction commitments and wheat in respect of which there are reduction commitments. The factual background and the available data on United States exports were set out in Section III.C.3 and Exhibit EC-16 of the European Communities' First Written Submission.

4.1294 The United States has in effect rejected the invitation to provide the proof required by Article 10.3 of the AA. It makes three points:

- It repeats that the FSC does not give rise to export subsidies within the meaning of the AA and adds in the alternative that the European Communities has not proved this.
- Article 10.3 does not shift the evidentiary burden where the exported product either does not appear in Section II, Part IV of the Member's schedule or the quantity reflected in the schedule is zero.
- The only agricultural product identified by the European Communities for which the United States has a positive reduction commitment is wheat and therefore if the burden of proof shifts to the United States at all under Article 10.3, it shifts only with respect to wheat.

4.1295 The European Communities need not comment further on the first point about whether the FSC subsidies are export subsidies for the purpose of the AA.

4.1296 On the second point, there is a further major legal disagreement. The United States does not appear to disagree that it is not allowed to give any export subsidies for maize, soybeans or cotton issue, but argues that a shift the evidentiary burden occurs only when the quantity reflected in the schedule is a specific positive amount. It supports this by selective and misleading quotation from Article 10.3 of the AA. The European Communities will remedy this and show the United States is wrong by re-quoting the provision emphasizing the parts it has omitted.

“Any Member which claims that *any quantity* exported in excess of a reduction commitment *level* is not subsidized must establish that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports in question.”

4.1297 The European Communities sees no reason why a “reduction commitment level” should not be or become zero. Why should the reversal of the burden of proof disappear as soon as the reduction commitment has reached zero? It is after all easier for the Member concerned to prove that the

exported quantities did not benefit from any subsidies if the commitment is zero than if it is a positive number. Also a zero commitment is more valuable to other Members and it is therefore more important that it be properly respected.

4.1298 On the third point, the European Communities notes that the United States accepts that it has reduction commitments, does not deny that it exports more than its reduction commitment as indicated in Exhibit EC-16, but does not attempt to prove that these amounts are not subsidised.

The **United States** further responds in its Oral Statement at the First Meeting of the Panel as follows:

4.1299 Finally, the FSC does not violate the export subsidy provisions of the AA. As explained in the First US Submission, the FSC does not fall under any of the categories of export subsidies set forth in Article 9.1 of the AA, including Article 9.1(d). With respect to the general definition of export subsidy in Article 1(e) of the AA, the Panel must, absent anything to the contrary in the AA, interpret Article 1(e) in light of the relevant provisions of GATT 1994 and the SCM Agreement. In the view of the United States, for the reasons previously explained, the FSC does not constitute a subsidy, let alone an export subsidy, under those provisions. Accordingly, the FSC does not constitute an export subsidy for purposes of the AA.

4.1300 With respect to the AA, the European Communities' claim that the US interpretation of Article 9.1(d) would allow direct payments to cover marketing expenses to go unremedied is specious and raises a non-existent problem. Direct payments are covered by Article 9.1(a), and the Panel should not distort the plain text of Article 9.1(d) to solve a non-problem.

The **European Communities** further rebuts the United States' response in its Second Submission as follows:

Introduction

4.1301 The European Communities has explained that the FSC scheme also violates Articles 3 and 8 of the AA read in conjunction with its Articles 9.1(d), 10.1, and 10.3 of the AA. The European Communities presented two lines of argument; the first based on the assumption that FSC subsidies fall under Article 9.1(d) of the AA⁵⁵³ and the second on the assumption that they do not⁵⁵⁴.

4.1302 The United States made a number of arguments in reply to which the European Communities provided an initial response at the First Meeting of the Panel⁵⁵⁵. The European Communities will simply refer the Panel to those arguments and not repeat them now except to the extent needed to respond to the arguments of the United States.

4.1303 The European Communities has a number of additional points to make.

The Meaning of the Term "Subsidy" in the AA

4.1304 The United States argues⁵⁵⁶ that since there is no definition of the term "subsidy" in the AA this term should be interpreted in the light not only of the SCM Agreement but also of Article XVI GATT. It then rather peremptorily concludes⁵⁵⁷ that it is therefore "obvious" that the FSC is not an export subsidy for the purposes of the AA.

4.1305 The European Communities considers that the term "subsidy" used in the AA must have the meaning given to it by Article 1 of the SCM Agreement. That Article defines the term subsidy for all

⁵⁵³ Paragraphs 183-188.

⁵⁵⁴ Paragraphs 189-191.

⁵⁵⁵ Paragraphs 96 to 113 of the European Communities' Statement to the First Meeting of the Panel.

⁵⁵⁶ Paragraph 170 to 174 of the US First Written Submission

⁵⁵⁷ Paragraph 174 of the US First Written Submission.

the purposes of the SCM Agreement and Article 3.1(a) contains an exception for export subsidies allowed by the AA. The subsidies thus excepted must be the same as the measures which are allowed by the AA and thus the word subsidy must have the same scope and meaning in both Agreements.

4.1306 The only difficulty that the European Communities can perceive with this approach is that the term “subsidy” used in the AA would cover both specific and non specific subsidies. However this problem does not arise since the AA only uses the term subsidy in connection with export subsidies.

4.1307 The United States does not explain how the definition of subsidy in Article XVI GATT would be different but it is clear from both the interpretative note to Annex 1A to the WTO Agreement and the negotiating history (the AA and the SCM Agreement were negotiated in parallel) that if there is any conflict between the definitions to be used for the purposes of the AA, the definition in the SCM Agreement must prevail.

4.1308 The European Communities would add that the definition of an export subsidy for the purpose of the AA is simply a subsidy which is contingent upon export performance and these are deemed to include those listed in Article 9 but *not* those contained in the Illustrative list in Annex I to the SCM Agreement. Therefore the United States contextual argument in paragraph 180 of its First Written Submission appears misconceived. For the purposes of the AA, the WTO members did not wish to distinguish between the export subsidies delivered through the tax system and in other ways.

4.1309 Accordingly, the FSC subsidies are export subsidies for the purposes of the AA for the same reason that they are subsidies under the SCM Agreement and are demonstrated to be contingent upon export performance for the purposes of that agreement.

Article 9.1(d) of the AA

4.1310 In its Statement to the First Meeting of the Panel, the European Communities refuted the United States that the FSC scheme reduces tax liability, not marketing costs and that “costs incurred by a firm for marketing expenses do not change depending upon whether or not the firm files an income tax return as a FSC.”⁵⁵⁸

4.1311 The European Communities argued that the existence of a subsidy must surely be independent of the means by which it is delivered. It would add that this is in fact clear from the rest of paragraph (d) where it is expressly provided that reducing the costs of international transport and freight is an example of the ways in which marketing costs can be reduced.

4.1312 The European Communities further argued that FSC subsidies when applied to agricultural products are by their nature related to the distribution or marketing of the products. Marketing means advertising, sales promotion and solicitation and these are all activities which the FSC is required to perform (or be responsible for).⁵⁵⁹

4.1313 The United States preliminary reply at the First Meeting of the Panel was merely to say that direct payments are covered by paragraph 9.1(a). This is true only to the extent that they are contingent upon exports and satisfy the other conditions of that provision. Article 9.1(d) has a separate purpose, to bring subsidies which reduce the costs of marketing exports under the disciplines of Article 9. That purpose applies whatever the means by which the subsidy is delivered.

US rejection of burden of proof that it is not circumventing its commitments under Article 10.3 of the AA

4.1314 The United States attempted to avoid the European Communities' alternative claim under Article 10.1 of the AA by simply rejecting the burden of proof that Article 10.3 of the AA provides

⁵⁵⁸ Paragraph 179 of the US First Written Submission.

⁵⁵⁹ See Sections 924(e)(1) and 924 (d)(1)(A) IRC.

that a Member must bear if it claims that any quantity exported in excess of a reduction commitment level is not subsidised. Curiously it did not even attempt to fulfil its burden of proof in respect of wheat for which it accepted that it had reduction commitments.

4.1315 The European Communities replied to the United States' arguments at the First Meeting of the Panel and since the United States has made no further argument, has nothing to add at present.

The **United States** further responds in its Second Submission as follows:

4.1316 With respect to the European Communities' claim that the FSC violates United States obligations under the AA, the United States previously has demonstrated that the FSC does not constitute an export subsidy for purposes of the AA.⁵⁶⁰ In this section, the United States will comment briefly on arguments made by the European Communities at the first meeting of the Panel.

4.1317 First, the European Communities does not appear to contest the fact that GATT Article XVI is relevant for purposes of interpreting the export subsidy provisions of the AA.⁵⁶¹ It acknowledges the United States argument that Article XVI is relevant, and rather than disputing that argument, it simply draws different conclusions than does the United States from the Article XVI precedents.

4.1318 Second, in support of its assertion that the FSC falls under Article 9.1(d) of the AA, the European Communities argues that if this were not the case, "a direct grant to companies marketing agricultural products would escape Article 9.1(d) ...".⁵⁶² However, as previously noted by the United States, a direct grant would be covered by Article 9.1(a), and the Panel should not distort the plain meaning of Article 9.1(d) in order to solve a non-existent problem.⁵⁶³

4.1319 Third, with respect to the European Communities' reliance on Article 10.3 of the AA, the United States again notes the inconsistency between the European Communities' reliance on this provision and its position with respect to the fourth sentence of footnote 59. The European Communities asserts that it was not required to raise its concerns regarding the FSC administrative pricing rules in an appropriate tax forum because the fourth sentence of footnote 59 is not identified as a special or additional rule and procedure under the DSU. However, Article 10.3, on which the European Communities relies, also is not identified as a special or additional rule and procedure under the DSU.

4.1320 Finally, the European Communities takes issue with the United States argument that Article 10.3, at most, shifts the burden of proof with respect to scheduled products, arguing instead that it "sees no reason why a 'reduction commitment level' should not be or become zero."⁵⁶⁴ The simple answer to the European Communities is that the plain text of Article 10.3 limits its application to products for which a Member has a "reduction commitment level." Pursuant to Article 3.3, these levels are specifically set forth in a Member's Schedule. The reduction commitments contained in a Member's Schedule show how the particular Member promised to *reduce* the level of budgetary outlays, as well as the volume of exports of specified products made with the benefit of export subsidies during the implementation period. The plain meaning of "reduction" presumes a positive quantity that can be reduced. The plain meaning does not encompass a Member's commitment to continue *not* to subsidize agricultural products not being subsidized. This latter commitment is not a promise to *reduce* quantities or budgetary outlays, but a promise to maintain the *status quo*.

4.1321 Moreover, the other main export subsidy provision of the AA which refers to reduction commitment levels – Article 9 – further supports the interpretation of "reduction commitment levels" as being limited to scheduled quantity commitments made on specified products. As written, the

⁵⁶⁰ First US Submission, paragraphs 169-180.

⁵⁶¹ EC Oral Statement, paragraphs 98-99.

⁵⁶² EC Oral Statement, paragraph 102.

⁵⁶³ US Oral Statement on the Merits, paragraph 38.

⁵⁶⁴ EC Oral Statement, paragraph 112.

provisions of Article 9 do not make sense if “reduction commitment levels” is interpreted to refer to the type of “zero commitment” Members made with regard to agricultural products not benefiting from export subsidies.

4.1322 Article 9.1 provides that “[t]he following export subsidies are subject to *reduction commitments* under this Agreement . . .” (emphasis added), and goes on to list the six general types of export subsidies, the products, quantities and outlays which had to be listed on Members’ Schedules. On its face, Article 9.1 links “reduction commitments” to specific export subsidies, a definition that does not encompass the kind of “zero” commitment Members undertook on all non-subsidized exports.

4.1323 Likewise, Article 9.2(b)(ii) allows Members to provide export subsidies in excess of the corresponding annual commitment levels (read “reduction commitment levels”), provided that “the cumulative quantities exported with the benefit of such export subsidies . . . does not exceed the cumulative quantities that would have resulted from full compliance with the relevant annual quantity commitment levels specified in the Member’s Schedule by more than 1.75 per cent of base period quantities.” The formula in Article 9.2(b)(ii) implicitly presumes a positive quantity of subsidized exports; otherwise, the “1.75 per cent of based period quantities” rule would make no sense in those situations where a Member’s commitment is zero subsidized exports and the Member had positive base period quantities of actual exports.

4.1324 With respect to the European Communities’ claims under the AA, the European Communities has failed to provide a coherent theory of how the FSC could be deemed an export subsidy for purposes of the AA, and the European Communities has adduced no evidence that could support any such theory. Furthermore, the European Communities’ contention that the FSC reduces the costs of marketing exports is inadequate to show a violation of the Agreement in view of the text of Article 9.1(d).

4.1325 Similarly, with respect to the European Communities’ claims under Article 10 of the AA, the European Communities has failed to establish that the FSC constitutes an export subsidy under Article 1(e) of the Agreement, a necessary prerequisite. The European Communities’ attempts to evade its burden of proof through resort to Article 10.3 should be equally unavailing. At most, Article 10.3 shifts the burden to the responding Member to establish that products exported in excess of a reduction commitment level did not benefit from the challenged measure or that the measure is not an export subsidy. In any event, even if Article 10.3 is considered as shifting the initial burden of making a *prima facie* case to the defending Member, the United States has shown that the FSC does not amount to an export subsidy under the AA, thereby shifting the burden of proof to the European Communities.

The **European Communities** further rebuts the United States’ response in its Oral Statement at the Second Meeting of the Panel as follows:

Introduction

4.1326 The United States only makes two points in its Second Written Submission on the AA which are not already dealt with in the European Communities’ Second Written Submission.

4.1327 The first is that Article 10.3 of the AA is not mentioned as a special or additional rule of procedure in Appendix 2 to the DSU. The second is a continuation of its argument that Article 10.3 does not apply to “zero commitments.” These will be dealt with in order.

Article 10.3 of the AA not being included in Appendix 2 of the DSU

4.1328 The United States finds that the European Communities is inconsistent in arguing on the one hand that the third sentence of footnote 59 cannot be a rule of jurisdiction or include an additional precondition to dispute settlement because it is not mentioned in Appendix 2 and on the other hand

that Article 10.3 of the AA reverses the burden of proof in the case that a Member argues that its exports exceeding the reduction commitment level are not subsidised.

4.1329 This argument is easily disposed of. According to Article 1.2 DSU, Appendix 2 lists the special or additional rules and procedures which derogate from those in the DSU. The DSU contains no rule or procedure on the burden of proof for establishing whether there is a violation of a covered agreement and therefore it was not appropriate to list Article 10.3 as a derogation. The DSU however does contain rules and procedures on when disputes may be brought before a panel and if the third sentence of footnote 59 were a derogation from this it would have been listed in Appendix 2 DSU.

Application of Article 10.3 of the AA to Zero Commitment Levels

4.1330 The United States has rejected the burden of proof that Article 10.3 of the AA provides that a Member must bear if it claims that any quantity exported in excess of a reduction commitment level is not subsidised. As the European Communities pointed out in its Second Written Submission, the United States has not even attempted to fulfil its burden of proof in respect of products for which it does have positive reduction commitments such as wheat !

4.1331 The United States' argument as developed in its Second Written Submission is that

- Zero is not a "level" and the plain meaning of "reduction" presumes a positive quantity that can be reduced, not a promise to maintain the *status quo*,⁵⁶⁵
- Article 9 refers to "reduction commitment levels" in connection with specific subsidies and this makes no sense for products for which no subsidies are allowed,⁵⁶⁶
- Article 9.2(b)(ii) allows Members to provide export subsidies in excess of the corresponding annual commitment levels provided that "the cumulative quantities exported with the benefit of such export subsidies . . . does not exceed the cumulative quantities that would have resulted from full compliance with the relevant annual quantity commitment levels specified in the Member's Schedule by more than 1.75 per cent of base period quantities." According to the United States 1.75 per cent of zero makes no sense.⁵⁶⁷

4.1332 In making this argument, the United States is ignoring Article 3.3 of the AA, which provides first that

"a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule *in excess of the budgetary outlay and quantity commitment levels specified therein*"

4.1333 This makes clear that what the Agreement sometimes calls "reduction commitments" (and sometimes "annual commitments") are more precisely *budgetary outlay and quantity commitment levels*. Article 3.3 goes on to provide that agricultural products not listed in the Schedule should be treated as having a "zero commitment", saying that a Member:

"shall not provide such subsidies in respect of any agricultural product *not specified in that Section of its Schedule.*"

4.1334 The European Communities also recalls that Article 10.3 provides that:

⁵⁶⁵ Paragraph 156 of the US Second Written Submission.

⁵⁶⁶ Paragraph 157-8 of the US Second Written Submission.

⁵⁶⁷ Paragraph 159 of the US Second Written Submission.

“Any Member which claims that *any quantity* exported in excess of a reduction commitment *level* is not subsidized must establish that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports in question.”

4.1335 The European Communities submits that zero is a “level”. A reduction commitment of zero can be easily understood as an obligation to reduce the quantity to zero *and to keep it there*. The first part of the obligation (reduce) makes no sense without the second (keep it there). There is no reason for the obligations of the parties to change radically at the moment the amount of the reduction commitment reaches zero.

4.1336 As regards Article 9, the European Communities simply notes that where there is a zero commitment, Article 9 becomes a simple prohibition on granting the listed subsidies as well as others and the fact that 1.75 per cent of zero is also zero causes no problem in applying Article 9 to zero commitment levels. There is simply no margin of tolerance allowed when the reduction commitment level is zero.

Conclusion

4.1337 Since the United States has not made any attempt to show that Agricultural products that are exported in excess of reduction commitment levels (including the zero commitment level applying to non-scheduled products by virtue of Article 3.3) do not benefit from FSC subsidies to an extent exceeding the commitment level, the European Communities submits that the Panel should find that the United States has violated Articles 3 and 8 of the AA read in conjunction with its Articles 9(1)(d), 10(1) and 10(3) AA.

The **European Communities** argues as follows in response to a question from the Panel following the Second Meeting of the Panel:

4.1338 The European Communities argues both.⁵⁶⁸

⁵⁶⁸ Paragraphs 4.1338-4.1346 reflect the European Communities' response to the following question from the Panel: In the written version of its oral statement at the first meeting of the Panel, the European Communities stated that its first submission should read as follows:

"The European Communities requests that the Panel find that, by maintaining the tax exemptions and special administrative pricing rules contained in the FSC scheme, the US has violated . . . Articles 3 and 8 read in conjunction with Articles 9.1(d), 10(1), and 10(3) of the Agreement on Agriculture by *granting export subsidies to agricultural products in excess of its reduction commitments* under that Agreement (e.g. wheat, maize, soya beans, and cotton)." (emphasis added).

In response to an oral question from the Panel, the European Communities stated that:

"Our request to you is to find that the application of FSC subsidies to agricultural products, for which there are reduction commitments . . . is a violation of the Agreement. This is *mandatory legislation*, anybody who wants to export any agricultural product is entitled to the FSC subsidy, and therefore the recommendation should be to remove the possibility of the FSC subsidy being given to any agricultural product for which there is a reduction commitment."

With respect to the Agreement on Agriculture, could the European Communities please clarify whether it is arguing:

- (a) that a violation arises to the extent that FSC subsidies are *in fact* granted to agricultural products that are exported in excess of US reduction commitments (without prejudice to who bears the burden of proof on that point); or

4.1339 Article 8 of the AA makes clear that Members must not grant “export subsidies otherwise than in conformity with this Agreement” (which is also stated in Article 3.1).

4.1340 The principal provision of the Agreement that allows export subsidies are Article 9 (within the reduction commitments – i.e. budgetary outlay and quantity commitment levels – referred to in Article 3.3). There may be other authorisations but the European Communities does not see any that are relevant and the United States has not argued that there are any.

4.1341 The fact that no other export subsidies than those allowed by the AA may be granted for agricultural products is also evident from the fact that the SCM Agreement prohibition on export subsidies is only disapplied for those subsidies which are allowed by the AA (see opening words of Article 3.1).

4.1342 Thus, if the FSC subsidies are not covered by Article 9.1(d) of the AA (and this is the United States position), then, they are not allowed at all for agricultural products and, as the Panel puts it in point (b), “the availability of the FSC scheme with respect to any agricultural products is in itself a violation of the Agreement on Agriculture”.

4.1343 Article 10.3 does not seem to lose its applicability even in this case, as the Member claiming that the quantity exported in excess of a reduction commitment level is not subsidised must establish that no subsidy has been granted. However, in the case of an subsidy, such subsidy could not be considered legal even if it did not exceed the limits set in the Schedule.

4.1344 Problems of fact as suggested in point (a) of the question only arise if the FSC subsidies do fall under Article 9.1(d). It could then be that the amount of the subsidies granted or the quantity exported with the benefit of the FSC subsidies exceed the limits specified in the US Schedule (which as the European Communities has explained may be zero for some products). This entails a violation of Articles 3 and 8 as indicated above.

4.1345 Given the fact that there are agricultural products for which the United States has a commitment of zero level the mandatory availability of FSC to any agricultural product (i.e. the fact that anybody who wants to export any agricultural product is entitled to FSC subsidies) is in itself a violation of Articles 3 and 8.

4.1346 Article 10.3 does also on its face apply in the case of exports of agricultural products benefiting from export subsidies other than those described in Article 9 but this then gives rise to an obligation on the United States to prove that the FSC scheme does not give rise to export subsidies within the meaning of the AA. Since the European Communities has demonstrated that the FSC scheme does give rise to export subsidies within the meaning of the SCM Agreement and that they should therefore be considered export subsidies for the purpose of the AA, this reversal of burden of proof probably becomes academic in respect of exports of agricultural products benefiting from export subsidies other than those allowed by the AA.

The **United States** argues as follows in response to a question from the Panel following the Second Meeting of the Panel:

4.1347 The United States will not comment on what the European Communities is arguing. However, in the view of the United States, the text of the Agreement makes clear that the mere availability of an export subsidy does not constitute a violation of the AA.⁵⁶⁹

(b) that the availability of the FSC scheme with respect to any agricultural products is in itself a violation of the Agreement on Agriculture?

⁵⁶⁹ Paragraphs 4.1347-4.1350 reflect the United States' comment on the following question to the European Communities from the Panel: In the written version of its oral statement at the first meeting of the Panel, the European Communities stated that its first submission should read as follows:

4.1348 Article 3.3 of the AA, for example, provides that a Member “shall not provide export subsidies . . . in excess of the budgetary outlay and quantity commitment levels specified [in the Member’s Schedule].” This language clearly contemplates that a Member may provide export subsidies, and violates its obligations only if the amount of export subsidies provided exceeds that Member’s commitment levels. This language is inconsistent with the notion that the mere availability of an export subsidy violates the AA.

4.1349 Likewise, while the United States does not agree with the European Communities that the FSC system is described by any of the paragraphs of Article 9.1, the language of Article 9.2 nevertheless indicates that the mere availability of a subsidy is not enough. For example, Article 9.2(a)(ii) refers to the “quantity . . . in respect of which such export subsidies may be granted in that year.”

4.1350 In a similar vein, Article 10.1 states that “[e]xport subsidies not listed in paragraph 1 of Article 9 shall not be *applied* in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments . . .” (Emphasis added). Article 10.3, which the European Communities has asserted is relevant to this dispute, refers to the need to “establish that no export subsidy . . . *has been granted* in respect of the quantity of exports in question.” (Emphasis added). The use of the word “applied” and the phrase “has been granted” is also inconsistent with the notion that the mere availability of an export subsidy violates the AA.

E. ARGUMENTS RELATING TO THE PANEL'S RECOMMENDATIONS

The **European Communities** argues as follows:

4.1351 Article 4.7 of the SCM Agreement provides as follows:

“If the measure in question is found to be a prohibited subsidy, the panel shall recommend that the subsidizing Member withdraw the subsidy without delay. In this regard, the panel shall specify in its recommendation the time-period within which the measure must be withdrawn.”

"The European Communities requests that the Panel find that, by maintaining the tax exemptions and special administrative pricing rules contained in the FSC scheme, the US has violated . . . Articles 3 and 8 read in conjunction with Articles 9.(1)(d), 10(1), and 10(3) of the Agreement on Agriculture by *granting export subsidies to agricultural products in excess of its reduction commitments* under that Agreement (e.g. wheat, maize, soya beans, and cotton)." (emphasis added).

In response to an oral question from the Panel, the European Communities stated that:

"Our request to you is to find that the application of FSC subsidies to agricultural products, for which there are reduction commitments . . . is a violation of the Agreement. This is *mandatory legislation*, anybody who wants to export any agricultural product is entitled to the FSC subsidy, and therefore the recommendation should be to remove the possibility of the FSC subsidy being given to any agricultural product for which there is a reduction commitment."

With respect to the Agreement on Agriculture, could the European Communities please clarify whether it is arguing:

- (a) that a violation arises to the extent that FSC subsidies are *in fact* granted to agricultural products that are exported in excess of US reduction commitments (without prejudice to who bears the burden of proof on that point); or
- (b) that the availability of the FSC scheme with respect to any agricultural products is in itself a violation of the Agreement on Agriculture?

4.1352 The European Communities recognises that the principle of immediate withdrawal may be difficult to apply in the present case. It submits that a reasonable period of time for withdrawal of the two FSC subsidies would be until the beginning of the next tax year (fiscal 2000) and requests the Panel to recommend accordingly.

4.1353 The European Communities requests the Panel to recommend that the United States withdraw the two FSC subsidies before the beginning of the next tax year (fiscal 2000).

The **United States** responds as follows:

4.1354 The European Communities, invoking Article 4.7 of the SCM Agreement, stated “that a reasonable period of time for withdrawal of the two FSC subsidies would be until the beginning of the next tax year (fiscal 2000)” and requested “the Panel to recommend accordingly.”⁵⁷⁰

4.1355 In the view of the United States, there are several factors that go into any determination concerning the amount of time reasonably necessary to implement a panel’s recommendations and rulings. Among these are: (a) the legal form of implementation (*e.g.*, legislation, regulation, decree, etc.); (b) the period of time in which the implementing Member can achieve the proposed legal form of implementation, assuming that the Member applies itself in good faith; and (c) the nature of the legislative or regulatory change to be made.

4.1356 At this time, it is difficult to assess these factors because the Panel has not yet made findings as to how, if at all, the FSC violates any United States obligations under the SCM Agreement or the AA. Thus, it is particularly difficult to assess the third factor cited above – the nature of the legislative or regulatory change to be made – without knowing what that change, if any, may be.

4.1357 In light of this, and recognizing that Article 4.7 requires the Panel to make a recommendation regarding the time period in which a measure must be withdrawn, the United States submits that a more orderly approach would be to use the interim review stage under Article 15 of the DSU as a vehicle for the parties to comment on the time to be allowed for implementation, should any implementation be required. The Panel then could take these comments into account for purposes of making a recommendation in its final report.

4.1358 Having said that, the United States nevertheless has some initial comments on the European Communities' suggestion. First, as previously noted⁵⁷¹, because the European Communities has invoked Article 4.7, a special or additional rule that benefits the complainant, then it becomes even more important that the Panel not let the European Communities' violation of Article 4.2, a special or additional rule that benefits the defendant, go unremedied.

4.1359 Second, in the United States, fiscal year 2000 begins on October 1, 1999. Should there be an appeal of this Panel’s findings, that appeal undoubtedly would be pending as of October 1, 1999. Therefore, the European Communities' suggestion clearly is inappropriate and unrealistic.

4.1360 Third, because the only measure properly before this Panel is the FSC statute itself, any changes to that statute would have to be made by legislative, rather than administrative, means. As previous arbitrators have recognized in proceedings under Article 21.3(c) of the DSU, where legislative means are required, a longer period of time may be necessary than would be the case if administrative means could be used.⁵⁷²

The **European Communities** rebuts the United States' response as follows:

⁵⁷⁰ EC Oral Statement, paragraph 120.

⁵⁷¹ Oral Statement of the United States on the Merits (9 February 1999), paragraph 39.

⁵⁷² See, *e.g.*, *Australia - Measures Affecting Importation of Salmon*, WT/DS18/9, Award of the Arbitrator issued 23 February 1999, paragraph 38, citing to *EC Measures Concerning Meat and Meat Products (Hormones)*, WT/DS26/15, WT/DS48/13, Award of the Arbitrator issued 29 May 1998, paragraph 25.

4.1361 The European Communities has submitted that a reasonable period of time for withdrawal of the two FSC subsidies would be until the beginning of the next tax year (fiscal year 2000). The United States responds that in the United States fiscal year 2000 begins on 1 October 1999 and that an appeal may be pending at that time. It also argues that abolishing the FSC will require legislative action and that this will take a longer time than administrative action.

4.1362 Accepting the plausibility of these arguments, the European Communities requests that the Panel fix two alternative dates for withdrawal. In the absence of an appeal the United States will have the final Panel Report on 6 July 1999 and should be able to revise its legislation before 1 October 1999. In the event of an appeal, the United States should be required to withdraw the FSC subsidies by 1 October 2000 (which is presumably the beginning of its fiscal year 2001). Since tax legislation is revised every year, there should be no difficulty in the United States modifying its legislation by that date.

F. CONCLUDING ARGUMENTS

The **United States** argues in its First Submission as follows:

Institutional and Process Considerations, as well as the Facts and the Law, Warrant a Rejection of the European Communities' Claims

4.1363 In the view of the United States, both the legal principles applicable to the European Communities' claims and the factual evidence before the Panel warrant a ruling in favor of the United States on the merits. As discussed above, the European Communities' main legal arguments fail to correctly identify the controlling legal standard, and its case is accordingly predicated on a wishfully simple, but legally incorrect, predicate. Beyond that, the European Communities' case is barren of factual support, as is evidenced by both the European Communities' failure to cite supporting evidence during consultations and its failure to adduce factual support in its First Submission.

4.1364 Beyond the merits, however, there are additional considerations that argue in favor of a decision rejecting the European Communities' claims. The first is found in a highly unusual provision in the SCM Agreement; namely, the language in footnote 59 indicating that disputes of the type raised here should be addressed, in the first instance, in an appropriate international tax forum. This remarkable, explicit provision reflects an institutional preference, borne of previous forays into issues of fundamental tax policy, to defer on such issues to institutions that have been designed, and are better equipped, to address technical tax issues than is the world's pre-eminent trade forum. The admonition in footnote 59 applies to the substance of this dispute and should not be lightly disregarded.

4.1365 In addition, were this Panel to render a decision abandoning the principle that economic activities occurring outside the taxing authority's territory need not be taxed, it would undercut the historic 1981 Council Decision that resolved an acrimonious, parallel dispute under the GATT 1947. For more than 17 years, the United States and other Members, including European Communities member States, have relied on that decision, and a decision now to disavow the principle on which the GATT Council ultimately resolved the *Tax Legislation Cases* would harm the WTO dispute settlement process and the WTO. WTO "rules" would be perceived as ephemeral standards on which governments and private parties could rely only at their peril and re-litigate at their pleasure.

4.1366 Finally, any decision rejecting or qualifying the principle that economic processes occurring outside a taxing authority's territory may, but need not, be taxed would upset the finely calibrated bargain reflected in the 1981 Council Decision and the SCM Agreement, both of which incorporate that principle. That principle expressly recognizes that different Members have different tax systems and that the *WTO Agreement* does not impose on any Member the obligation to adopt a territorial tax system over a global one, or vice versa. Disturbing the compromise solution achieved in 1981 and

thereafter would effectively return the parties to the *status quo ante* that existed prior to the 1981 Council Decision. That would mean that features of both European tax systems and the US FSC – both of which enjoy disciplined protection under the 1981 Council Decision – would again be at risk, as would the welfare of the private firms that have planned their activities on the basis of those features. Invalidating the 1981 solution would raise anew the vexing policy questions of how best to reconcile differing national tax systems under international trade rules that were designed to deal with national trade practices, not issues of national tax policy.

The **European Communities** argues in its Oral Statement at the First Meeting of the Panel as follows:

4.1367 The United States finally makes some comments⁵⁷³ on what it calls “institutional and process considerations” as to why the Panel should dismiss the European Communities' claims. Apart from repeating its previous position on the merits, it pretends in almost emotive language that the Decision adopting the reports on the *Tax Legislation Cases* and footnote 59 to the SCM Agreement is a “finely calibrated bargain” and that upsetting it would “harm the WTO dispute settlement process and the WTO”.

4.1368 As the European Communities has explained at some length today and will no doubt have to repeat, the 1981 decision is not applicable and that it and footnote 59 do not say what the United States claims or would wish them to say. If the “controlling legal standard” of the United States was really so important, the United States has had ample opportunity since 1981 to attempt to negotiate it.

4.1369 It is also quite clear that the European Communities and at least seven other WTO Members, who participated in the GATT 1947 dispute settlement consultations in 1985, did not share the view of the meaning of the “bargain” that the United States now claims to have.

4.1370 The FSC subsidies are clear prohibited subsidies under the WTO SCM Agreement. The pretended tax complexities are nothing but a fig leaf behind which the United States seeks to hide its violations. For the European Communities and, we trust, the Panel, the matter is clear. Exemptions from direct taxes are export subsidies at least when specifically related to exports. No tax system is going to be undermined by having to adopt principles and rules which are of general applicability and being required not to specifically exempt exports.

4.1371 The danger to the WTO dispute settlement process and the WTO lies not in upholding the agreed rules of the SCM Agreement but in allowing a powerful Member to escape its disciplines.

The **United States** argues in its Second Submission as follows:

A Decision Against the FSC Would Ensnarl the WTO in Issues of Fundamental Tax Policy, Invite Additional Tax Policy Disputes, and Undercut the Reasonable Expectations of Members that Relied on the 1981 Council Decision

4.1372 For the reasons discussed above, it is the view of the United States that, as a matter of law, this case should either be dismissed or, if decided on the merits, decided against the European Communities. It is also the view of the United States that such an outcome is also supported by considerations of sound trade policy and trade policy administration.

4.1373 Given the multiplicity of issues presented to the Panel, this case could be resolved on a number of possible grounds, either procedural or substantive. A ruling that the FSC is contrary to WTO principles could, in the view of the United States, have far-reaching reverberations. Such a decision could carry profound implications for national tax systems, including territorial systems, and could enmesh the WTO in a range of technical issues relating to national tax policy. Although certain

⁵⁷³ Paragraphs 196-199 of the US First Written Submission.

tax measures, such as discriminatory provisions that protect or subsidize a favoured national industry, may offend WTO subsidy rules and may be easy to resolve, broad questions of international tax policy and the structure of national tax systems are less clearly a matter for WTO adjudication or harmonisation.

4.1374 The tax policy issues raised by this challenge are fundamental ones. Although the European Communities seeks to invoke a broad principle against the United States from which it appears to claim immunity for itself and its member States, WTO principles must apply equally to all Members, and, to the extent possible, distinctions should not be maintained that are based on form over substance. Any WTO principle applicable to worldwide tax systems must also be applicable to territorial tax systems, and the effects that are inherent in a territorial system cannot be distinguished from parallel effects incorporated into worldwide systems in an effort to achieve parity.

4.1375 In this case, a decision rejecting the 1981 GATT Council principle that income from foreign economic activities need not be taxed would unavoidably prompt additional cases invoking that same principle against “territorial” systems, as the *Tax Legislation Cases* did in the 1970s. The unavoidable result of either a series of rulings against both worldwide and territorial systems or of asymmetrical results would necessarily be to force renegotiation of WTO principles affecting the ability of Members to structure their national tax systems and to achieve rough parity with systems that are structured differently. Not only would such a controversy reopen the principle that Members are not obligated to tax income from foreign economic activity, but it also would be likely to reopen traditional, if conceptually dubious, GATT distinctions between direct and indirect taxes and the border tax adjustment practices that relate to them.

4.1376 In the view of the United States, it is doubtful that such a scenario would advance the interests of the international trading system or that the still young WTO would be the optimum forum for undertaking so fundamental a review of national tax policies. That the scale of such an undertaking is incompatible with the timetable Members have established for WTO panels is reflected in the language in footnote 59 indicating that the WTO should not be the forum for considering such issues, at least not before being considered in an appropriate tax forum.

4.1377 Finally, a decision against the FSC would directly undercut the 1981 Council Decision on which both the United States and European countries have since relied. It was the principles articulated in that decision on which the US Congress in good faith relied in designing the FSC. Absent a compelling showing that the Members intended to discard the principles of the Council Decision – and the European Communities has made no such showing – this Panel should be loath to read this historic decision out of the SCM Agreement, particularly in light of the WTO provisions designed to assure continuity between the GATT and the WTO regimes. Among the risks of doing so is opening the door for Members to relitigate matters that have otherwise become settled principles under the GATT and the WTO.

4.1378 In short, it is the view of the United States that the legal arguments set forth above conclusively point to a Panel decision to dismiss European Communities' claims or to reject them on the merits. These legal arguments are reinforced by policy considerations relating both to the effective administration of WTO rules and dispute settlement processes and to the optimum examination of issues involving the interface between national tax systems.

The **European Communities** argues in its Oral Statement at the Second Meeting of the Panel as follows:

4.1379 The United States makes some more comments⁵⁷⁴ seeking to scare the Panel into deciding in its favour by arguing that a decision in the European Communities' favour would “ensnarl” or “enmesh” the WTO in a range of technical issues relating to tax policy.

4.1380 The European Communities must protest against these tactics.

4.1381 The WTO SCM Agreement clearly provides that direct tax practices are subject to its disciplines. Indeed subsidies granted through tax systems are regularly countervailed by the United States in particular. Why should clearly export contingent and local content contingent subsidies escape the agreed disciplines on export subsidies simply because they are part of the tax system of a powerful Member? Far from damaging the “still young WTO,” a correct decision by the Panel in this case will restore confidence of Members that the agreed disciplines apply to all equally. The European Communities also expects it to show the WTO dispute settlement system to be objective and judicial and an improvement over the political processes that prevailed at the time of the *Tax Legislation* cases.

4.1382 It is disingenuous for the United States to claim that the FSC scheme was enacted in good faith when it was contested from the beginning, notably by the European Communities and the legislative record shows that the US Congress knew this at the time.

4.1383 If other countries grant tax based subsidies similar to the FSC subsidies then they should clearly also be liable to dispute settlement and removal. The truth is that most countries operate their tax systems in an objective way for the purpose of raising revenue fairly and efficiently and do not use them as export incentives as the United States is clearly doing (and has admitted as the European Communities pointed out in the Introduction to its First Written Submission⁵⁷⁵).

4.1384 If the WTO rules should prove inadequate and need to be renegotiated that is nothing to be afraid of. The European Communities however believes in the correctness of its case and does not see why these rules should be rendered “inadequate”.

4.1385 The danger to the WTO dispute settlement process and the WTO lies not in upholding the agreed rules of the SCM Agreement but in distorting them to allow export-contingent subsidies to escape their disciplines under pressure from a powerful Member.

The **United States** argues in its Oral Statement at the Second Meeting of the Panel as follows:

4.1386 In conclusion, the numerous defects in the European Communities' arguments, whether taken individually or together, are fatal to the European Communities' case. The European Communities has failed to abide by the procedural rules that govern these proceedings and the European Communities has failed to present the Panel with sufficient arguments and evidence to meet its burden of presenting a *prima facie* case. Therefore, the United States requests that the Panel dismiss this case or rule on the merits that the European Communities has not established a violation of SCM Agreement Article 3.1(a), SCM Agreement Article 3.1(b), AA 9.1(d) or AA Article 10.

4.1387 In these closing remarks, we will attempt to step back from the details of this controversy and comment briefly on the overarching issues and distinctive features that the United States believes should figure prominently in your resolution of this matter.

4.1388 There are a number of features of this case that the United States finds troubling, and that the United States respectfully suggests should trouble this Panel as well. Several are threshold matters. As previously discussed, the United States believes that the European Communities' failure to conform to WTO procedural requirements is, and properly should be, fatal to its case. The

⁵⁷⁴ Paragraphs 188 to 194 of the US Second Written Submission following similar comments in paragraphs 196 to 199 of the US First Written Submission.

⁵⁷⁵ Where the European Communities refers to the title to Exhibit EC-3.

complexity of this case, its technical tax issues, the potentially far-reaching implications it may have, and the applicability of the one provision of the SCM Agreement that urges that parties go first to a more specialized forum – these factors all serve to emphasize the importance of adhering to procedural requirements designed to assure full exploration and development of the issues.

4.1389 Likewise, by failing to advance credible evidence in support of its claims and seeking instead to argue an *ipso facto* legal theory, the European Communities has failed to meet its burden of proof. The European Communities' repeated reliance on a sensationalized article in a popular news magazine reveals the paucity of credible evidence that the European Communities has been able to marshal in support of its claims. Although it does not have the burden of proof, the United States is the one party that has offered empirical factual evidence, evidence that contradicts the European Communities' conclusory assertions. Accordingly, the European Communities' evidentiary failures are a second threshold that the European Communities' case has failed to clear.

4.1390 On the merits, the European Communities has sought to repudiate an established GATT principle on which European Members and the United States have both relied for nearly 20 years. The contention that this historic principle has been rescinded, or modified so as not to apply to the United States, is supported by no textual language in subsequent agreements, no negotiating record to that effect, and no understanding among the affected parties. A proposition so bold as that advanced by the European Communities would face a difficult road even with extensive factual support. On an evidentiary record that is largely barren of factual and legal support, however, the proposition is unsustainable.

4.1391 Yet another issue of process is raised by the timing of the European Communities' claim. The principle that the European Communities now claims that it “does not recognize” is not a principle that has recently come to light. Nor is it a principle that was buried in the voluminous text of a newly negotiated agreement. Rather, this principle was one that was prominent, if not historic. It was the principle that broke the celebrated GATT logjam over four landmark tax cases. That resolution was achieved not through the usual mechanisms of GATT dispute settlement, but instead through action by the entire GATT Council. The Council did not merely broker a compromise; it articulated a broad principle of general applicability.

4.1392 To be sure, the European Communities claims that it had reservations about how the United States conformed its law to that new principle, nearly a decade and a half ago. It expressed reservations at that time, and the United States responded. However, the fact is that the European Communities did not challenge the United States implementation of the GATT Council Decision when the United States acted. Nor did it challenge it the following year, or the year after that. Rather, it stood by as the new United States law became an established part of the US tax code and became a part of the tax system and structure for all of the affected United States corporations. The European Communities now maintains that it never waived its objections.

4.1393 The notion that a Member can elect not to challenge another Member's implementation of a GATT or WTO decision and can instead indefinitely maintain a place-holder for future litigation at the time of its choosing is inconsistent with the spirit, if not the letter, of the GATT and the WTO dispute settlement system. Members should not be free, in the name of long latent objections or otherwise, to re-litigate previously resolved disputes, and an attempt to do so does raise questions of process. The European Communities was, by its own admission, attuned to the issue at the time, aware of the recourse available to it at the time, and fully informed in its decision not to pursue the issue. Its decision to do so now threatens the ability of Members to rely in good faith on the final resolution of a dispute.

4.1394 Finally, the European Communities' resuscitated objections to the FSC are also troubling because of the asymmetry they propose to create. It can not fairly be disputed that territorial tax systems confer an inherent tax advantage over worldwide tax systems in the case of exports jointly undertaken with foreign branches or affiliates. The result that the European Communities now espouses is that the GATT Council Decision that overrode three GATT panel holdings that territorial

tax systems inherently subsidize exports remains in full force and effect for territorial systems, but is no longer good law for competitor countries with different tax systems. Although the European Communities has advanced theories for such an asymmetrical result in its Second Submission, they do not obscure the fact that they are conveniently self-serving.

4.1395 In short, the United States is of the view that this case is not ripe for a decision on the merits; that this distinguished Panel is, at least at this stage, not the proper forum for this dispute; that the European Communities has, in every respect, failed to satisfy its burden of proof; that the fundamental principle that the European Communities now disavows cannot now be summarily discarded; that those who have relied on it in good faith have a stake in both its continued existence and its even-handed application; and that the genuinely complex issues of tax parity and tax competition cannot be fairly adjudicated on the basis of a set of WTO provisions that, at the very least, provide quite imperfect guidance on the issues put before this Panel. For these reasons, the United States urges that the European Communities' claims be rejected on the basis of the preliminary objections made by the United States, on the merits, or both.

V. ARGUMENTS PRESENTED BY THIRD PARTIES

A. BARBADOS

Barbados argues as follows in response to questions from the European Communities at the First Meeting of the Panel:

5.1 The purpose of requiring companies to licence with the Government is to:

- Monitor the establishment of Foreign Sales Corporations (FSCs); and
- Ensure that they meet the criteria for the concessions under the FSC Act Cap. 59C of the Laws of Barbados.

The licence is granted for a period of one year. A copy of a licence is attached.⁵⁷⁶

5.2 There is no reporting requirement. The status of the company is reviewed annually.⁵⁷⁷

5.3 The United States of America and the Commonwealth of Puerto Rico have been included in the First Schedule to the FSC Act.⁵⁷⁸

5.4 Barbados does not know of any other country that has laws under which a company may be designated a foreign sales corporation. If there are any such countries, Barbados, subject to the legislative process of scheduling such countries, would be pleased to include them in the Schedule.⁵⁷⁹

⁵⁷⁶ Paragraph 5.1 reflects the response of Barbados to the following question from the European Communities: The Barbados Foreign Sales Corporations Act 1984, as amended in 1994, provides tax exemptions and other privileges to "foreign sales corporations". Section 3(1) states that, to benefit from these exemptions a company has to have a licence and Section 3(2)(d) provides that the Registrar can only give licences to a company that satisfies him that it is designated or qualifies to be designated as a foreign sales corporation under the laws of a country specified in the First Schedule. What is the purpose of these licences? On what terms are they granted and, in particular, for what length of time? Would Barbados please provide a typical example of a licence with all company-specific information removed?

⁵⁷⁷ Paragraph 5.2 reflects the response of Barbados to the following question from the European Communities: What are the reporting requirements for foreign sales corporations in Barbados?

⁵⁷⁸ Paragraph 5.3 reflects the response of Barbados to the following question from the European Communities: The only country mentioned in the Schedule is the United States. Can Barbados confirm that no other country has been included in the First Schedule?

5.5 Barbados cannot confirm that only companies that satisfy United States of America legal requirements relating to FSCs will be granted a licence. The legislation does not seek to discriminate against persons from other countries. Barbados' policy is to seek investment worldwide for the conduct of service activity from Barbados. Barbados is prepared to work with countries to facilitate investment. In fact, under the provisions of Articles 118 to 120 of the Lomé IV Convention, the European Communities recognised the need for and agreed to cooperate in fostering trade in services in the African, Caribbean and Pacific States.⁵⁸⁰

5.6 The Barbados law was first enacted in 1985 and there was no intention to exclude GATT/WTO members from these tax privileges. Barbados would wish to cooperate with all WTO members.⁵⁸¹

B. CANADA

Canada argues as follows in its Third Party Submission:

5.7 Canada has supported the European Commission's request for the establishment of a panel regarding elements of the legislation governing the FSC. In this context, Canada wishes to highlight its specific concerns with respect to the FSC.

5.8 The FSC is a prohibited export subsidy as defined in Article 3 of the SCM Agreement.

5.9 The FSC programme clearly provides what constitutes a prohibited export subsidy as defined in Article 3.1(a) and 3.1(b) of the SCM Agreement.

5.10 The prohibited subsidy is delivered in the form of a reduction in the effective US tax rate on export income earned in qualifying export transactions conducted through offshore foreign sales corporations. As such, the FSC is tied to export or export earnings, contrary to Article 3.1(a). In addition, the provision of the reduction in the effective US tax rate on export income is also contingent upon the use of domestic over imported goods, contrary to Article 3.1(b).

5.11 Article 1.1 of the SCM Agreement identifies as a subsidy "government revenue that is otherwise due" which is foregone or not collected and which thereby confers a benefit. The tax reduction offered to United States exporters through the FSC programme clearly represents tax revenue which would otherwise be due were it not for the operation of the FSC programme. By foregoing such revenue, the United States is conferring a benefit on the users of the FSC programme by allowing them to retain funds that would otherwise be collected in taxes. Since such tax relief is contingent on export performance, i.e. the sale, lease or rental of "export property", the programme is in obvious contravention of Article 3.1(a) of the SCM Agreement.

5.12 The Illustrative List of Export Subsidies in Annex I of the SCM Agreement refers specifically, in paragraph(e), to:

The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.

⁵⁷⁹ Paragraph 5.4 reflects the response of Barbados to the following question from the European Communities: Does Barbados know of any other country in the world which has laws under which a company may be designated a foreign sales corporation? If yes, why is it not included in the First Schedule?

⁵⁸⁰ Paragraph 5.5 reflects the response of Barbados to the following question from the European Communities: Can Barbados confirm that only companies which satisfy United States legal requirements relating to FSCs will be granted a licence?

⁵⁸¹ Paragraph 5.6 reflects the response of Barbados to the following question from the European Communities: How does Barbados justify granting tax privileges to subsidiaries of United States corporations which are not available to those of other WTO Members? Is this not a violation of Article II GATS?

In sum, the FSC legislation excludes from United States taxation income generated by export performance. In the absence of the legislation, this income would be subject to United States taxation. Accordingly, the subsidies provided by the FSC programme are contingent upon export performance in the sense that they are tied directly to export earnings and take the form of an exemption of direct taxes payable by United States commercial enterprises.

5.13 The scope of paragraph(e) of Annex I is modified by footnote 59 which provides in part that:

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

The clear subsidy offered by the FSC programme cannot be justified on the grounds that FSC is a measure designed or intended to avoid the double taxation of foreign source income earned by United States enterprises. The FSC programme was never intended to alleviate double taxation, but rather to enhance United States exports. Other US tax measures ensure that United States corporations are not subject to international double taxation. FSC subsidies are available to United States exporters regardless of whether the export income in question is or would be subject to double taxation.

5.14 In this context, United States tax law provides for foreign tax credits to ensure that United States companies are not subject to double taxation with respect to foreign source income earned by their overseas subsidiaries. The foreign tax credit offers relief from both the withholding tax the foreign country may have imposed on any dividend remitted by the subsidiary to its parent corporation, as well as the underlying income tax, that is the income tax paid by the overseas subsidiary to the foreign country in which its profits are earned. Absent the FSC legislation, the income earned by the overseas sales subsidiaries of United States corporations would be subject to either one of the following regimes: (1) deferral of US taxation until dividends are remitted to the United States parent, where they would then be taxed and subject to a foreign tax credit; or (2) where the income of the subsidiary is considered "foreign base company sales income", taxation on a current basis in the United States, subject to a foreign tax credit. In both cases, where foreign source income is included in the taxable income of a United States taxpayer and subject to US tax, a foreign tax credit is provided for foreign income taxes paid. There can, therefore, be no international double taxation which is unrelieved after the application of US tax rules. Further, many FSCs are located in low or tax free territories in which double taxation is clearly not a consideration.

5.15 In addition, Article 3.1(b) of the SCM Agreement prohibits subsidies that are contingent on the use of domestic over imported goods. Under the FSC programme, the tax relief offered is only available in relation to income earned from the sale, lease or rental of "export property" of which not more than 50 per cent of the fair market value is attributable to articles imported into the United States. This provision is a legal requirement for companies to use at least some domestic goods in order to qualify for their subsidy. Such a subsidy is contingent on the use of domestic over imported goods and is therefore inconsistent with Article 3.1(b).

5.16 It is the clear intent of the FSC programme to enhance United States exports through the discriminatory application of a prohibited export subsidy. There is no legitimate tax policy rationale to support or excuse the operation of such a subsidy. As a country whose corporations compete with United States corporations for third market sales, Canada is very concerned about the trade distortive effects of the FSC subsidies on international trade and therefore supports efforts to seek its elimination through adjudication in the context of United States international trade obligations under the World Trade Organization.

Canada argues as follows in its Oral Statement at the First Meeting of the Panel:

5.17 Canada welcomes the opportunity to present its views to the panel examining the US Foreign Sales Corporation

5.18 As we stated in our written submission, Canada's position is that the FSC programme provides a prohibited export subsidy, as defined in Article 3 of the SCM Agreement

5.19 The programme provides for a reduction in the effective US tax rate, which is available only on export income earned in qualifying export transactions

5.20 As such, the FSC is tied to export or export earnings, contrary to Article 3.1(a) of the Agreement.

5.21 In addition, the reduction in the effective US tax rate on export income is contingent upon the use of domestic over imported goods, contrary to Article 3.1(b).

5.22 The tax reduction offered to United States exporters through the FSC programme constitutes a subsidy, since it is "government revenue that is otherwise due" which is not collected, and which thereby confers a benefit, within the meaning of Article 1.1

5.23 Since such tax relief is contingent on export performance – that is, the sale, lease or rental of "export property" – the programme is in contravention of Article 3.1(a).

5.24 The Illustrative List of Export Subsidies in Annex I refers specifically to the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes paid or payable by enterprises.

5.25 In sum, the FSC legislation excludes from US taxation income generated by export performance.

5.26 In the absence of this legislation, such income would be subject to US taxation.

5.27 Accordingly, the subsidies provided by the FSC programme are contingent upon export performance in the sense that they are tied directly to export earnings and take the form of an exemption of direct taxes payable by United States commercial enterprises.

5.28 Moreover, as noted in our written submission, the subsidy offered by the FSC programme cannot be justified on the grounds that this is a measure intended to avoid the double taxation of foreign source income earned by United States enterprises.

5.29 FSC subsidies are available to United States exporters regardless of whether the export income in question is or would be subject to double taxation.

5.30 The FSC programme was never intended to alleviate double taxation, but is designed instead to enhance United States exports.

5.31 Article 3.1(b) of the Agreement prohibits subsidies that are contingent on the use of domestic over imported goods.

5.32 Under the FSC programme, the tax relief offered is only available in relation to income earned from the sale, lease or rental of "export property", of which not more than 50 per cent of the fair market value is attributable to articles imported into the United States.

5.33 This requires companies to use at least 50 per cent domestic goods in order to qualify for their subsidy. This subsidy is thus contingent on the use of domestic over imported goods, which is inconsistent with Article 3.1(b).

5.34 In conclusion, it is Canada's position that the FSC programme benefits only United States exports through the discriminatory application of a prohibited export subsidy.

5.35 There is no legitimate tax policy rationale to support or excuse the operation of such a subsidy.

5.36 As a country whose corporations compete with United States corporations for third market sales, Canada is very concerned about the trade distortive effects of the FSC subsidies on international trade.

5.37 We therefore urge this panel to find that these subsidies are not consistent with United States obligations under the SCM Agreement.

Canada argues as follows in response to a question from the Panel at the First Meeting of the Panel:

5.38 The question of whether the FSC programme provides a prohibited export subsidy is answered by examining whether the subsidy is contingent, in law or in fact, upon export performance, and whether it is contingent upon the use of domestic over imported products. The trade effects of such subsidies are irrelevant: if they are so contingent, they are prohibited. It is Canada's submission that tax benefits under the FSC are contingent upon export performance, and are contingent upon the use of domestic over imported products. They are thus *ipso facto* prohibited.

5.39 Nevertheless, Canada is naturally concerned about the potentially distorting trade effects of the FSC programme. This concern is primarily related to the potential effects in third markets. Products exported by FSCs can be shipped anywhere in the world, and can therefore compete unfairly with Canadian exports in an unlimited number of markets. Moreover, neither Canada nor Canadian producers have any direct remedy in respect of third markets: there are no countervailing measures available. There is thus an unlimited potential for distortion, making this our greatest concern.

5.40 That said, Canada is concerned with the potential bilateral affects, and that concern was reflected to some degree in our written and oral submissions.

5.41 Tax remission under the FSC is contingent upon the use of domestic over imported products. This provides American-origin inputs with a competitive advantage over Canadian inputs in respect of sales to FSCs, and it is precisely why Canada is supporting the European Communities challenge under Article 3.1(b) of the Agreement on Subsidies and Countervailing Measures.

5.42 With respect to potential distortions in the Canadian market, Canada is, of course, concerned about the possibility of becoming a target for subsidized United States products. However, this is not of immediate importance in this case, given that our own trade laws would be available to remedy the situation.

C. JAPAN

Japan argues as follows in its Third Party Submission:

5.43 This third party submission is made by the Government of Japan ("GOJ") in support of the case brought by the European Communities against the favorable tax treatment accorded by the Government of the United States ("USG") to profits arising from the export of United States products through FSCs.

5.44 The provisions of the United States law (Sections 921-927 of the US Internal Revenue Code) that have created the FSC scheme providing subsidies are designed to reduce the tax level for United States companies on the condition of exporting certain goods (i.e. goods not more than 50 per cent of the fair market value of which is attributable to articles imported in the United States). The FSC scheme allows corporations to conduct modest levels of overseas activities and then use those activities to justify tax exemption on large portions of export earnings unrelated to those activities. Those United States companies exporting other goods or selling goods in the domestic market, are at

a disadvantage because of their higher tax burden. Furthermore, the USG applies special rules for transfer pricing which is only applied to FSCs.

5.45 GOJ urges the Panel to find that the FSC scheme is in violation of the SCM Agreement, since the tax exemptions under the scheme constitute subsidies under Article 1 and are prohibited under Article 3 of the SCM Agreement.

5.46 The FSC has been introduced in place of the Domestic International Sales Corporation ("DISC"). The law on DISCs provided tax exemptions on income from exports through DISCs.

5.47 Several European countries challenged the DISC law under the GATT, claiming that tax exemptions on income from exports through DISCs violated Article XVI:4 of the GATT as prohibited export subsidies. The GATT panel supported the European claim and, in 1976, found the US DISC law to be incompatible with GATT.⁵⁸² Though initially resisting the panel decision, the USG in 1981 finally agreed to adopt the panel report in exchange for an understanding ("the 1981 Understanding") to be adopted by the GATT Council. The report was thus adopted

"on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length."⁵⁸³

5.48 After adoption of the report, the USG amended the DISC law. In 1984, the US Congress enacted a law which was to replace the DISC with the FSC. As we show below, however, this revised scheme continues to be incompatible with the WTO rules, in particular, the SCM Agreement.

5.49 The United States law creating FSCs sets forth economic process requirements and foreign management requirements which a FSC would have to meet to qualify for tax exemption.

5.50 Furthermore, the new law allows a FSC to choose administrative pricing rules or arm's length pricing to determine the transfer price between the FSC and its parent corporation. By providing administrative pricing rules as well as arm's length pricing rule, the law allows FSCs to increase profits subject to the exemption compared to the profits resulting from arm's length pricing. These pricing rules will be examined in more detail below.

5.51 As stated above, FSCs must meet certain foreign economic process and foreign management requirements to qualify for tax exemption benefits on export sales.

5.52 For a given transaction to meet the foreign economic process requirements, both a *participation* test and a *direct cost* test must be met. To satisfy the participation test, the FSC or its agent must participate in export transactions outside the United States. For this purpose, export transactions mean: solicitation (other than advertising), negotiation, or contracting. Only one of these activities needs to be initiated abroad for the related transaction to qualify for FSC tax benefits.

5.53 The direct cost test focuses on five activities involving expenses: (1) advertising and sales promotion; (2) processing orders and making delivery arrangements; (3) delivering the export

⁵⁸²Panel Report "US - Tax Legislation (DISC)," L/3851, adopted on 7-8 December 1981, BISD 23S/98, 114.

⁵⁸³GATT, BISD 28S, p. 114.

property to the customer; (4) determining and transmitting the invoice or statement of account and receiving payment; and (5) assuming credit risk.

5.54 For a given export transaction, the direct cost test can be satisfied in two alternative ways. First, the test is met if at least half of the aggregate direct costs the FSC incurs in the five categories above are foreign direct costs. Second, the test is met if at least 85 per cent of the direct costs incurred by the FSC in any two of the five categories above (tested separately) are foreign direct costs.

5.55 The United States law dictates that FSCs must be "managed" abroad. This requirement, however, can be met with three easy steps. First, all formally-convened board of director and shareholder meetings must be held outside the United States. Second, the FSC's principal bank account must be maintained in a qualified foreign country or United States possession. Third, all cash dividends, legal and accounting fees, and salaries of board members and officers must be paid from a bank account maintained abroad.

5.56 FSCs are required to be located outside the United States in a qualifying country or eligible possession. Comparing with the DISCs, this appears, on its face, to be a positive move towards the compatibility with "the 1981 Understanding". Yet the regulations define an office as a building or a portion of a building consisting of at least one room, regularly used and operated for some corporate business, and owned or leased by the corporation or the corporation's dependent or independent agent.⁵⁸⁴ Practically, this means that the parent corporation can hire a management firm in the tax haven country to lease a room in which to conduct the minimum business required under the law.

5.57 The USG also allows the FSC to organize itself in one of the qualifying United States possessions such as Guam or the US Virgin Islands.

5.58 To make a proper accounting of profits between domestic activities and foreign activities of a controlled subsidiary, arm's length pricing should be used. The US Internal Revenue Code specifically requires that the prices of transactions between related subsidiaries be at arm's length. Furthermore, footnote 59 to the SCM Agreement declares that:

The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length.

5.59 The FSC law, however, did not adopt the method of Internal Revenue Code and the principles laid out in the SCM Agreement. The FSC law provides two alternative administrative pricing methods for calculating the transfer price between the FSC and its parent: (1) the combined taxable income (CTI) method, which allocates profit to the FSC in an amount equal to 23 per cent of the net profit from the export sale; and (2) the foreign trading gross receipts (FTGR) method, which allocates profit to the FSC in an amount equal to the lesser of 1.83 per cent of export receipts or 46 per cent of the net profit from the export sale.

5.60 Although arm's length pricing may be used as well, in practice most FSCs use either or both of the administrative pricing methods. This is because the CTI and FTGR methods allow for a larger allocation of profits to the FSC. An "administrative convenience" would be a system whereby the CTI 23 per cent method, for example, was mandatory across the board—no other methods would be permitted. A system in which exporters are allowed to choose, after a transaction has been completed, which of three transfer pricing methods they would like to use is not an "administrative convenience."

5.61 The USG has established a system by which, according to its submission, companies can "approximate" the arm's-length method. However, the basic rationale for using the arm's-length

⁵⁸⁴ 49 Fed. Reg. 48288-89.

method of pricing is to procure exact accounting of profits between domestic activities and foreign activities, thereby *avoiding* an approximation. Special administrative price ruling methods are inherently imperfect; they may make allocation more convenient, but the accounting under these methods are clearly different from the actual accounting. Applying a 23 per cent allocation to all transactions will clearly distort actual calculations.

5.62 The difference between the amount of taxes collected under the FSC scheme and the amount that would be collected under the US tax law is revenue foregone. The USG has itself calculated the amount of revenue foregone as a result of the application of the FSC laws. According to a Treasury Report published in 1997, "the revenue cost of the FSC programme is estimated at \$1,380 million for calendar year 1992."⁵⁸⁵ Given the minimal overseas activities involved in most FSCs, this substantial revenue "otherwise due" illustrates the magnitude of the problem.

5.63 Article 1.1 of the SCM Agreement provides that a subsidy shall be deemed to exist if:

- there is a "financial contribution" by a government or public body, and
- a "benefit" is thereby conferred.

5.64 Both of these elements exist with respect to the tax exemptions and the special administrative pricing rules under the FSC scheme, thus constituting subsidies under the SCM Agreement.

5.65 The tax exemptions accorded under the FSC scheme is by itself the equivalent of a financial contribution in the meaning of the forgoing or not collecting government revenue that is otherwise due as specified in Article 1.1(a)(1)(ii). Essentially, the FSC scheme operates to allow a company to evade taxes on income that would otherwise be due. Moreover, while normal United States corporations are required to use the arm's-length pricing method to allocate income, special administrative pricing rules under the scheme allows FSCs to choose the arm's-length, CTI, or FTGR methods of income allocation. FSCs will naturally choose the method which results in the least amount of taxes paid. As a result, the amount of tax collected by the USG is smaller than that under the arm's-length method.

5.66 The second prong of the definition of a subsidy under Article 1.1 of the SCM Agreement is that a "benefit" must be incurred. The financial advantage to the parent corporation of a FSC is logically clear: the tax burden of the FSCs and their parents is substantially reduced as a result of applying the FSC scheme and benefits them.

5.67 Article 3.1(a) of the SCM Agreement provides that:

Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

- (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I.⁵⁸⁶

5.68 Both the FSC tax exemptions per se and the increase in the amount of those tax exemptions arising out of the application of the administrative pricing rules depend on export performance. The whole purpose of the FSC law is to facilitate export sales which, in turn, will be subject to tax exemptions. Thus, the subsidies are contingent on export performance.

5.69 Item (e) of Annex I of the SCM Agreement lists measures to be deemed as a prohibited export subsidy:

⁵⁸⁵ "The Operation and Effect of the Foreign Sales Corporation Legislation 1 July 1992 to 30 June 1993," at p. 16, Dept. Treas. Rept. (November 1997).

⁵⁸⁶ Footnotes omitted.

The full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.⁵⁸⁷

5.70 The tax exemptions under the FSC scheme also have all the main elements in the text of Item (e). They are:

- exemptions
- specifically related to exports
- of direct taxes
- payable by industrial or commercial enterprises

5.71 Article 3.1(b) refers to the other type of subsidies prohibited under the SCM Agreement, "subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."

5.72 The FSC tax exemptions are limited to income from the export of products "not more than 50 per cent of the fair market value of which is attributable to articles imported in the United States" Thus, the subsidies are contingent upon the use of United States goods over imported goods, contrary to Article 3.1(b).

5.73 Footnote 59 reaffirms the principle of arm's length methods and, as the United States notes in its first submission, paragraph 112, implies that Members may rely on administrative practices to allocate income as long as they do not contravene the arm's length principle and cause a significant saving of direct taxes. The United States has not demonstrated that the actual operation of administrative pricing rules does not contravene the arm's length principle while we note the facts as described in the preceding paragraphs, in particular paragraph 20.

5.74 The USG's reliance to the "significant savings" language of footnote 59 is particularly inappropriate. The claim of the USG is that the revenue reduction of \$1,380 million for calendar year 1992 does not constitute "significant savings" because that amount is only 0.93 per cent of the total gross receipts for that year. The USG suggests that the standard found in Article 11.9 of the SCM Agreement, which sets up a one per cent *de minimis* threshold for challenging "actionable" subsidies, should properly be the standard by which "significant savings" are determined. The USG relies on Annex IV to the SCM Agreement and footnote 64 for the notion that subsidy savings should be calculated based on the total sales for that fiscal year. The USG thus concludes that because 0.93 per cent does not meet on per cent *de minimis* threshold, it should not be considered significant.

5.75 According to USG calculation, application of the CTI method results in a 15 per cent tax exemption of the *total* income of both the FSC and its related supplier. Article 11.9, Annex IV, and footnote 64 all apply to subsidies which are not prohibited but merely "actionable," as defined in Article 5. *Export* subsidies of the type challenged here are *per se* prohibited. The *de minimis* threshold was established specifically for actionable subsidies, not prohibited subsidies. Even assuming that the USG had some basis for claiming that a *de minimis* standard should apply, why does it feel that a one per cent threshold is appropriate? Section 351.106(c) of the US Antidumping and Countervailing Duty Regulations states that, in reviewing a countervailing duty order, the USG will treat as *de minimis* any "countervailable subsidy rate that is less than 0.5 per cent *ad valorem* . The USG has clung to this 0.5 per cent rate through successive trade negotiations, so it obviously feels that 0.5 per cent is an appropriate *de minimis* threshold.

⁵⁸⁷ SCM Agreement, Annex I, Illustrative List of Export Subsidies (footnotes omitted).

5.76 The USG bases portions of its argument on the notion that the FSC Scheme does not violate the SCM Agreement because it is in accordance with the 1981 Understanding. The 1981 Understanding set forth two principles to apply to the tax exemption of foreign-source income. Those principles are: (1) GATT does not require an exporting country to tax economic processes that occur outside its territorial limits; and (2) arm's-length pricing is mandatory, under GATT, in transactions between exporting enterprises and foreign buyers under common control.

5.77 However, the FSC law fails to live up to either of these principles adopted by the GATT Council. In particular, the FSC administrative pricing rules is different from the Understanding's arm's-length pricing. The FSC scheme allows companies not to use normal transfer pricing rules, but to choose the most favourable method out of the "arm's-length" standard, CTI and FTGR methods.

5.78 In relation to the 1981 Understanding, the United States states in its first submission, paragraph 106, that the exemption of some or all of the income generated from foreign economic activities, through whatever means, is not an export subsidy. The 1981 Understanding provides no basis for such argument but only states that economic activities outside territorial limits need not be taxed. It should be judged in light of the SCM Agreement whether the tax exemption constitutes an export subsidy.

5.79 The USG requests the panel to dismiss European Communities' claim by arguing that the European Communities has not correctly addressed the request for consultations and the European Communities should seek its claim under an appropriate tax forum.

5.80 The USG cites to Article 4.2 of the SCM Agreement, which states:

A request for consultations under paragraph 1 shall include a statement of available evidence with regard to the existence and nature of the subsidy in question.

5.81 The USG appear to read this provision strictly, however, Article 4.2 requires only that the requesting member provide a statement of "available evidence with regard to the existence and nature of the subsidy in question". In this case, the United States law (Sections 921-927 of the IRC) can be considered as a statement of available evidence.

5.82 Moreover, footnote 59 does not *require* Members to bring certain disputes to forum outside WTO. It merely holds that Members may draw attention of another Member to the measure at issue and that, in such circumstances, the Members shall attempt to resolve their differences in certain fora other than WTO.

5.83 Furthermore, while footnote 59 applies to the resolving of certain differences arising over the principle of arm's-length pricing, the current dispute focuses on issues much broader than arm's-length pricing. The European Communities is challenging the tax exemptions under the FSC scheme as a subsidy on the export of certain goods. WTO is the only forum dealing with the relationship of the rights and obligations under the WTO Agreement.

5.84 For the above reasons, GOJ requests that the Panel find that the tax exemptions and administrative pricing rules in the FSC scheme violate the SCM Agreement by granting subsidies contingent in law upon export performance and upon the use of domestic over imported goods. The FSC scheme meets the definition of "subsidy" in Article 1.1 and falls within the definition of prohibited subsidies in both subparagraphs (a) and (b) of Article 3.1.

Japan argues as follows in its Oral Statement at the First Meeting of the Panel:

5.85 On behalf of the GOJ, we would like to express our appreciation for the acceptance by the European Communities and the USG of Japan's request to participate as a third party in the Panel proceedings under Article XXIII relating to the tax treatment of FSCs.

5.86 The GOJ urges the Panel to find that the FSC scheme is in violation of the WTO Agreement, in particular, the SCM Agreement.

5.87 The FSC scheme provides for tax exemptions that would otherwise be due for companies if the FSC scheme did not exist. Furthermore, FSCs can choose among an arm's-length pricing and two administrative pricing methods to minimize their tax obligation. The difference between the amount which the FSCs pay by using the most beneficial pricing methods and the amount which the FSCs would have to pay if there were only one pricing method available is foregone or uncollected "government revenue that is otherwise due." Thus, there is a "financial contribution" by the USG. Substantially reduced tax burdens under the FSC scheme clearly "benefit" corporations.

5.88 Thus, the FSC scheme constitutes a subsidy as defined under Article 1 of the SCM Agreement.

5.89 Subsidies contingent on export performance are prohibited *per se* under the SCM Agreement. The FSC scheme provides for tax exemptions for "exempt foreign trade income" which depends on export performance by FSCs.

5.90 Furthermore, the amount of the tax exemption can be increased substantially through the application of administrative pricing rules. Only export income can take advantage of this tax exemption. Thus, the FSC scheme constitutes an export subsidy prohibited under Article 3.1(a).

5.91 The USG attempt to apply a *de minimis* standard to a prohibited subsidy outright is misplaced. Moreover, the 1981 Understanding provides no basis for the USG argument but only states that economic activities outside territorial limits need not be taxed. FSC Scheme should be judged in light of the SCM Agreement as the tax exemption under the scheme constitutes an export subsidy.

5.92 Moreover, the FSC tax exemptions and the special administrative pricing rules are available only to income from the export of products not more than 50 per cent of the fair market value of which is attributed to articles imported into the United States. Thus, the FSC subsidies are contingent upon United States over imported goods, contrary to Article 3.1(b).

5.93 As to the procedural issues, the GOJ finds that the USG claim has no legitimacy and should be declined. The GOJ believes that Article 4.2 requires that a party requesting consultations must provide whatever basis for the claim is "available" at the time of the request for consultations. The European Communities satisfied this by pointing out the provisions of United States law (Sections 921-927 of the IRC) at issue in its request. Furthermore, the USG points to the text of footnote 59 to the SCM Agreement in claiming that the European Communities has to bring its case under a tax forum or under bilateral tax treaties. The GOJ believes that footnote 59 does not require Members to bring disputes to forum outside the WTO. Above all, while footnote 59 applies to the issue over price ruling, the dispute at issue has much broader scope.

5.94 For these reasons, the GOJ requests that the Panel find that the FSC scheme is in violation of the WTO Agreement and would like to request that the FSC scheme be amended to be in conformity with WTO obligations.

VI. INTERIM REVIEW

6.1 On 23 July 1999, the Panel issued its interim report to the parties. On 6 August 1999, the European Communities and the United States requested the Panel to review precise aspects of the interim report, in accordance with Article 15.2 of the DSU. The European Communities also requested the Panel to hold a further meeting, with both parties requesting that the further meeting not be held during the month of August. The meeting was held on 6 September 1999.

6.2 The European Communities requests that we modify the last sentence of paragraph 7.6 of the interim report to state that, "[I]n conclusion, there is no basis for holding that the EC's request for

consultations does not contain a statement of available evidence", a conclusion that the European Communities considers to flow from the previous statements. Because the existing language accurately reflects the nature of our consideration of the matters discussed in paragraph 7.6, we decline to make the change requested by the European Communities.

6.3 The European Communities considers that the term "due process", used by the Panel in paragraph 7.10, arises exclusively out of US law, and requests that we replace it by a more "neutral" term, such as "rights of defence". We note, however, that the term "due process" has been used extensively in WTO dispute settlement proceedings. *See, e.g., India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, Report of the Appellate Body adopted 16 January 1998, paragraph 94 (referring to ". . . the demands of due process that are implicit in the DSU . . ."). Further, we note that the concept of due process, unlike that of rights of defence, encompasses the rights of both complaining and defending parties. Accordingly, we decline to make the change requested by the European Communities.

6.4 The European Communities requests that, in the second sentence of paragraph 7.34 relating to the United States' preliminary objection to our examination of any "related measures", we replace the term "legal instruments" with "measures" and restructure the sentence. The United States considers that there is no lack of clarity in the sentence. We have made certain modifications in order to clarify the second sentence of paragraph 7.34.

6.5 The European Communities considers that the Panel erred in failing to rule on the FSC administrative pricing rules (paragraphs 7.124-7.129). The European Communities argues that it presented its case in the form of two distinct export subsidy complaints in order to ensure that the Panel would consider and rule on both elements of the FSC scheme (i.e., the FSC exemptions and the FSC administrative pricing rules). The European Communities does not agree that to make an independent ruling on the consistency of the administrative pricing rules would require the Panel either to perform a legal analysis based upon legal interpretations to which it has already objected, or to examine a hypothetical scheme in which the FSC exemptions are eliminated but the administrative pricing rules continue to be utilised in another context. In the view of the European Communities, if the FSC administrative pricing rules cannot be considered as an independent or separate export subsidy, then they should logically be considered as an integral element of the FSC scheme along with the FSC exemptions. While the United States does not agree with the Panel's finding with respect to the FSC exemptions, it considers that, by finding the FSC exemptions to be a prohibited export subsidy, regardless of how they are calculated, the Panel has completely resolved this dispute.

6.6 We remain of the view that we have addressed those claims on which a finding is necessary in order to enable the DSB to make sufficiently precise findings and rulings so as to allow for prompt compliance by the United States. In particular, we consider that to address the WTO consistency of administrative pricing rules in the situation where the exemptions to which they relate no longer exist would require us to analyse a hypothetical scheme with undetermined parameters. We further recall that, from its first submission onward, the European Communities has requested that we address the administrative pricing rules as a separate prohibited subsidy independent of the FSC exemptions, and it is only in its request for interim review that it asks for the first time that we examine the FSC exemptions and administrative pricing rules together. Accordingly, we decline to make the modifications requested by the European Communities. We have however made certain modifications to the language of paragraphs 7.127 and 7.129 with an eye to clarifying the reasoning and removing unnecessary language.

6.7 The European Communities requests that we modify our discussion (paragraphs 7.41-7.48) of the meaning of "otherwise due" such that we refer to the situation that would exist but for the "scheme" or "programme" in question, rather than the "measures in question". In the view of the European Communities, the use of the term "measures" can give rise to misunderstanding because as used in Article 6.2 of the DSU it is defined by the complaining party, and because the existence of a subsidy cannot depend on how narrowly or widely a complaining party has formulated its legal provisions. The United States argues that the terms "programme" and "scheme" are less precise than

the term "measure", and that the Panel in any event clearly identifies the measures in question in this dispute. We note that, whether the term "measure", "scheme" or "programme" is used, the application of the concept of "otherwise due" in other disputes would require panels to apply their best judgement on a case-by-case basis (*See* paragraph 7.93 and footnote 664). We consider, moreover, that we have been sufficiently clear in our application of the general principle to this case. Accordingly, we decline to make the modifications requested by the European Communities.

6.8 The European Communities considers that we should clarify paragraph 7.43 to make clear that a tax regime is defined by both the levels of taxation and the basis for taxation. We have made certain modifications to paragraph 7.43.

6.9 The European Communities requests that we utilise the term "derogation" or "deviation" rather than "exemption" when referring to the special source rules in paragraphs 7.94 and 7.95. We decline to make the modification requested by the European Communities. As suggested by the EC in its submissions, and for the sake of simplicity, we have used the term "exemptions" when referring to certain aspects of the FSC scheme. We note, however, that the term as used in our Report may extend beyond the technical meaning of that term.

6.10 The European Communities argues that, in our discussion of the application of the concept of "otherwise due" to the FSC exemptions (paragraph 7.98), our example relating to the non-application of Subpart F is "inapposite". In the view of the European Communities, a FSC and its parent would have no interest in the FSC not distributing all its income since they benefit from an even greater advantage, i.e., exemptions. Thus, the importance of the controlled foreign corporation exemption is that it allows the FSC scheme to function without interference from the rules in Subpart F. The European Communities suggests that we replace the Subpart F example with an example based upon the FSC special source rules or, if we decide to address the FSC administrative pricing rules in the context of our examination of the FSC exemptions, based upon those rules. The United States responds that the FSC exemption from Subpart F has been a key aspect of the European Communities' claims throughout this dispute. Further, the United States considers that the discussion in the interim report is perfectly clear. If the FSC measures did not exist, income from FSC transactions would be subject to Subpart F; this in turn would mean that the tax on such income would not, because of the provisions of Subpart F, be deferred, deferral being the norm of US tax law. Because in our view paragraph 7.98 is sufficiently clear, we decline to make the modification suggested by the European Communities.

6.11 The European Communities argues that the Panel should have ruled on its claim under Article 3.1(b) of the SCM Agreement. In the view of the European Communities, our invocation of the principle of judicial economy (paragraph 7.132) is inappropriate because "it would be (theoretically) possible" for the local content subsidy to be maintained even if the export subsidies are removed. The European Communities further considers that what it refers to as "the final reason" for our not reaching this claim – that the legal issues were not thoroughly explored – is "unacceptable" because the European Communities set out its case and responded to all arguments made by the United States. The United States contends that the Panel correctly noted that the definition of "export property" serves simply to define the scope of the FSC tax exemption, and that, having declared that exemption to be WTO-inconsistent, the Panel has achieved a complete resolution of the dispute. The United States further contends that a finding on the Article 3.1(b) claim would be an entirely new finding with respect to which the United States would be entitled to interim review under Article 15.2 of the DSU.

6.12 We continue to believe that a finding on the European Communities' Article 3.1(b) claim is not necessary to enable the DSB to make sufficiently precise rulings so as to allow for prompt compliance by the United States in this dispute. As stated in our report and acknowledged by the European Communities, the definition of "export property" at issue serves simply to define the scope of the FSC exemptions, which we have found to be prohibited export subsidies. Although at our interim review meeting the European Communities suggested that we should reach this claim because the United States could offer a tax subsidy to all US goods that met a particular local content

requirement, whether sold in the United States or abroad, any such approach would in our view involve an entirely new and hypothetical scheme not before this Panel. In respect of our statement (footnote 698) that the legal issues regarding the Article 3.1(b) claim were not thoroughly explored, a review of the argumentation relating to the claim clearly reveals that it was not the focus of the parties' attention. As far as the legal status of the claim is concerned, we have noted that the claim was not abandoned. We consider that this is a factually correct account of the matter.

6.13 We have made additional minor modifications to paragraphs 2.1, 4.1133, 7.10, 7.23 and 7.95 and footnote 710 of the report.

VII. FINDINGS

A. REQUESTS FOR PRELIMINARY RULINGS

1. Statement of Available Evidence

7.1 The United States contends that the European Communities' request for consultations in this dispute failed to include a "statement of available evidence" as required by Article 4.2 of the Agreement on Subsidies and Countervailing Measures (hereinafter "SCM Agreement"). In the view of the United States, this failure deprived the United States of its right to learn of the existence of such evidence in advance of the consultations held in this matter and the dispute settlement system of the benefits that Article 4.2 was designed to provide. Because the European Communities failed to comply with this mandatory requirement, the Panel should dismiss the European Communities' claims under Article 3 of the SCM Agreement. In the view of the United States, to fail to dismiss these claims would allow a complainant to ignore Article 4.2 with impunity, thereby reducing that Article to redundancy or inutility, which would be contrary to basic principles of public international law.

7.2 The European Communities argues that, in a dispute relating to a subsidy arising out of a generally applicable law, the available evidence may be the law itself. In this case, the European Communities' request for consultations contained a statement of available evidence in that it referred to the relevant US legal provisions. The European Communities further contends that, even if its request for consultations were not deemed to comply fully with Article 4.2 of the SCM Agreement, there would still not be any basis to dismiss its claims under Article 3 of the SCM Agreement. In the European Communities' view, non-dismissal of a claim for failure to comply with the "statement of available evidence" requirement would not reduce that requirement to "redundancy and inutility", as Article 4.2 was intended to have its effectiveness in the *consultation* phase of the dispute settlement process. Thus, the United States' remedy would have been to request further information and possibly to decline to enter into further consultations until the European Communities had done so. Finally, the European Communities considers that the United States has in no sense been denied its right of defense in this dispute.

7.3 In considering the United States' objection, we first recall that Article 4.2 of the SCM Agreement provides as follows:

"A request for consultations under paragraph 1 [of Article 4] shall include a statement of available evidence with regard to the existence and nature of the subsidy in question."

7.4 The European Communities contends that its request for consultations contains a "statement of available evidence" within the meaning of Article 4.2 because it refers to the relevant US legal provisions. Accordingly, we presume that the European Communities is referring to the following language in its request for consultations as representing its "statement of available evidence":

"The European Communities wish to convey to the United States of America a request for consultations under Article 4 of the "Understanding on Rules and

Procedures Governing the Settlement of Disputes" ("hereinafter referred to as the "Understanding"), Article XXIII:1 GATT 1994 and Article 4 of the Agreement on Subsidies and Countervailing Measures (ASCM) *with respect to Sections 921-927 of the Internal Revenue Code and related measures establishing special tax treatment for "Foreign Sales Corporations" (FSC).*⁵⁸⁸ (emphasis added).

7.5 We note that the word "evidence" has been defined as "available facts, circumstances, etc., supporting or otherwise a belief, proposition, etc.", the word "available" has been defined as "at one's disposal", and the word "statement" has been defined as "expression in words".⁵⁸⁹ Thus, in its ordinary meaning Article 4.2 requires that a Member include in its request for consultations an expression in words of the facts at its disposal at the time it requests consultations in support of its view that it has, in the words of Article 4.1, "reason to believe that a prohibited subsidy is being granted or maintained". On the basis of the ordinary meaning of Article 4.2, it is evident that a complainant must identify, but need not annex, available evidence to its request for consultations.

7.6 In view of the ordinary meaning of Article 4.2, the European Communities' request for consultations could reasonably be considered to contain a statement of available evidence. In this respect, we note the United States' acknowledgement at the first meeting of the Panel that there may be cases where the only evidence relied on by a complainant is a statute, regulation or other legal instrument. In this case, in fact, the primary evidence on which the European Communities relies is Sections 921 through 927 of the US Internal Revenue Code and related measures. The European Communities request for consultations, in as much as it specifically refers to these materials, contains an expression in words of evidence with regard to the existence and nature of the subsidy in question. Although the European Communities did not recite the formulation "statement of available evidence" when referring to these materials, we do not consider that the explicit use of that descriptive term is necessary provided that the relevant evidence is itself referred to. It is true, of course, that the European Communities in its first submission referred to a variety of additional materials, primarily in the form of secondary sources⁵⁹⁰, and that these additional materials were not identified in the request for consultations. Even assuming that these materials represent "evidence" and that a Member is required to identify *all* available evidence in its request for consultations, we are not in a position to determine whether as a factual matter these materials were at the disposal of the European Communities at the time it made its request for consultations and that the European Communities knew at that time that it would rely on those materials. In short, it may well be that the European Communities' request for consultations does contain a statement of available evidence.

7.7 Even assuming that the European Communities' request for consultations does not contain a statement of available evidence, the question remains whether we are required to dismiss the European Communities' claims under Article 3 of the SCM Agreement for this reason. In considering this question, we note that a Member generally has a right to request establishment of a panel under Article 4.7 of the DSU if consultations "fail to settle a dispute within 60 days after the date of receipt of the request for consultations".⁵⁹¹ Where, as here, the claim relates to a violation of Article 3 of the SCM Agreement, Article 4.4 of the SCM Agreement authorizes a Member to request establishment of a panel if no mutually agreed solution has been agreed within thirty days of the request for

⁵⁸⁸ WT/DS108/1, 28 November 1997.

⁵⁸⁹ *Concise Oxford Dictionary*, Ninth edition, 1995.

⁵⁹⁰ The materials in questions were comprised of testimony before the US Congress, reports and other descriptive materials relating to the FSC prepared by US government officials, articles in tax, legal and business publications about the FSC, copies of the requests for consultations and establishment of a panel in this dispute, and excerpts from OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. All of these materials are explanatory of the FSC except for the OECD *Guidelines*, which were submitted in support of the European Communities' view of the meaning of the concept of the "arm's length" principle referred to in footnote 59 to the SCM Agreement.

⁵⁹¹ Of course, a Member may also request establishment of a panel under Article 4.3 of the DSU if a Member does not respond within ten days after the date of the receipt of the request, or does not enter into consultations within a period of no more than 30 days, or a period otherwise mutually agreed.

consultations. Although these provisions differ with respect to timing and in certain other respects, we consider that they both embody the principle that the sole prerequisite to requesting establishment of a panel is that consultations have been held or requested to be held and that the relevant specified time-period has elapsed.⁵⁹² We found no specific provisions either in the DSU or Article 4 of the SCM Agreement requiring a panel to dismiss a claim under Article 3 of the SCM Agreement because the complaining Member failed to respect the requirement that the request for consultations contain a statement of available evidence.

7.8 We note that the United States argues, based upon the Appellate Body Report in *Guatemala – Cement*⁵⁹³, that a panel must dismiss a claim if the complainant has failed to respect a relevant procedural requirement. *Guatemala – Cement*, however, dealt with a different factual situation than the case at hand. Specifically, the complainant in that dispute failed in its request for establishment of a panel to identify a cognisable measure at issue. As the Appellate Body explained in *European Communities – Bananas*⁵⁹⁴, a panel must scrutinize a request for establishment of a panel very carefully because it often forms the basis for the terms of reference of the panel and because it informs the defending party and third parties of the legal basis for the complaint. *Guatemala – Cement* simply does not address the issue of procedural flaws at the prior consultation phase.

7.9 We note the United States' argument that the requirement to include a "statement of available evidence" would be reduced to "redundancy or inutility" if panels did not enforce non-compliance through the dismissal of claims where that requirement was not met. In our view, however, the requirement that a statement of available evidence be included in a request for consultations is not reduced to "redundancy or inutility" because a failure to comply with it is not enforceable through the dismissal by a panel of claims arising under Article 3. Rather, the principle to which the United States refers, which is sometimes called the "principle of effective treaty interpretation", requires that a treaty be interpreted so as to give meaning to all its terms. In this case, the United States is in fact contending that a failure to dismiss the European Communities' claims would preclude an effective sanction for failure to comply with the requirement, rather than that it would fail to give meaning to the terms of Article 4.2.

7.10 The United States contends that it has been denied its right to learn of the existence of available evidence in advance of the consultations held in this dispute. We do not consider that the United States' due process rights in this dispute have been abridged by the alleged failure of the European Communities to include a statement of available evidence in its request for consultations. First, we note that the legal basis of the European Communities' claims and the evidence which is at the core of the European Communities' Article 3 claims (that is, the relevant provisions of the Internal Revenue Code) was certainly made clear by the European Communities' request for consultations. Second, the additional "evidence" which the European Communities has placed before the Panel in its first submission – and which the United States suggests might have been evidence available to the European Communities at the time it requested consultations – is all public information readily accessible to, and in most cases prepared by, the United States. Finally, the United States acknowledged at the first meeting of the Panel that it was of the view at the time it was made that the request for consultations was "procedurally flawed", but that it "did not feel, and still [does] not feel, that there is any rule in either the DSU or the Subsidies Agreement that requires us to perfect the European Communities' pleadings for it". While this may well be the case, it appears to us that the United States consciously chose not to seek clarification regarding the evidence in question at the

⁵⁹² See *Korea – Taxes on Alcoholic Beverages*, WT/DS75/R-WT/DS84/R, Report of the Panel adopted on 17 February 1999, paragraph 10.19 (stating, in the context of an argument relating to the adequacy of consultations, that "[t]he only requirement under the DSU is that consultations were in fact held, or were at least requested, and that a period of sixty days has elapsed from the time consultations were requested to the time a request for a panel was made.")

⁵⁹³ *Guatemala – Anti-Dumping Investigation Regarding Portland Cement from Mexico*, WT/DS60/AB/R, Report of the Appellate Body adopted on 25 November 1998.

⁵⁹⁴ *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/AB/R, Report of the Appellate Body adopted on 25 September 1997, paragraph 142.

point it received the request for consultations, and consequently is not now well-situated to complain of an abridgement of its due process rights.

7.11 For the foregoing reasons, we deny the United States' request to dismiss the European Communities' claims under Article 3 of the SCM Agreement on the grounds that the European Communities failed to include in its request for consultations a statement of available evidence regarding the existence and nature of the subsidy in question.

2. Appropriate Tax Forum

7.12 The United States argues that footnote 59 to item (e) of the Illustrative List annexed to the SCM Agreement expressly directs WTO Members to resolve certain issues raised by exemptions from direct taxes in an appropriate tax forum before resorting to WTO dispute settlement. Specifically, the United States considers that, when disagreements over technical transfer pricing practices or fundamental tax policy arise, the WTO Member should seek to resolve those issues through the facilities of existing bilateral tax treaties or other specific international mechanisms. In this case, the United States contends that a focus of the European Communities' complaint is FSC administrative pricing rules. In the view of the United States, the European Communities should have raised this matter in the Organization for Economic Cooperation and Development ("OECD") or in the competent authority process under the relevant bilateral tax treaties. Accordingly, the United States requests the Panel to defer or dismiss all EC claims relating to the FSC administrative pricing rules until the European Communities has attempted to resolve the issues it raises in those fora.

7.13 The European Communities considers that, while footnote 59 represents a reminder to Members of the existence of tax mechanisms which may provide a better forum than WTO dispute settlement for resolving differences relating to arm's length pricing, that footnote is couched in hortatory language and it is left to the discretion of Members whether to resort to such alternative mechanisms. The European Communities contends that, because it is complaining about an export subsidy, the WTO is the appropriate forum; neither the OECD nor bilateral tax treaties are appropriate fora or offer facilities for the resolution of the issues it raises in this dispute. The European Communities further argues that, if footnote 59 had been intended to constitute a requirement to exhaust alternative fora before resorting to WTO dispute settlement, it would have been identified as a special or additional dispute settlement provision in Appendix 2 to the DSU. Finally, the European Communities considers that because, the United States did not raise its concern before establishment of this Panel, it is estopped from raising its objection before the Panel.

7.14 We recall that footnote 59 is a footnote to item (e) of the Illustrative List of Export Subsidies, concerning the exemption, remission or deferral, specifically related to exports, of direct taxes or social welfare charges. Footnote 59 provides that:

"The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence.

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

7.16 We further recall that footnote 59 is not identified as a special or additional rule or procedure in Appendix 2 to the DSU.

7.17 In considering the preliminary objection raised by the United States, we take as a starting-point that, under Article XXIII of GATT 1994, the DSU and Article 4 of the SCM Agreement, a Member has the right to resort to WTO dispute settlement at any time by making a request for consultations in a manner consistent with those provisions. This fundamental right to resort to dispute settlement is a core element of the WTO system. Accordingly, we believe that a panel should not lightly infer a restriction on this right into the WTO Agreement; rather, there should be a clear and unambiguous basis in the relevant legal instruments for concluding that such a restriction exists.

7.18 In light of the foregoing, we believe that the question before us is whether footnote 59 limits the right of a Member to resort to dispute settlement at any time, i.e., whether footnote 59 requires a Member to resort to what the United States refers to as "alternative tax fora" *before* resorting to WTO dispute settlement. In our view, footnote 59 provides that, in certain circumstances, "Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms" The parties to this dispute disagree as to the implications of the words "shall normally", with the European Communities contending that this means that the resort to such facilities is within the discretion of the complaining Member, and the United States contending that, while there may be unusual circumstances where the recourse to other fora is not practicable, it would be incumbent upon the European Communities to demonstrate that this is the case. In our view, however, this difference of view need not be here decided. Even assuming that footnote 59 requires Members to attempt to resolve their differences through alternative tax fora, that footnote does not provide that the right to resort to WTO dispute settlement at any time is circumscribed by that alleged requirement.

7.19 Not only does footnote 59 not provide a clear and unambiguous basis for circumscribing the right to resort to WTO dispute settlement at any time, but it arguably indicates to the contrary. In this respect, we recall that, while footnote 59 provides that Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, it further states that this is "without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence." We consider that a restriction on the ability of a Member to pursue dispute settlement at any time would prejudice the rights of a WTO Member. Thus, this clause at a minimum strongly suggests that footnote 59 was not intended to restrict a Member's right to pursue dispute settlement at any time. We acknowledge that the reference to rights and obligations *under GATT 1994* leaves us somewhat puzzled, in particular given that "the right of consultation created in the preceding sentence" would appear to be a right provided under the SCM Agreement itself and not under GATT 1994. In response to a question from the Panel, both parties have expressed the same view that the reference to GATT 1994 reflects the fact that this provision was carried over from the Tokyo Round Subsidies Code, and that it should properly be read to refer to rights and obligations under the WTO Agreement. Whether or not this is the case, this clause reinforces our view that the drafters did not intend footnote 59 to limit a Member's rights under other provisions, including those relating to dispute settlement.

7.20 Finally, the fact that footnote 59 is not identified as a special or additional dispute settlement provision provides substantial additional confirmation of our understanding of the ordinary meaning of footnote 59. It will be recalled that Appendix 2 to the DSU contains a list of all special or additional rules in the covered agreements, including numerous provisions of the SCM Agreement. If footnote 59 had been intended to circumscribe the right of a Member to pursue dispute settlement at any time, we believe that it would have been identified as a special or additional dispute settlement provision in that Appendix. Nor do we consider that the United States' argument that Article 10.3 of the Agreement on Agriculture, on which the European Communities relies in its first submission, is not identified in Appendix 2, undermines this conclusion. In our view, Article 10.3, which relates to

allocation of the burden of proof with respect to certain claims under the Agreement on Agriculture⁵⁹⁵, is qualitatively different in its implications from footnote 59 as interpreted by the United States, which allegedly relates to the fundamentally procedural issue of when a Member may resort to dispute settlement.

7.21 We note the arguments of the parties regarding whether or not "facilities" exist in the OECD and under bilateral tax treaties appropriate for the resolution of the differences between the parties regarding what they characterise as "arm's length pricing" issues. We further note the differences of view among the parties regarding whether the European Communities could be considered already to have attempted to resolve these issues in the OECD. We consider, however, that footnote 59 does not require a Member to resort to alternative tax fora before resorting to WTO dispute settlement. Accordingly, we need not decide those questions here.

7.22 For the foregoing reasons, we deny the United States' request that we dismiss or defer the European Communities' claims regarding the FSC administrative pricing rules until the European Communities has attempted to resolve the issues it raises through the facilities of existing bilateral tax treaties or other specific international instruments.

3. Specificity of the Request for Establishment of a Panel

7.23 The United States contends that the European Communities' request for establishment of a panel fails to comply with the requirement of Article 6.2 of the DSU to "identify the specific measures at issue". In particular, the United States relies on the Appellate Body report in *European Communities – Computer Equipment*⁵⁹⁶ for the view that, in certain cases, in order to identify the specific measures at issue, it is necessary to identify the products subject to the measures in dispute. In the view of the United States, because the nature of the export subsidy obligations imposed by the Agreement on Agriculture differ depending on the products at issue and the commitments made by the United States thereunder, the European Communities' request for establishment of a panel should have, but had not, identified the specific products in question. Rather, the United States had to wait until it received the European Communities' first submission to learn of the products in question. Accordingly, the Panel should dismiss the European Communities' claims under the Agreement on Agriculture. In its second submission, the United States narrows and limits its preliminary objection to the European Communities' failure to identify the *scheduled* agricultural products in question.⁵⁹⁷

7.24 The European Communities contends that the measure at issue in this dispute is the FSC scheme and that the legal basis for its complaint is a violation of certain provisions of the Agreement on Agriculture specified in its request for establishment of a panel with respect to all agricultural products. This is not comparable to the tariff binding situation in *European Communities – Computer Equipment*, where the measure (the applied tariff) applies to a particular product. The European Communities identified *examples* of products in its first submission because it is invoking what it considers to be the reversal of the burden of proof provided for in Article 10.3 of the Agreement on Agriculture for these products and it wanted to limit the burden on the United States to just those products, which the United States exports to the European Communities.

7.25 The preliminary objection of the United States is based upon an alleged failure of the European Communities' request for establishment of a panel to comply with Article 6.2 of the DSU. Article 6.2 provides, in relevant part, that the request for the establishment of a panel:

⁵⁹⁵ See paragraphs 7.134 - 7.143, *infra*.

⁵⁹⁶ *European Communities – Customs Classification of Certain Computer Equipment*, WT/DS62/AB/R-WT/DS67/AB/R-WT/DS68/AB/R, Report of the Appellate Body adopted on 22 June 1998, paragraph 67.

⁵⁹⁷ Footnote 65, *supra*.

". . . shall indicate whether consultations were held, identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly."

7.26 The Appellate Body has, in *European Communities – Bananas*, explained that "it is incumbent upon a panel to examine the request for establishment very carefully to ensure its compliance with both the letter and spirit of Article 6.2 of the DSU". It further explained that:

"It is important that a panel request be sufficiently precise for two reasons: first, it often forms the basis for the terms of reference of the panel pursuant to Article 7 of the DSU; and, second, it informs the defending party and the third parties of the legal basis of the complaint."⁵⁹⁸

7.27 In *European Communities – Computer Equipment*, the Appellate Body has further explained that:

". . . Article 6.2 of the DSU does *not* explicitly require that the products to which the 'specific measures at issue' apply be identified. However, with respect to certain WTO obligations, in order to identify the 'specific measures at issue', it may also be necessary to identify the products subject to the measures in dispute."⁵⁹⁹

7.28 In applying these principles to the case at hand, we are of course required to examine very carefully the European Communities' request for establishment of a panel. With respect to the European Communities' claims under the Agreement on Agriculture, that request states that:

"The FSC scheme is an export subsidy within the meaning of Article 1(e) of the AA. Since the United States has declared that the Scheme is not taken into account for the purpose of compliance with their commitments under the AA, the European Communities considers that there is a violation of Articles 3 and 8 AA read in conjunction with Articles 9(1)(d), 10(1) and 10(3) of the same Agreement."⁶⁰⁰

7.29 The question before us is whether the European Communities' request for establishment is sufficiently precise to satisfy the requirements of Article 6.2 of the DSU. We consider that it is. In its request for establishment of a panel, the European Communities states that in its view the FSC is an export subsidy and that "the United States has declared that the [FSC] Scheme is not taken into account for the purpose of compliance with their commitments under the AA" Accordingly, given the inherently all-encompassing nature of this claim, it constitutes a claim that the FSC could give rise to violations of the Agreement on Agriculture with respect to any agricultural product. Consequently, and in the absence of any specification as to the products at issue, this request puts the United States and third parties on notice that the European Communities asserts the existence of violations of the Agreement on Agriculture with respect to all agricultural products.

7.30 Further, we see no meaningful distinction between the case where a request for establishment simply alleges that a Member has breached its commitments with respect to all agricultural products, and the case where a Member makes such an allegation and attaches a list of all agricultural products. In either event, the scope of the products at issue will be known. Whether or not the complaining Member attaches such a list, the terms of reference are clear and both the defending party and third parties are fully informed regarding the legal basis of the complaint.

⁵⁹⁸ *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/AB/R, Report of the Appellate Body adopted on 25 September 1997, paragraph 142.

⁵⁹⁹ *European Communities – Customs Classification of Certain Computer Equipment*, WT/DS62/AB/R-WT/DS67/AB/R-WT/DS68/AB/R, Report of the Appellate Body adopted on 22 June 1998, paragraph 67.

⁶⁰⁰ WT/DS108/2, 9 July 1998.

7.31 Of course, the fact that a complainant in its request for establishment complains about violations relating to a broad range of products does not discharge it from its obligation to present such evidence and argument as is necessary to raise a presumption of a violation of the WTO Agreement. Thus, to the extent that the existence of a violation depends upon product-specific information, a complainant which casts its complaint broadly in terms of the products to which it applies must as a general rule be prepared to present the necessary evidence and argument to sustain its claims if it hopes to prevail on the substance of the dispute. (*See* paragraph 7.163)

7.32 For the foregoing reasons, we consider that the European Communities request for establishment of a panel sufficiently identifies the "specific measures at issue" within the meaning of Article 6.2 of the DSU. Accordingly, we deny the United States' request that we dismiss the European Communities' claims under the Agreement on Agriculture.

4. Related Measures

7.33 The European Communities requested establishment of a panel "with respect to Sections 921-927 of the Internal Revenue Code and related measures establishing special tax treatment for 'Foreign Sales Corporations' (FSC)".⁶⁰¹ The United States contends that any "related measures" not identified by the time of the European Communities' first submission are not properly before the Panel. The European Communities responds that its complaint relates to the tax exemption and transfer pricing subsidies accorded to United States exported goods under the body of law it has described as the "FSC scheme", that the European Communities had already identified many other provisions related to that scheme, and that the Panel should therefore reject the United States' request for a ruling.

7.34 In our view, this dispute relates to certain tax treatment under the FSC scheme which is alleged by the European Communities to be inconsistent with the SCM Agreement and the Agreement on Agriculture. The primary legal instruments governing this tax treatment may be found in Sections 921-927 of the US Internal Revenue Code, which are identified in the European Communities' request for establishment of a panel. In our examination of the WTO-consistency of this tax treatment, we have not found it necessary to examine any other legal instruments governing this tax treatment not specifically identified by the European Communities by the time of its first submission to the Panel.⁶⁰² Accordingly, we do not consider it necessary to rule on the United States' request in this regard.

B. CLAIMS UNDER ARTICLE 3.1(a) OF THE SCM AGREEMENT

1. Overview of the parties' arguments

7.35 The European Communities claims that the FSC scheme confers subsidies within the meaning of Article 1 of the SCM Agreement which are contingent upon export performance within the meaning of Article 3.1(a) of that Agreement and are thus prohibited under the latter provision. In the view of the European Communities, the FSC scheme involves two subsidies. First, the European Communities identifies certain exemptions from income taxes for FSCs and their parent companies provided by the FSC scheme. Second, the European Communities identifies administrative pricing rules which it considers derogate from the normal transfer pricing rules and to increase the amount of income shielded from taxation by the FSC exemptions. In the European Communities' view, these exemptions and administrative pricing rules represent a financial contribution within the meaning of Article 1.1(a)(1)(ii) because "government revenue that is otherwise due is foregone or not collected", and a benefit is conferred because the revenue foregone is

⁶⁰¹ WT/DS108/2 dated 9 July 1998.

⁶⁰² We have examined Section 245(c) of the US Internal Revenue Code in respect of the dividends-received deduction for shareholders of a FSC and Section 951(e) of the US Internal Revenue Code in respect of the exemption of foreign trade income of a FSC from the anti-deferral rules. *See* paragraphs 7.96-7.97, *infra*. Sections 245(c) and 951(e) were however identified in the European Communities' first written submission (paragraph 65). Accordingly, the terms of the United States' preliminary objection do not extend to these provisions.

equal to the amount of money which does not have to be paid in taxes by FSCs and their parents. The European Communities further considers that the subsidies arising from the exemptions and administrative pricing rules are contingent upon export performance within the meaning of Article 3.1(a) because they depend upon the existence and amount of "exempt foreign trade income" which can only be produced by the export of US goods. Finally, the European Communities considers that the subsidies conferred by the FSC scheme fall within the scope of item (e) of the Illustrative List of Export Subsidies ("Illustrative List"), thus confirming the application of the Article 3.1(a) prohibition.

7.36 The United States contends that the FSC scheme does not confer any export subsidy. In the view of the United States, footnote 59 to item (e) of the Illustrative List contains the "controlling legal standard" applicable to the European Communities' export subsidy claims. The United States considers that footnote 59 indicates that income generated from foreign economic processes need not be taxed, and that the exemption of some or all of such income, by whatever means, is not a prohibited export subsidy. The United States further argues that a 1981 decision and understanding of the GATT 1947 Council⁶⁰³ (hereinafter "1981 understanding") establishes that the exemption from tax of income attributable to foreign economic processes does not constitute the foregoing of revenue that is "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement, and that exempting income from foreign economic processes is not therefore to be considered to be contingent upon export performance. In the United States' view, footnote 59 further allows Members to use administrative or other practices to distinguish income derived from economic processes outside their territory from income derived from economic processes within their territories, so long as the overall allocation of income approximates arm's length results and does not result in a "significant saving" of direct taxes in export transactions. The United States considers that the FSC scheme merely exempts from taxation certain income attributable to foreign economic processes, and that its FSC administrative pricing rules are administrative practices to distinguish foreign- from domestic-source income which do not result in a significant saving of direct taxes in export transactions. Consequently, it considers that the FSC scheme does not confer any export subsidy within the meaning of Article 3.1(a) of the SCM Agreement.

2. Order in which the issues will be addressed

7.37 In structuring and ordering their arguments, the parties have taken different approaches. The European Communities begins its analysis with Articles 1 and 3 of the SCM Agreement, and then proceeds to item (e) of the Illustrative List as "confirmation" for its conclusions. In its first submission, on the other hand, the United States urges the Panel to begin its analysis with footnote 59 of item (e) of the Illustrative List. The United States relies on the Appellate Body report in *European Communities – Bananas* for the proposition that, where the issues before a panel implicate two provisions, the panel should examine the more specific provision first.⁶⁰⁴ In subsequent submissions, and in response to the European Communities' approach, the United States begins its argumentation from Article 1, without however abandoning its view that we should begin our analysis with the "more specific provision".

7.38 We note that the statements in the Appellate Body report in *European Communities – Bananas* relied upon by the United States relate to the order in which the Panel should have addressed certain *claims*, rather than the order in which it should have addressed various provisions relating to a particular claim. In this case, the European Communities has presented a claim under Article 3.1(a) of the SCM Agreement, and the parties have pointed to a number of legal provisions, including Articles 1 and 3 of the SCM Agreement and the Illustrative List (as well as to the 1981 understanding) that they consider relevant to our analysis. Here, the European Communities as claimant has based its arguments primarily on Articles 1 and 3 of the SCM Agreement, rather than on the Illustrative List,

⁶⁰³ *Tax Legislation*, BISD 28S/114, 7-8 December 1981.

⁶⁰⁴ *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/AB/R, Report of the Appellate Body adopted on 25 September 1997, paragraph 204.

and we consider that our analysis would best be structured by looking first at those Articles.⁶⁰⁵ In addition, and in light of the fact that the European Communities has alleged the existence of two distinct subsidies, we will first address the issue of FSC exemptions, and thereafter will address the issue of FSC administrative pricing rules.

3. Existence of a subsidy: FSC exemptions

7.39 Article 3.1(a) of the SCM Agreement provides that subsidies "within the meaning of Article 1" which are contingent upon export performance are prohibited. Consequently, in order for a measure to be an export subsidy within the meaning of Article 3.1(a) of the SCM Agreement, it must be a subsidy within the meaning of Article 1 of that Agreement. Accordingly, we will first examine whether the exemptions identified by the European Communities under the FSC scheme are subsidies within the meaning of Article 1.1 of the SCM Agreement.

7.40 Article 1.1 of the SCM Agreement provides, in relevant part, that:

"For the purpose of this Agreement, a subsidy shall be deemed to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:

.....

(ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)[footnote omitted];

.....

and

(b) a benefit is thereby conferred."

It is evident from Article 1 that two elements must be met in order for a subsidy to exist within the meaning of that Article. First, there must be a financial contribution by a government. Second, a benefit must thereby be conferred. We will consider each element in turn.

(a) Financial contribution

(i) *When foregone revenue is "otherwise due"*

7.41 Before turning to the case at hand and considering whether, in the case of the FSC scheme, revenue is foregone which is otherwise due, we first consider whether, as a general rule, the tax regime of a Member represents the proper benchmark for assessing whether foregone revenue is "otherwise due".

7.42 It will be recalled that, under Article 1 of the SCM Agreement, there is a financial contribution and hence a possible subsidy where "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)". The adjective "due" has been defined, *inter alia*, to mean "that is owing or payable, as a debt".⁶⁰⁶ Furthermore, the financial contribution must be by a *government* (or any public body within the territory of a Member) and arises only where *government* revenue which is "otherwise due" is foregone or not collected. Thus,

⁶⁰⁵ We do not mean to suggest that it would never be appropriate to begin the analysis of an export subsidy issue by reference to the Illustrative List – particularly in a case where the claimant relied primarily upon that List – but merely that we have chosen to begin with Articles 1 and 3 in this case.

⁶⁰⁶ *Shorter Oxford English Dictionary* (Third Edition).

the question to be asked in examining whether a financial contribution in the form of revenue foregone exists is whether taxes are "owing or payable" to a government within the territory of a Member. When a taxpayer seeks to establish whether taxes are "owing or payable" to a government, he must look to that government's own tax regime. In our view, therefore, it is clear that whether tax or other government revenue is otherwise "owing or payable" must, absent a clear indication to the contrary in the SCM Agreement, be determined by reference to that government's own tax regime.

7.43 The United States has argued that "if, under WTO rules, a WTO Member is not obligated to tax certain categories of income, then the exemption of such income from taxation cannot constitute a subsidy, let alone an export subsidy".⁶⁰⁷ It need hardly be stated, however, that the WTO Agreement does not impose any general obligation on Members to levy taxes or duties, nor to levy them at a particular level. To the contrary, however unlikely it might be in practice, a WTO Member is in principle free not to levy any taxes or duties whatsoever. In the case of import duties, in fact, it could be said that the complete elimination of import duties would be consistent with the object and purpose of the WTO Agreement. That being the case, there is in the WTO Agreement no theoretical "correct" benchmark for taxes that would represent the norm for taxes and duties "otherwise due". Accordingly, the determination whether revenue foregone is "otherwise due" must involve a comparison between the fiscal treatment being provided by a Member in a particular situation and the tax regime otherwise applied by that Member (or, in the case of tax treatment at a sub-Member level, the tax regime otherwise applied by the taxing authority in question).

7.44 We note that, in the one WTO panel report adopted to date regarding an alleged subsidy in the form of a financial contribution involving revenue foregone, it is implicit that the proper benchmark for determining whether revenue foregone was "otherwise due" involves a comparison with the tax regime otherwise applied by the Member. In *Indonesia – Certain Measures Affecting the Automobile Industry*, the parties (including the United States) agreed, and the Panel found, that exemptions from luxury taxes of up to 35 per cent and from import duties of up to 200 per cent involved the foregoing of revenue otherwise due.⁶⁰⁸ Clearly, however, Indonesia had no general WTO obligation to impose such duties and taxes, much less to impose them at these levels. Nevertheless, the Panel and the parties appear to have considered that revenue was foregone that was otherwise due because Indonesia did not collect these otherwise applicable duties and taxes in the context of the national car programme.

7.45 In accordance with its ordinary meaning, we took the term "*otherwise due*" to refer to the situation that would prevail but for the measures in question. It is thus a matter of determining whether, absent such measures, there would be a higher tax liability. In our view, this means that a panel, in considering whether revenue foregone is "otherwise due", must examine the situation that would exist but for the measure in question. Under this approach, the question presented in this dispute is whether, if the FSC scheme did not exist, revenue would be due which is foregone by reason of that scheme.

7.46 The European Communities terms this a "formalistic" approach, and prefers an approach under which the question posed is whether there is a "deviation from or exemption to the generally applied rate or basis for collection"⁶⁰⁹ of taxes. In other words, the European Communities contends that under this approach, a measure would involve revenue foregone which was otherwise due if it resulted in the foregoing of revenue which would be due under the Member's "generally applicable" tax regime. The European Communities further developed this approach in response to questions from the Panel, explaining that there would only be foregoing of revenue that was otherwise due if the exemption or exclusion from taxation is "not based on neutral and objective criteria, i.e., the

⁶⁰⁷ Paragraph 4.526, *supra*.

⁶⁰⁸ *Indonesia – Certain Measures Affecting the Automobile Industry*, WT/DS54/R-WT/DS55/R-WT/DS59/R-WT/DS64/R, paragraph 14.155, Report of the Panel adopted on 23 July 1998.

⁶⁰⁹ Paragraph 4.591, *supra*.

exemption or exclusion is special or programmatic".⁶¹⁰ We see no textual basis in Article 1 of the SCM Agreement, however, to consider that whether revenue foregone is "otherwise due" generally should be determined by other than the situation that would exist in the absence of the measures in question. Thus, although it may well be that, in many cases, the test proposed by the European Communities would generate the same result as the "but for" test, we consider that it is the latter test which is grounded in the actual text of the SCM Agreement.

7.47 It may be worth noting that, in the context of countervailing duties, the United States itself uses a "but for" test as the basis for determining whether a subsidy exists in the case of revenue foregone. Thus, Section 351.509 of the US regulations governing countervailing duties provides that:

"[I]n the case of a program that provides for a full or partial exemption or remission of a direct tax (e.g., an income tax), or a reduction in the base used to calculate a direct tax, a benefit exists to the extent that the tax paid by a firm as a result of the program is less than the tax the firm would have paid *in the absence of the program*."⁶¹¹ (emphasis added)

7.48 We hasten to add that the United States' explanation accompanying its regulation specifies that, "in the case of a foreign tax measure that exempts from taxation (either in whole or in part) income attributable to economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country, the Department would not consider such a measure to be an export subsidy. . ."⁶¹² This however does not detract from the general approach of the regulations that whether revenue foregone is "otherwise due" should be determined on the basis of an examination of the tax treatment that would be applied by the Member in the absence of the measures in question.

(ii) *Does the 1981 Understanding Control When Revenue Foregone is "Otherwise Due"?*

7.49 Having determined that, as a general rule, whether revenue foregone is "otherwise due" should be determined by examining the situation that would exist under a Member's tax regime in the absence of the measures at issue, we must next consider whether some different interpretation should be applied in the context of this dispute.

7.50 The United States argues that the term "otherwise due" must be interpreted in light of the 1981 understanding taken in conjunction with the adoption of certain panel reports involving subsidies allegedly prohibited by Article XVI:4 of GATT 1947. Specifically, the United States considers that the 1981 understanding represents an interpretation of Article XVI:4 of GATT 1947 which is part of GATT 1994 by virtue of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the WTO Agreement. The United States further considers that, when read in the light of the 1981 understanding, it is clear that the exemption of foreign source income from taxation does not constitute the foregoing of revenue that is "otherwise due" within the

⁶¹⁰ The United States disputes that the reference point for determining whether revenue foregone is "otherwise due" must as a general matter relate to the generally applicable tax regime of the Member in question, and describes at length the complexity of determining in particular circumstances which rules are the "general" rules and which are the "exceptions". In the view of the United States, this approach confuses the issue of whether revenue foregone is "otherwise due" with the issue of specificity under Article 2 of the SCM Agreement. The United States has not, however, advocated application of a "but for" approach, nor has it been able to identify any generally relevant alternative to a Member's own tax regime for determining when foregone revenue is "otherwise due". When asked by the Panel what criteria it considered should be applied when examining whether revenue foregone was "otherwise due", the United States responded that "one obvious criterion is whether there has ever been a decision or ruling under the same or a related agreement". Other criteria identified were "the desirability of avoiding results that exalt form over substance" and "the need to have clear rules". Paragraphs 4.1103-4.1114, *supra*.

⁶¹¹ 19 Code of Federal Regulations, Section 351.509.

⁶¹² 63 Federal Register 65376 (25 November 1998).

meaning of Article 1.1(a)(ii) of the SCM Agreement.⁶¹³ The United States argues, in the alternative, that the 1981 understanding represents "subsequent practice" within the meaning of Article 31(3)(b) of the Vienna Convention on the Law of Treaties, or constitutes a "decision" within the meaning of Article XVI:1 of the WTO Agreement that shall "guide" the WTO.

7.51 The European Communities argues that the 1981 understanding represents, at most, a decision under Article XXIII of GATT 1947, taken in the "dispute settlement rather than rule-making mode",⁶¹⁴ to adopt certain panel reports. The European Communities relies on the Appellate Body report in *Japan – Alcoholic Beverages*⁶¹⁵ for the proposition that the understanding, like an adopted panel report, does not constitute an "other decision" within the meaning of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the WTO Agreement and therefore is not a part of the GATT 1994. The European Communities further considers that the 1981 understanding is not a "decision" within the meaning of Article XVI:1 of the WTO Agreement. In any event, the European Communities considers that the 1981 understanding is irrelevant to a dispute under the SCM Agreement because it involved at most Article XVI:4 of GATT 1947. Finally, the European Communities considers that the substance of the 1981 understanding does not support the position of the United States in this dispute.

7.52 Background to the 1981 understanding. In July 1973, the GATT Council established four panels which are commonly referred to as the *Tax Legislation* Cases. The first of these panels involved a complaint by the European Communities that the United States' Domestic International Sales Corporation ("DISC") legislation was inconsistent with Article XVI:4 of GATT 1947. The remaining three panels, which were established simultaneously with the DISC panel, involved complaints by the United States that certain income tax practices of Belgium, France and the Netherlands were inconsistent with Article XVI:4 of GATT 1947. The four panels, which had the same composition, issued their reports on 2 November 1976. The panels found that both the DISC legislation and the tax practices of Belgium, France and the Netherlands "had effects which were not in accordance with [the contracting parties'] obligations under Article XVI:4" of GATT 1947.⁶¹⁶

7.53 The *Tax Legislation* panel reports proved controversial, and five years passed before they were adopted through the 1981 understanding. The 1981 understanding provides as follows:

The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore,

⁶¹³ The United States further argues that the 1981 understanding is relevant to interpreting Article 3.1(a), item (e) of the Illustrative List of Export Subsidies and footnote 59 to that item. Our consideration of the legal status of the 1981 understanding to interpretation of the SCM Agreement is equally applicable in these various contexts.

⁶¹⁴ Paragraph 4.847, *supra*.

⁶¹⁵ *Japan – Taxes on Alcoholic Beverages*, WT/DS8/AB/R-WT/DS10/AB/R-WT/DS11/AB/R, Report of the Appellate Body adopted on 1 November 1996.

⁶¹⁶ *United States Tax Legislation (DISC)*, adopted 7-8 December 1981, BISD 23S/98, paragraph 74; *Income Tax Practices Maintained by France*, adopted 7-8 December 1981, BISD 23S/114, paragraph 53; *Income Tax Practices Maintained by Belgium*, adopted 7-8 December 1981, BISD 23S/127, paragraph 40; *Income Tax Practices Maintained by the Netherlands*, adopted 7-8 December 1981, BISD 23S/137, paragraph 40.

Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.⁶¹⁷

7.54 The 1981 understanding was accompanied by the following statement by the Chairman of the Council:

Following the adoption of these reports the Chairman noted that the Council's decision and understanding does not mean that the parties adhering to Article XVI:4 are forbidden from taxing the profits on transactions beyond their borders, it only means that they are not required to do so. He noted further that the decision does not modify the existing GATT rules in Article XVI:4 as they relate to the taxation of exported goods. He noted also that this decision does not affect and is not affected by the Agreement on the Interpretation and Application of Articles VI, XVI and XXIII. Finally, he noted that the adoption of these reports together with the understanding does not affect the rights and obligations of contracting parties under the General Agreement.⁶¹⁸

7.55 Whether the 1981 understanding is part of GATT 1994. The first question we must consider with respect to the 1981 understanding is whether it represents an "other decision of the CONTRACTING PARTIES to GATT 1947" within the meaning of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the WTO Agreement.⁶¹⁹ We recall that Annex 1A to the WTO Agreement provides, in relevant part, as follows:

"The General Agreement on Tariffs and Trade ("GATT 1994") shall consist of:

(a) the provisions in the General Agreement on Tariffs and Trade, dated 30 October 1947 . . . as rectified, amended or modified by the terms of legal instruments which have entered into force before the date of entry into force of the WTO Agreement;

(b) the provisions of the legal instruments set forth below that have entered into force under the GATT 1947 before the date of entry into force of the WTO Agreement:

- (i) protocols and certifications relating to tariff concessions;
- (ii) protocols of accession . . .;
- (iii) decisions on waivers granted under Article XXV of GATT 1947 and still in force on the date of entry into force of the WTO Agreement[footnote omitted];

⁶¹⁷ *Tax Legislation*, BISD 28S/114, 7-8 December 1981.

⁶¹⁸ *Ibid.*

⁶¹⁹ As noted above, the European Communities relies upon the Appellate Body Report in *Japan – Alcoholic Beverages* for the proposition that the 1981 understanding is not an "other decision" for the purposes of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the WTO Agreement. In that case, the Appellate Body found that adopted panel reports do not "in themselves" constitute "other decisions of the CONTRACTING PARTIES to the GATT 1947" within the meaning of that provision. We do not consider that *Japan – Alcoholic Beverages* addresses the precise situation presented in this case. In that dispute, the issue was the status of adopted panel reports themselves. The 1981 understanding, however, was not limited to the adoption of certain panel reports. Rather, the text of the understanding, when read against the background of the *Tax Legislation* cases, indicates disagreement with certain aspects of those reports. Further, the reports were adopted "on the understanding that with respect to these cases, and in general, economic processes . . . located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country . . ." (emphasis added). Because the 1981 understanding is not simply a decision to adopt certain panel reports, *Japan – Alcoholic Beverages* does not in itself offer a clear answer to the issue now before us.

- (iv) other decisions of the CONTRACTING PARTIES to GATT 1947;
- (c) the Understandings set forth below:
 - (i) Understanding on the Interpretation of Article II:1(b) of the General Agreement on Tariffs and Trade 1994;
 - (ii) Understanding on the Interpretation of Article XVII of the General Agreement on Tariffs and Trade 1994;
 - (iii) Understanding on Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994;
 - (iv) Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994;
 - (v) Understanding in Respect of Waivers of Obligations under the General Agreement on Tariffs and Trade 1994;
 - (vi) Understanding on the Interpretation of Article XXVIII of the General Agreement on Tariffs and Trade 1994; and
- (d) The Marrakesh Protocol to GATT 1994."

7.56 It would appear to us that, taken on its own and read in isolation, the phrase "other decisions of the CONTRACTING PARTIES to GATT 1947" in its ordinary meaning is broad enough to encompass the 1981 understanding.⁶²⁰ In this respect, we note that the word "decision" has been defined, *inter alia*, as "the action of deciding (a contest, question, etc.); settlement, determination; (with *a* and *pl.*) a conclusion, judgement: esp. one formally pronounced in a court of law".⁶²¹ In our view, even a decision to adopt a panel report, *i.e.*, to make appropriate recommendations or to give a ruling under Article XXIII:2 of GATT 1994, falls within the ordinary meaning of the term "decision". The Appellate Body in *Japan – Alcoholic Beverages* itself refers to the action of the CONTRACTING PARTIES in adopting a panel report as a "decision"⁶²² and, as we have seen, the 1981 understanding goes beyond simple adoption of the *Tax Legislation* panel reports in several respects. Further, there

⁶²⁰ The parties have argued extensively about whether the 1981 understanding was adopted pursuant to Article XXIII:2 or Article XXV of GATT 1947. In our view, this is not the precise question that should be posed. Article XXV was an umbrella provision regarding decision-making by the CONTRACTING PARTIES. That Article XXV joint action involved "decision-making" is confirmed by Article XXV:4 of GATT 1947, which provided that, "[e]xcept as otherwise provided for in this Agreement, decisions of the CONTRACTING PARTIES shall be taken by a majority of the votes cast". One form of joint action by the CONTRACTING PARTIES involved making appropriate recommendations or giving rulings under Article XXIII, and the 1981 understanding involves, at least in part, joint action under that provision. There are however numerous other provisions "which involve joint action" in GATT 1947 (See John H. Jackson, *World Trade and the Law of GATT* (Bobs-Merrill, 1969), section 5.4) and Article XXV further provided for joint action "with a view to facilitating the operation and furthering the objectives of GATT 1947". Thus, even if one takes the view that the 1981 understanding goes beyond making a recommendation or ruling under Article XXIII:2, such action would still have been authorized under Article XXV:1, which allowed the CONTRACTING PARTIES broad power for decision-making in order to facilitate the operation and furthering of the objectives of GATT 1947. This does not of course mean that the 1981 understanding necessarily represents a decision within the meaning of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the WTO Agreement to adopt an "interpretation" of GATT 1947. One can imagine numerous forms of joint action under Article XXV:1, other than interpretations, to facilitate the operation and further the objectives of GATT 1947.

⁶²¹ *Oxford Shorter English Dictionary* (Third edition).

⁶²² *Japan – Alcoholic Beverages*, p. 13 ("We do not believe that the CONTRACTING PARTIES, in deciding to adopt a panel report, intended that their *decision* would constitute a definitive interpretation of the relevant provisions of GATT 1947.") (emphasis added).

can be no doubt that the decision was taken by the CONTRACTING PARTIES, as the actions of the GATT 1947 Council were referred to the CONTRACTING PARTIES for their approval.⁶²³

7.57 That the 1981 understanding was a decision by the CONTRACTING PARTIES of GATT 1947 does not however necessarily mean that the 1981 understanding is the type of decision which falls within paragraph (1)(b)(iv) of the language of Annex 1A incorporating GATT 1994 into the WTO Agreement. Clearly, it would not be appropriate for us to read the phrase "other decisions of the CONTRACTING PARTIES to GATT 1947" in isolation. Rather, we consider that "other decisions of the CONTRACTING PARTIES to GATT 1947" are only incorporated into GATT 1994 through this language to the extent that they fulfill the criteria of the chapeau to that paragraph, *i.e.* that they are "the provisions of the legal instruments set forth below that have entered into force under the GATT 1947 before the date of entry into force of the WTO Agreement". In other words, we consider that only those "other decisions of the CONTRACTING PARTIES to GATT 1947" which have the characteristics of a "legal instrument" that can "enter into force" form part of GATT 1994.

7.58 In interpreting these terms, we must of course begin with an examination of their ordinary meaning. In this respect, we note that the word "instrument" has been defined by one dictionary as follows: "*Law.* A formal legal document whereby a right is created or confirmed, or a fact recorded; a formal writing of any kind, as an agreement, deed, charter, or record, drawn up and executed in legal form".⁶²⁴ Similarly, a legal dictionary has defined the word "instrument" to mean, *inter alia*, "[a] document or writing which gives formal expression to a legal act or agreement, for the purpose of creating, securing, modifying or terminating a right; a writing executed and delivered as the evidence of an act or agreement".⁶²⁵ Thus, the term "legal instrument" in its ordinary meaning involves the existence of a formal legal text that has a binding effect in determining the rights and/or obligations of the parties thereto, which in this case would be all GATT 1947 contracting parties.⁶²⁶

7.59 This is in our view confirmed contextually by the references in Articles II.2 and II.3 of the WTO Agreement to the Agreements "and associated legal instruments included in Annexes 1, 2 and 3" as "binding on all Members" or, in the case of Plurilateral Trade Agreements in Annex 4, on all Members that have accepted them. We find further confirmation in the reference, in the chapeau to paragraph (1)(b) of the language of Annex 1A incorporating GATT 1994 into the WTO Agreement, to "entry into force", which implies that the legal instrument has binding effect on the contracting parties. Further, it is not the legal instruments themselves but the "provisions" of the legal instruments that form part of GATT 1994. The reference to provisions again implies in our view the existence of a binding and formal legal text.

7.60 Our understanding of the nature of the "legal instruments" that may constitute part of GATT 1994 is also confirmed by a review of the types of specific "legal instruments", in addition to "other decisions of the CONTRACTING PARTIES to GATT 1947", which are identified in paragraph 1(b) of the language of Annex 1A incorporating GATT 1994 into the WTO Agreement. The other types of legal instruments specifically identified are protocols and certifications relating to tariff concessions, protocols of accession and decisions on waivers granted under Article XXV of GATT 1947. These legal instruments share the common characteristics of being formal legal texts which have a binding effect in determining the rights and/or obligations of all contracting parties.

7.61 Further, we consider it significant that all of the other items listed in paragraph 1 of the language of Annex 1A incorporating GATT 1994 into the WTO Agreement share the common characteristics identified above. Thus, in addition to the text of GATT 1947 as rectified, amended, or

⁶²³ CONTRACTING PARTIES, Thirty-Eighth Session, *Summary Record of the First Meeting*, SR.38.1, 15 December 1982.

⁶²⁴ *Shorter Oxford English Dictionary* (Third edition).

⁶²⁵ *Black's Law Dictionary* (Revised fourth edition).

⁶²⁶ In fact, the term "legal instrument" is used in the immediately preceding paragraph (a) in the context of the rectification, amendment or modification of the text of GATT 1947. This would appear to represent further confirmation of our understanding of the term "legal instrument".

modified, and the legal instruments whose characteristics we are now considering, the other items identified as constituting part of GATT 1994 are a series of formal Understandings regarding the interpretation of GATT 1994, the texts of which were part of the Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations⁶²⁷, and the Marrakesh Protocol of GATT 1994. Again, these are formal legal texts which have a binding effect in determining the rights and/or obligations of the parties thereto. Thus, the context of paragraph 1(b) confirms our view of the scope of the term "legal instrument" as used in that paragraph.

7.62 Finally, we consider that our understanding of the scope of the items included in paragraph 1(b) is appropriate in light of the implications of the inclusion of an item in that paragraph. It will be recalled that the GATT 1994 "shall consist of" the items identified in paragraph 1 of the language of Annex 1A incorporating GATT 1994 into the WTO Agreement. In other words, an item identified in paragraph 1 actually becomes part of GATT 1994, is of legal status equal to the provisions of GATT 1947 itself, and thus becomes an "integral part" of the WTO Agreement which is "binding on all Members" under Article II:2 of the WTO Agreement. In our view, the purpose of the language of Annex 1A incorporating GATT 1994 into the WTO Agreement was to transpose into the WTO system the rights and obligations of contracting parties to GATT 1947. We do not consider that this language should be interpreted to make legally binding on all WTO Members decisions of the CONTRACTING PARTIES that lacked this character under GATT 1947. Thus, the interpretation of "legal instrument" set forth above is in our view fully consistent with the object and purpose of the language of Annex 1A incorporating GATT 1994 into the WTO Agreement.

7.63 In short, we conclude that, in order for a decision of the CONTRACTING PARTIES to GATT 1947 to be a part of GATT 1994 within the meaning of paragraph 1(b)(iv), it must be a legal instrument within the meaning of the chapeau to paragraph 1, *i.e.*, it must be a formal legal text which represented a legally binding determination in respect of the rights and/or obligations generally applicable to all contracting parties to GATT 1947.

7.64 Applying this interpretation to the issue at hand, we must consider whether the 1981 understanding was in fact a formal legal text which had a binding legal effect on all contracting parties to GATT 1947. The United States has referred to the 1981 understanding as representing "joint action" under Article XXV:1 of GATT 1947 which is "akin to an authoritative interpretation of a WTO agreement by the Ministerial Conference". In other words, the United States considers that the 1981 understanding was an interpretation of Article XVI:1 which was legally binding on all contracting parties to GATT 1947.⁶²⁸

7.65 But did the CONTRACTING PARTIES in adopting the 1981 understanding effectively take a decision which was legally binding on all contracting parties to GATT 1947? An examination of the text of the 1981 understanding itself is inconclusive. As noted above, the 1981 understanding provides that the GATT 1947 Council adopted certain panel reports subject to an understanding "with respect to these cases, *and in general*" (emphasis added). Consequently, while the understanding is couched primarily in terms of resolving certain disputes, the language "in general" could be taken to extend its application beyond the disputes in question. At the same time, the 1981 understanding is not expressed in the mandatory language which usually characterizes binding legal instruments. The understanding uses terms such as "should not be regarded as export activities" and "should for tax purposes be", where a binding legal instrument might be expected to use the term "shall". In addition,

⁶²⁷ MTN/FA (15 December 1993).

⁶²⁸ It may be noted that, unlike the WTO Agreement, GATT 1947 nowhere specifically provided the CONTRACTING PARTIES with authority to make "interpretations" of GATT 1947 and, although such authority seems to have been widely recognized by the contracting parties, the existence of that power as a legal matter was not entirely clear. *See* John. H. Jackson, *World Trade and the Law of GATT* (Bobs-Merrill, 1969), section 5.5 ("In summary, although a careful legal analysis, having particular reference to the preparatory work, could lead one to conclude that the CONTRACTING PARTIES of GATT do not have the legal power to make a binding interpretation of the General Agreement, nevertheless, in practice, the CONTRACTING PARTIES do make interpretations and there seems to be remarkably little objection to those interpretations".).

the phrases "on the understanding that" and "it is further understood that", expressed in the passive voice (rather than, for example "the CONTRACTING PARTIES agree" or "the CONTRACTING PARTIES decide") arguably suggest the non-binding nature of the understanding. Finally, although this is by no means a conclusive element, the understanding is not expressed in the precise manner that might be expected of a binding legal instrument.

7.66 Given that the text of the 1981 understanding does not give us a clear answer as to its legal status, we consider that it is appropriate for us to examine the circumstances in which the 1981 understanding was adopted. Only in this way may we arrive at a conclusion as to the precise legal implications of the 1981 understanding.

7.67 The GATT 1947 Council does not indicate the legal basis for the 1981 understanding. We recall, however, that the Council was required to report to the CONTRACTING PARTIES on matters considered between sessions of the CONTRACTING PARTIES. The Council's Report to the CONTRACTING PARTIES, adoption of which constituted approval by the CONTRACTING PARTIES of the Council's actions, reported in full the discussion of the Council and its adoption of the 1981 understanding.⁶²⁹ The item appeared under agenda item 15 of the Council's report, entitled "Recourse to Articles XXII and XXIII." The Council Report was approved by the CONTRACTING PARTIES without any discussion of the 1981 understanding.⁶³⁰ In short, while the 1981 understanding was couched in general terms that go beyond the particular disputes under consideration, the mechanism under which it was approved by the CONTRACTING PARTIES was essentially concerned with dispute settlement in order to facilitate the resolution of certain disputes. This would suggest that the 1981 understanding was adopted to resolve the *Tax Legislation* disputes as between the parties to those disputes, rather than to establish rights and obligations that were legally binding on all contracting parties.⁶³¹

7.68 It is even more important, in our view, to take account of the actual circumstances surrounding the adoption by the Council of the 1981 understanding, as that provides the most reliable evidence as to what the Council thought it was doing by adopting the 1981 understanding. In our view, the most important element which must be examined in considering this question is the statement of the Chairman of the Council in connection with the adoption of the understanding. That statement includes the following language:

"Finally, [the Chairman] noted that the adoption of these reports together with the understanding does not affect the rights and obligations of contracting parties under the General Agreement."⁶³²

The United States contends that this language simply means that the Council was seeking to "restore" or confirm its existing understanding of Article XVI:4, which the *Tax Legislation* panel reports had upset.⁶³³ We do not however consider that this statement can be dismissed so lightly. In our view, it is simply not possible to reconcile the view that the Council was providing an "authoritative [i.e., legally binding] interpretation" of Article XVI:4 with language indicating that the 1981 understanding "does not affect the rights and obligations of contracting parties under the General Agreement". An interpretation which was legally binding on all contracting parties would in our view by its very binding nature "affect" rights and obligations of contracting parties under the General Agreement,

⁶²⁹ Council of Representatives, *Report on Work Since the Thirty-Seventh Session*, L/5414, 12 November 1982.

⁶³⁰ CONTRACTING PARTIES, Thirty-Eighth Session, *Summary Record of the First Meeting*, SR.38.1, 15 December 1982.

⁶³¹ As the Appellate Body explained in *Japan – Alcoholic Beverages*, WT/DS8/AB/R-WT/DS10/AB/R-WT/DS11/AB/R, Report of the Appellate Body adopted on 1 November 1996, p. 13, under GATT 1947, "the conclusions and recommendations in an adopted panel report bound the parties to the dispute in a particular case, but subsequent panels did not feel legally bound by the details and reasoning of a previous panel report." [footnotes omitted]

⁶³² *Tax Legislation*, L/5271, 7-8 December 1981.

⁶³³ Footnote 341, *supra*.

even if that interpretation simply served to "clarify" the precise scope of those rights and obligations. In our view, therefore, this statement demonstrates that the 1981 understanding was not perceived as being legally binding on all contracting parties.

7.69 How much weight should be given to the Chairman's statement in assessing the legal status of the 1981 understanding? Although the Chairman's statement is described as having been made "following the adoption of these reports", it is clear that the understanding and the accompanying statement were part of a single integrated proposal, and that the statement did not represent impromptu after-the-fact remarks by the Chairman. Rather, drafts of the 1981 understanding, which were the basis for consideration of the proposed understanding and which were circulated to all members of the Council in advance of the meeting at which the 1981 understanding was adopted, included both the 1981 understanding itself and the Chairman's statement.⁶³⁴ The introductory sentence to the draft understanding and accompanying Chairman's statement provides that:

"[t]he following text has emerged from informal consultations between interested delegations and is being circulated to the members of the Council for consideration."

Further, it is notable that the 1981 understanding and the accompanying Chairman's statement were published together in their entirety in document L/5271 and subsequently in the Basic Instruments and Selected Documents.⁶³⁵ Certainly, therefore, the Chairman's statement, including the caveats discussed above, were an integral part of the overall package agreed among the contracting parties, and must play a critical role in our assessment as to whether the 1981 understanding was a formal legal text which represented a legally binding determination in respect of the rights and/or obligations generally applicable to all contracting parties to GATT 1947.

7.70 The significance of the Chairman's statement, and the importance that contracting parties attached to it, are clearly reflected in the interventions of delegations both before and after the 1981 understanding was adopted. Two of the three delegations which spoke prior to the adoption of the 1981 understanding referred to the Chairman's statement, with the European Communities stating that:

"in document C/W/376/Rev.1 it was explicitly mentioned that the adoption of these Reports, together with the proposed understanding, did not affect rights and obligations of contracting parties under the General Agreement".⁶³⁶

The United States and Canada also referred specifically to the Chairman's statement prior to the adoption of the 1981 understanding. The delegate of Canada noted that "the proposed understanding stated that the adoption of the Reports, including the DISC Panel Report, would not diminish rights and obligations under Article XVI:4", a statement endorsed by the delegate of the United States.

7.71 The intervention of Brazil is notable, as it addressed precisely the issue now under consideration by the Panel:

"The representative of Brazil said his delegation had not opposed the consensus to take the decision because it did not want to be an obstacle to solving an old and serious problem in the GATT, but could not support it because it was objectionable on at least two grounds. He said in respect of substance, the understanding was too cryptic. Moreover, the decision purported to give an interpretation that – although applicable to parties adhering to Article XVI:4 only – was of a general character. It was the understanding of his government that, under the rules in force, decisions on cases submitted to the process of dispute settlement in the GATT should be circumscribed to these individual cases only. General interpretations, in GATT

⁶³⁴ *Item 4 of the Agenda*, C/W/376/Rev.1, 8 December 1981.

⁶³⁵ BISD 28S/114.

⁶³⁶ C/M/154, 28 January 1982, p. 6.

practice, were formulated through different mechanisms. He reserved all his country's rights under the General Agreement and the MTN agreements to which Brazil was a signatory."⁶³⁷

The United States considers that this statement establishes that, despite Brazil's reservations, the 1981 understanding was accepted by the Council to be an interpretation binding on all contracting parties. In our view, however, the intervention of Brazil is a demonstration of the reluctance of some contracting parties to accept the status of the 1981 understanding as an interpretation binding on all contracting parties, and explains why the Chairman's statement contained the caveat discussed above. In short, Brazil accepted the 1981 understanding as a resolution to certain disputes, but no more.

7.72 The United States points to the intervention of Chile as confirmation that the 1981 understanding was an interpretation that was legally binding on all contracting parties and not merely the basis for the resolution of certain disputes. Specifically, the representative of Chile stated that "it *would have been* more appropriate to adopt an understanding with a judicial approach rather than a legislative one, *as the present case seemed to be*"⁶³⁸ (emphasis added by the United States). The United States fails to mention the sentence immediately preceding that quoted by the United States, in which the representative of Chile states that:

"his delegation had taken note that rights and obligations under the General Agreement had in no way been affected or reduced by the understanding and by the panel reports which had been adopted."⁶³⁹

7.73 The United States further points to discussions of the DISC in the Council subsequent to the adoption of the 1981 understanding as confirmation that "the Council members considered the [1981 understanding] to be a substantive 'decision' by the Council, and not merely the routine adoption of a panel report".⁶⁴⁰ The fact that the European Communities and other contracting parties referred to the 1981 understanding in discussions regarding the DISC, and that they criticised the DISC for not being in conformity with that understanding, is hardly surprising, however. After all, the DISC was one of the measures at issue in the *Tax Legislation* panel reports, and the purpose of a decision under Article XXIII is precisely to resolve a particular dispute. Thus, we see no inconsistency between the view that the 1981 understanding did not establish generally applicable rights and obligations binding on all GATT 1947 contracting parties and the discussions identified by the United States.

7.74 In conclusion, we consider that the circumstances surrounding the adoption of the 1981 understanding, and in particular the Chairman's statement which was inseparable from the 1981 understanding itself, indicate that the understanding was not a legal instrument with binding legal force on all contracting parties. In our view, it would appear that the disclaimer language of the Chairman's statement was a *sine qua non* for Council adoption of the understanding. Under these circumstances, it would not be appropriate for us to conclude that the 1981 understanding was an "other decision" within the meaning of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1947 into the WTO Agreement.

7.75 Whether the 1981 understanding represents subsequent practice. In its first submission, the United States contends not only that the 1981 understanding is an "other decision" that is thus part of GATT 1994, but also that it constitutes a "subsequent practice" within the meaning of Article 31(3)(b) of the Vienna Convention on the Law of Treaties "with respect to GATT Article XVI:4, as amended by the Subsidies Code."⁶⁴¹ Of course, the 1981 understanding could not represent a subsequent practice with respect to GATT 1994, but at most only with respect to GATT 1947. In any event, we consider that the 1981 understanding is not "subsequent practice" within the meaning of the Vienna

⁶³⁷ *Ibid.*, pp. 7-8.

⁶³⁸ *Ibid.*, p. 8.

⁶³⁹ *Ibid.*, p. 8.

⁶⁴⁰ Paragraph 4.1168, *supra*.

⁶⁴¹ Paragraph 4.380, *supra*.

Convention for the same reason as it is not a "part" of GATT 1994. In this respect, we recall that, under Article 31(3)(b) of the Vienna Convention, an interpreter must take into account, together with the context, "[a]ny subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation". Here, we have seen that the 1981 understanding was conditioned by the statement of the Chairman of the GATT 1947 Council that the understanding "did not affect the rights and obligations of contracting parties under the General Agreement", and it is clear that many contracting parties considered that significant caveat as central to the adoption of the understanding. To treat the 1981 understanding as subsequent practice "establishing the agreement of the parties regarding the interpretation" of GATT 1947 would not be consistent with that explicit qualification.

7.76 Whether the 1981 understanding is a "decision" within the meaning of Article XVI:1 of the WTO Agreement. Having concluded that the 1981 understanding is not a part of GATT 1994, we must next consider the United States' argument that it represents a "decision" within the meaning of Article XVI:1 of the WTO Agreement by which the WTO shall be guided. In this respect, we recall that Article XVI:1 of the WTO Agreement provides as follows:

"Except as otherwise provided under this Agreement or the Multilateral Trade Agreements, the WTO shall be guided by the decisions, procedures and customary practices followed by the CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947."

7.77 As previously discussed,⁶⁴² we consider that the 1981 understanding does represent a "decision" by the CONTRACTING PARTIES to GATT 1947. Further, Article XVI:1 of the WTO Agreement on its face is not limited to decisions in the form of "legal instruments", but rather applies to all decisions by the CONTRACTING PARTIES to GATT 1947 – including decisions to adopt panel reports– as well as to procedures and customary practices of the CONTRACTING PARTIES.⁶⁴³ Thus, we conclude that the 1981 understanding is a decision within the meaning of Article XVI:1 of the WTO Agreement.

7.78 In our view, the difference between the more particularly defined range of actions falling within the ambit of Article XVI:1 of the WTO Agreement and the list of "legal instruments" that are incorporated into GATT 1994 pursuant to the language in Annex 1A incorporating GATT 1994 into the WTO Agreement is explained by the different implications of the two provisions. Inclusion of a decision in the language of Annex 1A means that the decision actually becomes part of GATT 1994 and thus of the WTO Agreement. Inclusion of a decision within the scope of Article XVI:1 of the WTO Agreement, on the other hand, means that the WTO "shall be guided" by that decision. A decision which is part of GATT 1994 is legally binding on all WTO Members (to the extent it is not in conflict with a provision of another Annex 1A agreement), while a decision which provides "guidance" in our view is not legally binding but provides direction to the WTO.⁶⁴⁴ It is important to

⁶⁴² Paragraphs 7.55-7.56, *supra*.

⁶⁴³ A number of panels have explicitly or implicitly found that adopted GATT 1947 panel reports fall within the scope of Article XVI:1 of the WTO Agreement. *See, e.g., India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, Report of the Panel adopted, as modified by the Report of the Appellate Body, on 16 January 1998, WT/DS50/R, paragraph 7.19; *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, Report of the Panel adopted, as modified by the Report of the Appellate Body, on 25 September 1997, WT/DS27/R/USA, paragraph 7.40.

⁶⁴⁴ Regarding the legal status of adopted panel reports, the Appellate Body in *Japan – Alcoholic Beverages* (p. 14) explained that:

"[a]dopted panel reports are an important part of the GATT *acquis*. They are often considered by subsequent panels. They create legitimate expectations among WTO Members, and, therefore, should be taken into account where they are relevant to any dispute. However, they are not binding, except with respect to resolving the particular dispute between the parties to that dispute."

note that, as explained by the Appellate Body, adopted panel reports should be taken into account "where they are relevant to a dispute".⁶⁴⁵ In our view, this consideration applies equally to any other decision, procedure or customary practice of the CONTRACTING PARTIES to GATT 1947.⁶⁴⁶

7.79 Although we have found that the 1981 understanding is a decision within the scope of Article XVI:1 of the WTO Agreement, we do not believe that the 1981 understanding, which relates to the *Tax Legislation* cases, is in fact *relevant* in this dispute. In this respect, we recall that the claims under consideration here relate to violations of Part II of the SCM Agreement. The *Tax Legislation* cases, and hence the 1981 understanding, relate to Article XVI:4 of the GATT 1947. The United States considers that *Tax Legislation* panel reports are relevant to the interpretation of the SCM Agreement because the SCM Agreement is an "interpretation" of Article XVI:4, and because "an examination of the text of the SCM Agreement makes clear that the SCM Agreement and Article XVI are not to be construed in isolation from each other."⁶⁴⁷ In our view, however, it would not be appropriate to attribute relevance to an understanding regarding the application of Article XVI:4 of the GATT 1947 to claims under the SCM Agreement, both because Article XVI:4 differs dramatically from the export subsidy disciplines in the SCM Agreement, and because the contracting parties themselves limited the scope of their action to Article XVI:4. Let us consider these points in turn.

7.80 First, we note that the provisions of the SCM Agreement which we are called upon to interpret in this dispute differ dramatically from those of Article XVI:4 of GATT 1947. For example, a core issue in this dispute is whether revenue foregone was "otherwise due" within the meaning of Article 1.1(a)(ii) of the SCM Agreement such that a financial contribution – and hence a potential subsidy – may exist within the meaning of Article 1 of the SCM Agreement. Although the United States would have us look to the 1981 understanding to derive the meaning of this provision, the phrase "otherwise due" nowhere appears in Article XVI:4 of the GATT 1947. Nor does the term "financial contribution". In fact, nowhere in Article XVI of GATT 1947 is there any definition whatsoever of the term "subsidy". Rather, that term is first defined in the GATT/WTO context only in Article 1 of the SCM Agreement, and the inclusion of this detailed and comprehensive definition of the term "subsidy" is generally considered to represent one of the most important achievements of the Uruguay Round in the area of subsidy disciplines.⁶⁴⁸ Under these circumstances, it would in our view be inappropriate to place any weight in interpreting the definition of subsidy found in Article 1 of the SCM Agreement on an understanding regarding Article XVI:4 of GATT 1947 which was adopted more than a decade before that definition was formulated.

7.81 A similar situation exists with respect to the concept of "export subsidy" as expressed in Article 3.1(a) of the SCM Agreement. Article 3.1(a) contains a precise definition of the concept of "export subsidy", which subsidies are prohibited by the SCM Agreement. While it is of course true that Article XVI:4 contained a prohibition on what could be termed to be "export subsidies", in fact the text of Article XVI:4 never uses the term "export subsidy", much less defines it. Rather, Article XVI:4 provides that contracting parties "shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market". Thus, the language of Article 3.1(a) of the SCM Agreement that must be interpreted in this dispute has no counterpart in Article XVI:4 of GATT 1947.⁶⁴⁹

⁶⁴⁵ *Japan – Alcoholic Beverages*, p. 14.

⁶⁴⁶ To take an extreme example, it is highly unlikely that the 1981 understanding would provide relevant guidance with respect to the interpretation of the Agreement on Sanitary and Phytosanitary Measures.

⁶⁴⁷ Paragraph 4.679, *supra*.

⁶⁴⁸ See, e.g., C. Pouncey and K. J. Kuilwijk, *WTO Disciplines on Subsidies: An Overview of Residual Problems – Part I*, in *International Trade Law and Regulation*, Vol. 4, Issue 5 (October 1998), p. 173.

⁶⁴⁹ We recognize that, although not part of the text of Article XVI:4 of GATT 1947, item (c) of the "1960 list" found in the Report of the Working Party relating to the Provisions of Article XVI:4 (BISD 9S/185) is similar, although by no means identical, to item (e) of the Illustrative List annexed to the SCM Agreement. We note, however, that item (e) of the Illustrative List is identical – except in regard to certain aspects of

7.82 We do not mean to suggest that Article XVI of GATT 1994 has somehow ceased to be legally operative or has been simply replaced by the SCM Agreement. The statement of the Appellate Body in *Brazil – Desiccated Coconut* that "the negotiators of the *SCM Agreement* clearly intended that, under the integrated *WTO Agreement*, countervailing duties may only be imposed in accordance with the provisions of Part V of the *SCM Agreement* and Article VI of the GATT 1994, taken together"⁶⁵⁰ is, in our view, equally applicable to the relationship between Part II of the SCM Agreement and Article XVI of the GATT 1994. Thus, we agree with the United States that "the SCM Agreement and Article XVI are not to be construed in isolation from each other."⁶⁵¹ This however demonstrates precisely the problem with relying on an analysis of Article XVI:4 made at a time when the SCM Agreement did not yet exist. In our view, *Brazil – Desiccated Coconut* in fact reinforces the view that Article VI of GATT 1994 cannot be invoked independently of the SCM Agreement because, as the Appellate Body explains, "[t]he *SCM Agreement* contains a set of rights and obligations that go well beyond merely applying and interpreting Articles VI, XVI and XXIII of the GATT 1947".⁶⁵² Read in this light, *Brazil – Desiccated Coconut* confirms what we consider to be the self-evident proposition that legal principles derived from Article XVI:4 of GATT 1947, read in isolation and without the benefit of the detailed provisions of the SCM Agreement regarding the concepts of "subsidy" and "export subsidy", can be of little, if any, interpretative guidance in understanding the scope of a Member's obligations regarding export subsidies under the SCM Agreement.

7.83 Further, we note that the CONTRACTING PARTIES themselves limited the implications of the 1981 understanding to Article XVI:4 of GATT 1947, and specified that it was not relevant to the interpretation of the then-existing elaboration of Article XVI, the Tokyo Round Subsidies Code.⁶⁵³ Specifically, the Chairman of the Council in his statement in conjunction with the adoption of the 1981 understanding

"noted also that this decision does not affect and is not affected by the Agreement on the Interpretation and Application of Articles VI, XVI and XXIII".⁶⁵⁴

7.84 We have already explained why we consider that the 1981 understanding cannot be read without reference to the Chairman's statement. It would in our view be incongruous, to say the least, if the 1981 understanding could be relied upon in the interpretation of the WTO SCM Agreement, when the Chairman's statement specifically excluded reliance upon it in the interpretation of the Tokyo Round Subsidies Code, which is in practical if not legal terms the predecessor agreement to the SCM Agreement. This is particularly the case, in that the language of footnote 59 to the SCM Agreement, on which the United States relies heavily in its defense in this dispute, is transcribed verbatim from footnote 2 to item (e) of the Illustrative List of Export Subsidies annexed to the Tokyo Round Subsidies Code.

footnote 59 – to its counterpart in the Tokyo Round Subsidies Code, and that, as discussed below, the Chairman's statement accompanying the 1981 understanding explicitly precluded the use of the 1981 understanding to interpret the Tokyo Round Subsidies Code.

⁶⁵⁰ *Brazil – Measures Affecting Desiccated Coconut*, WT/DS22/AB/R, Report of the Appellate Body adopted on 20 March 1997, p. 16.

⁶⁵¹ Paragraph 4.679, *supra*.

⁶⁵² *Brazil – Measures Affecting Desiccated Coconut*, WT/DS22/AB/R, Report of the Appellate Body adopted on 20 March 1997, p. 17.

⁶⁵³ Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade.

⁶⁵⁴ *Tax Legislation*, 28S/114, 7-8 December 1981. The United States has argued that, "[b]ecause the Subsidies Code was an agreement that interpreted, *inter alia*, Article XVI, the [1981 understanding] would have been equally applicable to the provisions of the Subsidies Code . . . Thus, going into the Uruguay Round, the FSC was protected by the [1981 understanding] under both Article XVI and the Subsidies Code". Second Submission of the United States to the Panel, footnote 47. Clearly, this view cannot be reconciled with Chairman's statement that the 1981 understanding "does not affect and is not affected by" the Tokyo Round Subsidies Code.

7.85 In conclusion, we do not consider that the 1981 understanding is part of GATT 1994, nor that it represents subsequent practice in the application of GATT 1947 establishing the agreement of the contracting parties regarding its interpretation. The 1981 understanding is in our view a "decision" within the meaning of Article XVI:1 of the WTO Agreement which shall "guide" the WTO to the extent relevant. However, we consider that the 1981 understanding cannot provide guidance in understanding detailed provisions of the SCM Agreement which did not exist at the time the understanding was adopted.⁶⁵⁵

(iii) *Footnote 59 as Context for the Interpretation Of Article 1.1(a)(1)(ii)*

7.86 The United States' reference to the 1981 understanding is part of a broader argument that any revenue foregone as a result of FSC exemptions is not "otherwise due" because it arises from income which is attributable to "foreign economic processes". In the view of the United States, the "controlling legal principle" which serves as the "analytical starting-point" in this dispute is that "Members are not obliged to tax income attributable to foreign economic activity".⁶⁵⁶ The United States considers that because, under this "controlling legal principle", Members are not obliged to tax income attributable to foreign economic activity, revenue arising from such income is not "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement. Because in the view of the United States the FSC scheme merely exempts from taxation certain income arising from such foreign economic processes, it does not involve the foregoing of revenue "otherwise due".⁶⁵⁷

7.87 The United States derives this "controlling legal standard" from two sources which it considers to be context within the meaning of Article 31(1) of the Vienna Convention on the Law of Treaties.⁶⁵⁸ As we have seen, the first source relied upon as relevant context is the 1981 understanding, which the United States considers to be part of GATT 1994. For the reasons stated above, we do not consider that the 1981 understanding is "part of GATT 1994", and thus does not constitute part of the context of Article 1.1(a)(1)(ii) of the SCM Agreement within the meaning of Article 31(1) of the Vienna Convention. The United States further argues, however, that the same "controlling legal standard" (i.e., that income arising from foreign economic activities need not be taxed) can be derived from footnote 59 to item (e) of the Illustrative List of Export Subsidies. Accordingly, it is to that footnote that we now turn.

7.88 It will be recalled that Annex I to the SCM Agreement contains an Illustrative List of Export Subsidies ("Illustrative List"). Item (e) of the Illustrative List identifies as an export subsidy:

"The full or partial exemption remission, or deferral specifically related to exports, of direct taxes⁵⁸ or social welfare charges paid or payable by industrial or commercial enterprises.⁵⁹"

⁵⁸ Footnote omitted.

⁶⁵⁵ We note that Article XVI:1 of the WTO Agreement states that the WTO shall be guided by the decisions, procedures and customary practices followed by the CONTRACTING PARTIES to GATT 1947 "except as otherwise provided under [the WTO Agreement] or the Multilateral Trade Agreements". In light of our view regarding the lack of relevance of the 1981 understanding to this dispute, we need not and do not address whether the SCM Agreement "provides otherwise" than the 1981 understanding in the sense of Article XVI:1 of the WTO Agreement.

⁶⁵⁶ Paragraph 4.523, *supra*.

⁶⁵⁷ The United States asserts that this legal principle is relevant both to establishing whether there is a subsidy within the meaning of Article 1 and whether there is an export subsidy within the meaning of Article 3. We address the latter issue in Section VII.B.4(c), *infra*.

⁶⁵⁸ Article 31(1) of the Vienna Convention provides that "[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."

⁵⁹ The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence.

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

7.89 The United States considers that it must be implied from footnote 59 that income from foreign economic activities need not be taxed. In the view of the United States:

"The necessary predicate of footnote 59 is that income from foreign economic processes may be exempted from direct taxes. Were that not the case, the arm's length principle would be irrelevant. The arm's length principle prevents income from being inappropriately shifted between parties or functions. In the context of export transactions, the principle focuses on ensuring that income properly attributable to economic processes *within* the taxing jurisdiction is not shifted to another jurisdiction. If the SCM Agreement were interpreted as requiring that income attributable to both foreign and domestic economic processes be taxed by the domestic taxing authority, the shifting of income between related parties would be irrelevant (because no tax advantage would be gained), and the relevant portions of the footnote would be devoid of meaning."⁶⁵⁹

The United States further considers that this footnote constitutes part of the context of Article 1.1(a)(1)(ii) of the SCM Agreement, and that when read in light of this context it must be concluded that the revenue from such foreign economic activities cannot be "otherwise due".

7.90 We note that the use of a footnote to an item in the Illustrative List of Export Subsidies as context for the interpretation of Article 1 of the SCM Agreement poses certain interpretive problems. It is of course the case that the text of Article 1 must be read in its context, and that context includes the whole of the SCM Agreement (and, indeed, the WTO Agreement in its totality).⁶⁶⁰ That said, we consider that the degree to which a provision is *relevant* context and the weight to be given to a contextual element will differ from case to case, and may depend, *inter alia*, on the relationship between the provision being interpreted and the provision being relied upon as context. In this section of the Report, we are considering US arguments regarding the interpretation of the definition of "subsidy" as it appears in Article 1 of the SCM Agreement. Footnote 59, on the other hand, relates to the Illustrative List of *Export Subsidies*, and is obviously thus of greater relevance to determining when a measure is an *export subsidy* than to determining whether it is a *subsidy* as such. Further, it is worthy of note that most elements of the Illustrative List of Export Subsidies, including the relevant portions of footnote 59, already existed in the Tokyo Round Subsidies Code, long before any definition of the term "subsidy" was created. Thus, we must at a minimum exercise considerable

⁶⁵⁹ Paragraph 4.366, *supra*.

⁶⁶⁰ *United States – Anti-Dumping Duty on Dynamic Random Access Semiconductors (DRAMs) of One Megabit or Above from Korea*, WT/DS99/R, Report of the Panel adopted on 19 March 1999, paragraph 6.21.

caution in the use of Illustrative List as context for the interpretation of Article 1 of the SCM Agreement.⁶⁶¹

7.91 The United States' view that footnote 59 is predicated on the assumption that "income from foreign economic processes may be exempted from direct taxes" is not without some persuasive force. It is in fact difficult to understand why the arm's length principle would be referred to in the second sentence of footnote 59 if WTO Members were required to tax all income from foreign economic processes. In other words, if WTO Members were required to tax all income of all entities, whether arising from activities within the territory of the Member in question or from activities outside the territory of that Member, then the shifting of income from the exporting enterprise to a related foreign buyer through non-arm's-length pricing would not as a general rule insulate that income from taxation in the exporting country, much less result in a "significant saving of direct taxes in export transactions" within the meaning of footnote 59. Even the European Communities appears to concede this point, when it acknowledges that "this sentence [the second sentence of footnote 59] assumes that the foreign related buyer may not be taxed at the same level as the exporter and this may lead to a lower total tax charge for the income arising from the export transaction".⁶⁶² Thus, for the purposes of our analysis, we will assume that the United States is correct in its assertion that footnote 59 is "predicated on the assumption that income from foreign economic processes may be exempted from direct taxes".

7.92 The United States would have us consider that this is dispositive with respect to the question whether foregone revenue is "otherwise due" and thus as to whether exemptions of certain income from taxation under the FSC scheme constitute a subsidy within the meaning of the SCM Agreement. We do not agree. First, and as noted above, because footnote 59 relates to an item in the Illustrative List of Export Subsidies, it is unclear what conclusions can be drawn with respect to the existence of a subsidy (as opposed to the existence of an *export* subsidy). More importantly, we consider that the United States has made an unwarranted leap of logic from the proposition that "income arising from foreign economic processes may be exempted from direct taxes" to the proposition that "if countries are under no obligation to tax income from foreign economic processes, then they should be free to exempt all such income *or just part of it*" (emphasis added).⁶⁶³ As we have already discussed at some length, it is as a general matter necessary in determining whether revenue foregone is "otherwise due" to look to the situation which would exist under a Member's tax regime in the absence of the measures in question. Thus, even assuming for the sake of argument that footnote 59 is predicated on the assumption that income arising from foreign economic processes is not as a general matter "otherwise due" within the meaning of Article 1.1(a)(1)(ii), we could at most conclude that a decision by a Member not to tax any income arising from foreign economic processes would not represent the foregoing of revenue "otherwise due". There is in our view however nothing in footnote 59 which would lead us to conclude that a Member that decides that it will tax income arising from foreign economic processes does not forego revenue "otherwise due" if it decides in a selective manner to exclude certain limited categories of such income from taxation.

(iv) *Whether FSC exemptions represent the foregoing of revenue "otherwise due"*

7.93 In the foregoing sections, we have concluded that whether revenue foregone is "otherwise due" is to be determined on the basis of an examination of the fiscal treatment that would be applicable "but for" the measures in question. Of course, as in other areas under the WTO

⁶⁶¹ It should be noted that footnote 1 to Article 1 of the SCM Agreement refers, *inter alia*, to the Illustrative List of Export Subsidies with respect to the issue when exemptions or remissions of duties and indirect taxes represent a subsidy within the meaning of Article 1. That footnote clearly is not applicable in the context of this dispute, which relates to issues of direct taxes.

⁶⁶² Paragraph 4.472, *supra*. The European Communities continues to note, however, that "[t]he quoted sentence does not say or even imply that the exporting country has the right to *exempt from tax* income from an export transaction which would otherwise bear tax."

⁶⁶³ Paragraph 4.699, *supra*.

Agreement, the application of this test requires panels to apply their best judgement on a case-by-case basis.⁶⁶⁴

7.94 Turning to the facts in this case, the European Communities has at various points described the "exemptions" provided by the FSC scheme in slightly different terms. As we understand it, the following are the exemptions which the European Communities alleges are provided under the FSC scheme and the general or standard tax regime from which these exemptions deviate. The first exemption relates to the circumstances under which the income of a FSC itself is or is not treated as taxable income of that corporation by the United States. The second and third exemptions relate to whether and when the US parent of a FSC is subject to taxation with respect to income generated by that FSC. It should be noted that the European Communities does not allege that each of the exemptions separately represents a prohibited export subsidy; rather, the European Communities' allegation appears to be that these "interconnected exemptions" taken together "complement each other and lead, as they are intended to lead, to less tax being paid than would be the case if the FSC scheme did not exist (or rather if it did not contain the FSC exemptions)".⁶⁶⁵

7.95 The first exemption alleged by the European Communities relates to the application by the United States of "formulaic" rules for determining whether income of a FSC is domestic- or foreign-source income. Section 882(a) of the US Internal Revenue Code provides that the taxable income of a foreign corporation engaged in trade or business in the United States includes only income "which is effectively connected with the conduct of a trade or business in the United States", and Section 864 of the US Internal Revenue Code sets forth the rules for determining whether the income of a foreign corporation is "effectively connected with the conduct of a trade or business in the United States". Section 921(a) of the US Internal Revenue Code, however, provides that "[e]xempt foreign trade income of a FSC shall be treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States." Section 923(a) of the US Internal Revenue Code provides that either 32 per cent or 16/32 of a FSC's foreign trade income (depending upon whether or not the administrative pricing rules are used) shall be treated as "exempt foreign trade income".⁶⁶⁶ These source rules in the view of the European Communities represent a deviation from Section 864 of the US Internal Revenue Code. In other words, the European Communities is alleging that the rules provided for determining whether the income of a FSC is "effectively connected with the conduct of a trade or business within the United States" exempt from taxation certain income of a FSC which in the case of a non-FSC would be treated as taxable by the United States.

7.96 The second exemption alleged by the European Communities relates to the non-application to the foreign trade income of a FSC of the anti-deferral rules for "Controlled Foreign Corporations" under subpart F of the US Internal Revenue Code. The United States taxes the foreign-source income of foreign subsidiaries of US corporations only at the time the income is transferred to the US parent company in the form of dividends. This principle is known as "deferral". Under Section 951(a) of the US Internal Revenue Code, however, a United States shareholder in a controlled foreign corporation must include in his gross income each year a *pro rata* share of certain forms of undistributed income, known as Subpart F income, from the controlled foreign corporation. Section 951(e) of the US Internal Revenue Code exempts the foreign trade income of a FSC from the "anti-deferral" provisions of Subpart F. In other words, the European Communities is alleging that the foreign trade income of a FSC is exempted from the requirements of Subpart F and that the parent of a FSC need not report as

⁶⁶⁴ As the Appellate Body explained in the context of "like product" analysis under Article III of GATT 1994, "[i]n applying the criteria cited in *Border Tax Adjustments* to the facts of any particular case . . . panels can only apply their best judgement in determining whether in fact products are "like". This will always involve an unavoidable element of individual, discretionary judgement." *Japan – Taxes on Alcoholic Beverages*, WT/DS8/11-WT/DS10/11-WT/DS11/8, Report of the Appellate Body adopted on 1 November 1996, pp. 20-21.

⁶⁶⁵ Paragraph 4.271, *supra*.

⁶⁶⁶ 30 per cent or 15/23, in the case of a corporate shareholder. See US Internal Revenue Code, Section 291(a)(4).

income undistributed income from the FSC that would otherwise be subject to immediate taxation under Subpart F.

7.97 The third exemption alleged by the European Communities relates to the tax treatment of dividends paid by FSCs to their parent corporations. As a general matter, dividends received by a US corporation derived from the foreign-source income of a foreign corporation are taxable. Under Section 245(c) of the US Internal Revenue Code, however, shareholders of a FSC are eligible for a 100 per cent dividends-received deduction from distributions made out of the "earnings and profits attributable to foreign trade income" of a FSC. In other words, the European Communities is alleging that the parent of a FSC need not pay income taxes on income distributed to it and attributable to the foreign trade income of a FSC that would otherwise be fully taxable at the time the income was distributed to it.

7.98 Applying the "but for" test to the FSC scheme, there can be no doubt that, in the absence of the FSC scheme, income which is shielded from taxation by that scheme would be subject to taxation. For example, in the absence of the FSC scheme a US shareholder of a controlled foreign corporation would be required to include as income each year a *pro rata* share of certain forms of undistributed income, which under the FSC scheme that shareholder is exempted from the need to report, and to pay immediately taxes, on that undistributed income. In other words, but for the FSC scheme, the income in question would not benefit from "deferral". Similarly, and in the absence of the FSC scheme, the parent of a foreign corporation would be required to pay income taxes on dividends made out of the earnings and profits attributable to foreign trade income of that corporation. Thus, it is clear to us that, on the basis of the "but for" test, the FSC scheme shields from taxation income that would be taxed in the absence of the FSC scheme. It does not appear to us that the United States disputes this conclusion.

7.99 It is conceivable that a particular exemption may not in every case individually result in the foregoing of revenue that is otherwise due. Thus, for example, the United States contends that, except for FSCs, foreign corporations are virtually never subject to US taxation *directly* on their foreign source income under Section 864 of the US Internal Revenue Code.⁶⁶⁷ In our view, however, our task is not to analyse each separate "exemption" separately to determine whether revenue is foregone which is otherwise due. Rather, given that the European Communities has alleged that the various exemptions are interconnected and that together they represent a single subsidy, we consider that our task is to look at the various exemptions provided by the FSC scheme as a totality, and to assess whether taken together they involve a financial contribution in the form of the foregoing of revenue otherwise due.

7.100 In our view, the various exemptions identified by the European Communities, taken together, involve the foregoing of revenue which is otherwise due. Viewed as an integrated whole, the exemptions provided by the FSC scheme represent a systematic effort by the United States to exempt certain types of income which would be taxable in the absence of the FSC scheme. Thus, application of special source rules for FSCs serves to protect a certain proportion of the foreign trade income of a FSC from direct taxation, whether or not that income would be taxable under the source rules provided for in Section 864 of the US Internal Revenue Code. The exemption from the anti-deferral rules of Subpart F of the US Internal Revenue Code ensure that the undistributed foreign trade income of a FSC is not immediately taxable to the US parent of a FSC, even though such income might otherwise be subject to the anti-deferral rules. Finally, the 100 per cent dividends-received deduction ensures that, even when the FSC distributes earnings attributable to foreign trade income to the US parent company, the US parent will not be subject to US income taxes on that income. Taken together, it is clear that the various exemptions under the FSC scheme result in a situation where certain types of income are shielded from taxes that would be due in the absence of the FSC scheme.

⁶⁶⁷ Paragraph 4.1128, *supra*. The caveat "directly" is significant, in that the foreign-source income of a US-owned foreign corporation would be taxable either when distributed to the US parent or, in the case of the Sub-part F income of a controlled foreign corporation, as an imputed dividend whether or not distributed. This example demonstrates the importance of looking at the FSC exemptions as a package rather than separately.

7.101 We recognize that the application of the FSC scheme might not in all cases result in tax treatment more favourable than that absent the FSC scheme and it could thus be argued that in those cases there is no foregoing of revenue otherwise due.⁶⁶⁸ However, a corporation is free to elect for each fiscal year whether or not to have the status of a FSC.⁶⁶⁹ Thus, in those cases where an exporter considers that it is better off from a tax perspective exporting directly rather than using the FSC scheme, it has the option on an annual basis to opt out of the FSC scheme. Accordingly, it would only be in the case of a miscalculation by an exporter as to the tax advantages of FSC election that application of the FSC scheme would not result in the foregoing of revenue that is otherwise due. We find empirical confirmation for our view in a US contribution to an OECD report on tax expenditures which shows "revenue foregone" of US\$1.4 billion in 1995 arising from the "exclusion of income from foreign sales corporations".⁶⁷⁰

7.102 For the foregoing reasons, we conclude that the various exemptions under the FSC scheme, taken together, result in the foregoing of revenue which is otherwise due and thus give rise to a financial contribution within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.

(b) Benefit

7.103 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 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".⁶⁷¹ We note that the United States has raised no contrary argument with respect to the issue of benefit.

4. Contingency upon Exportation: FSC Exemptions

(a) Article 3.1(a)

7.104 In the previous section, we have concluded that the various exemptions under the FSC scheme give rise to a financial contribution that confers a benefit, and thus represent a subsidy within the meaning of Article 1 of the SCM Agreement. We now consider whether that subsidy is contingent upon export performance within the meaning of Article 3.1(a) of the SCM Agreement.

7.105 Article 3.1 of the SCM Agreement provides, in relevant part, that:

"Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

- (a) subsidies contingent, in law or in fact⁴, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I⁵;

⁴ This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is

⁶⁶⁸ Statement of Joseph H. Guttenag, International Tax Counsel, Department of the Treasury before the United States Senate, 21 July 1995, p. 12.

⁶⁶⁹ US Internal Revenue Code, Section 927(f).

⁶⁷⁰ Organisation for Economic Co-operation and Development, *Tax Expenditures – Recent Experiences* (Paris, 1996), p. 107 *et seq.*

⁶⁷¹ US Department of Commerce, *Foreign Sales Corporations – A Tax Incentive for Exporters*, p. 1.

granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

⁵ Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement."

7.106 As discussed in the previous section of this Report, the FSC scheme gives rise to a subsidy through a series of interconnected exemptions from the taxation of certain income. The first exemption shields from taxation the "exempt foreign trade income" of a FSC, while the second and third exemptions protect the US parent of a FSC from US taxation with respect to undistributed and distributed "foreign trade income" of a FSC. Under Section 923(b) of the US Internal Revenue Code, the term "foreign trade income" is defined to mean the "gross income of a FSC attributable to foreign trading gross receipts". Section 924 of the US Internal Revenue Code, entitled "Foreign trading gross receipts", provides in relevant part as follows:

"(a) In general. Except as otherwise provided in this section, for purposes of this subpart, the term "foreign trading gross receipts" means the gross receipts of any FSC which are:

- (1) from the sale, exchange, or other disposition of export property,
- (2) from the lease or rental of export property for use by the lessee outside the United States,
- (3) for services which are related and subsidiary to –
 - (A) any sale, exchange or other disposition of export property by such corporation, or
 - (B) any lease or rental of export property described in paragraph (2) by such corporation,
- (4) for engineering or architectural services for construction projects located (or proposed for location) outside the United States, or
- (5) for the performance of managerial services for an unrelated FSC or DISC in furtherance of the production of foreign trading gross receipts described in paragraphs (1), (2) or (3)."

7.107 Under Section 924 of the US Internal Revenue Code, the income of a FSC relating to "foreign trading gross receipts" arises (with the exception of subparagraph 4 relating to engineering or architectural services) only from the sale or lease of "export property" or from services relating to the sale or lease of such property. Section 927(a) of the US Internal Revenue Code, in turn, defines the term "export property" to mean property:

- (A) manufactured, produced, grown, or extracted in the United States by a person other than a FSC,
- (B) held primarily for sale, lease or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct use, consumption or disposition outside the United States, and
- (C) not more than 50 per cent of the fair market value of which is attributable to articles imported into the United States."

7.108 In light of the above provisions, we consider that the subsidy conferred by the various exemptions under the FSC scheme is "contingent upon export performance" within the ordinary meaning of Article 3.1(a) of the SCM Agreement. The subsidy is only available with respect to "foreign trading income"; foreign trading income arises from the sale or lease of "export property" or the provision of services relating to the sale or lease of export property; and export property is limited in effect to goods manufactured, produced, grown or extracted in the United States which are held for direct use, consumption or disposition outside the United States. Thus, the existence and amount of the subsidy depends upon the existence of income arising from the exportation of US goods or the provision of services relating to the exportation of such goods. The existence of such income, in turn, depends upon the exportation of US goods or, at a minimum, in the case of income from services related to the exportation of US goods, upon "anticipated exportation" within the meaning of footnote 4 to Article 3.1(a) of the SCM Agreement.

(b) Item (e) of the Illustrative List of Export Subsidies

7.109 In our view, the status of the FSC exemptions as an export subsidy within the meaning of Article 3.1(a) of the SCM Agreement is confirmed by item (e) of the Illustrative List. It will be recalled that Article 3.1(a) includes the export subsidies "illustrated in Annex I", i.e., the Illustrative List of Export Subsidies. Under item (e) of the Illustrative List, the following is an export subsidy:

"The full or partial exemption remission, or deferral specifically related to exports, of direct taxes⁵⁸ or social welfare charges paid or payable by industrial or commercial enterprises."⁵⁹ [footnotes omitted]

7.110 We consider that the FSC exemptions at issue in this dispute do constitute the "full or partial exemption remission, or deferral . . . of direct taxes . . . paid or payable by industrial or commercial enterprises". In this respect, we note, first, that both FSCs and their US parents are "industrial or commercial enterprises". Second, the exemptions provided under the FSC scheme are in our view "exemptions" within the meaning of item (e) or, in the case of the exemption from the anti-deferral rules of Subpart F, represent the "deferral" of direct taxes. Finally, we note that, under footnote 58 to item (e), the term "direct taxes" means, in relevant part, "taxes on wages, profits, interests, rents, royalties and all other forms of income". Thus, the US corporate income taxes from which the FSC scheme provides exemptions are "direct taxes" within the meaning of item (e).

7.111 We further consider that the FSC exemptions are "specifically related to exports" within the meaning of item (e). In this respect, we recall our conclusion that the FSC exemptions in question shield from taxation "foreign trading income", that foreign trading income arises from the sale or lease of "export property" or the provision of services relating to the sale or lease of export property, and that export property is limited in effect to those goods manufactured, produced, grown or manufactured in the United States which are held for direct use, consumption or disposition outside the United States.

7.112 The United States does not appear to argue that the FSC exemptions do not fall within the language of item (e). To the contrary, the United States appears to concede implicitly that FSC exemptions are exemptions from direct taxes which are specifically related to exports. In the course of criticizing what it considers to be the "simplistic" approach of the European Communities in this dispute, the United States complains that "[t]he EC, in effect, has done nothing more than point out what is plain for all to see – namely, that the FSC is a tax exemption which pertains to exports".⁶⁷² And in a description of the FSC scheme prepared by the United States and submitted to the Panel in this dispute, the United States explains that the FSC provides a "partial exemption from taxation of income derived by a FSC from export sales"⁶⁷³ and a "100 per cent dividends received deduction on

⁶⁷² Paragraph 4.975, *supra*.

⁶⁷³ *Description of Foreign Sales Corporation (FSC)*, Appendix A to the First Submission of the United States to the Panel, paragraph 1.

repatriation of that income".⁶⁷⁴ These descriptions are consistent with the characterization of the FSC consistently provided in US government secondary sources. Furthermore, the United States' Government has stated that "[t]he FSC provisions provide a limited exemption from US tax for income arising from certain export transactions"⁶⁷⁵ and that "[t]he tax incentive provided by the FSC legislation is in the form of a permanent exemption from federal income tax for a portion of the export income attributable to the offshore activities of FSCs".⁶⁷⁶

(c) Footnote 59 to item (e)

7.113 The United States argues that FSC exemptions are not prohibited export subsidies by reason of footnote 59 to item (e). The United States considers that, while paragraph (e) states the "general rule" that the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes is an export subsidy, footnote 59 "qualifies the scope" of item (e) of the Illustrative List and "makes clear that exempting income attributable to foreign economic processes from direct taxation is not a prohibited export subsidy" covered by that item.⁶⁷⁷ The United States, citing footnote 5 to Article 3.1(a), further argues the Illustrative List "gives specific meaning" to Article 3.1(a), identifying practices that do or do not come within the prohibition of Article 3.1(a). Accordingly, "[i]f the Illustrative List treats a measure as not being an export subsidy, it is not prohibited. No further analysis is needed to divine the meaning of Article 3.1(a) with respect to measures addressed by the Illustrative List".⁶⁷⁸ In other words, and put simply, the United States' view is that, by reason of footnote 59, FSC exemptions are not prohibited export subsidies within the meaning of item (e), and that, as a result, FSC exemptions cannot be considered to be export subsidies within the meaning of Article 3.1(a) of the SCM Agreement.

7.114 The European Communities contests the United States' view regarding the relationship between the Illustrative List of Export Subsidies and Article 3.1(a) of the SCM Agreement. The European Communities considers that the Illustrative List contains a number of subsidies which are deemed to be *included* in Article 3.1(a), but that it cannot be used *a contrario* to determine whether a subsidy is *excluded* from the coverage of that Article. Rather, the List can be used to establish that a measure is not a prohibited export subsidy only in cases where, as provided by footnote 5, there is a clear statement to that effect in the Illustrative List. In the view of the European Communities, there is no such clear statement in footnote 59. Thus, the European Communities is entitled to establish the existence of an export subsidy within the meaning of Article 3.1(a) without reference to the Illustrative List. In any event, the European Communities does not consider that footnote 59 "qualifies" item (e) of the Illustrative List such that the FSC exemptions at issue in this case are removed from the scope of item (e).

7.115 As discussed previously, we consider that the FSC exemptions at issue in this dispute fall within the scope of the language of item (e) of the Illustrative List. In our view, an analysis of the issues raised by the parties with respect to footnote 59 should thus begin with a consideration of whether, as argued by the United States, the FSC exemptions at issue in this case are taken outside the scope of item (e) by reason of that footnote. If the United States is correct in its view that footnote 59 has the effect of excluding the FSC exemptions from the scope of item (e), then we must consider the parties' arguments regarding the relationship of the Illustrative List to Article 3.1(a) of the SCM Agreement. If, on the other hand, we conclude that footnote 59 does not serve to remove the FSC exemptions at issue from the scope of item (e), then a discussion of the relationship between the Illustrative List and Article 3.1(a) would be neither necessary nor appropriate for the resolution of this dispute.

⁶⁷⁴ *Ibid.*, paragraph 1.

⁶⁷⁵ Testimony of Joseph J. Guttenag, International Tax Counsel, Department of the Treasury, Before the Committee on Finance, US Senate, 21 July 1995, p. 10.

⁶⁷⁶ US Department of Commerce, *Foreign Sales Corporations – A Tax Incentive for US Exporters*.

⁶⁷⁷ Paragraph 4.364, *supra*.

⁶⁷⁸ Paragraph 4.363, *supra*.

7.116 We have already considered the relevance of footnote 59 as context for the interpretation of Article 1 of the SCM Agreement, and quoted the footnote in full at that time. Nevertheless, and in light of the central role of that footnote to the United States' position in this dispute, we recall that footnote 59 provides as follows:

"The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. *The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length.* Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence.

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

7.117 On what basis does the United States consider that footnote 59 would exclude the FSC exemptions at issue in this case from the application of item (e)? As we have seen in our discussion of Article 1, the United States considers that "the necessary predicate of footnote 59 is that income from foreign economic activity may be exempted from direct taxes".⁶⁷⁹ In the context of Article 1, the United States derived from this principle that revenue derived from foreign economic activity was not "otherwise due" and that the FSC exemptions which exempt *some or all* such revenue from taxation could not be deemed to give rise to a subsidy within the meaning of Article 1 of the SCM Agreement. In the context of item (e) of the Illustrative List, the United States' argument is much the same. In the view of the United States, "the exemption of *some or all* of the income generated by foreign economic activities, through whatever means, is not an export subsidy".⁶⁸⁰ Thus, the United States argues that footnote 59 authorizes a Member to exempt from taxation revenue arising from foreign economic processes related to export transactions, even if it does not exempt from taxation revenue arising from foreign economic processes unrelated to export transactions.

7.118 In considering the United States' argument, we first note that footnote 59 nowhere explicitly provides that it is "qualifying" (i.e., narrowing) the scope of item (e) in the manner argued by the United States. This is not to say that we agree with the European Communities that a footnote may only "explain" and not "contradict" the provision to which it relates.⁶⁸¹ In fact, several provisions of footnote 59 itself could be considered to "qualify" item (e). Thus, the first sentence of footnote 59 could be considered to "qualify" item (e) in providing that "deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected", while the last sentence of footnote 59 could be construed to have the same effect in providing that "[p]aragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member".⁶⁸² Nowhere, however, does footnote 59 state that "item (e) is not intended to prevent Members from exempting from direct taxes foreign-source income relating to export transactions". The existence of explicit "qualifying"

⁶⁷⁹ Paragraph 4.366, *supra*.

⁶⁸⁰ Paragraph 4.382, *supra* (emphasis added).

⁶⁸¹ Paragraph 4.639, *supra*. To the contrary, it could be observed – and not entirely in jest – that the most important provisions of the WTO Agreement are found in footnotes, and it is certainly not the case that language found in a footnote to the WTO Agreement is somehow subsidiary in legal terms to that found in the body of the Agreement.

⁶⁸² The United States has not asserted that either of these provisions is relevant to this dispute.

language in footnote 59 regarding deferral and double taxation serves to underline the absence of any explicit statement in respect of the principle which the United States contends may be found in footnote 59. If the Members had desired to exempt from the export subsidy prohibition certain exemptions from direct taxation that were specifically related to exports, they might have been expected to do so explicitly.

7.119 The question remains whether the "qualification" on the scope of item (e) asserted by the United States can be implied from the language of footnote 59. We think not. In Section VII.B.3(a)(iii) of this Report, we noted the United States' view that it could be implied that "income from foreign economic activity may be exempted from direct taxes". Even assuming that the United States is correct in this regard, however, this does not mean that a Member is also entitled to choose to assert its taxing authority over income derived from foreign economic activities generally and then create an exemption from such taxation specifically for income derived from export activities. Under item (e) of the Illustrative List, it is only tax exemptions, remissions and deferrals that are "specifically related to exports" that are prohibited export subsidies. Arguably, a broad exemption of income deriving from foreign economic activities from taxation would not be an exemption "specifically related to exports", because it would exempt income derived from any foreign economic activity, whether involving the exportation of goods to a foreign market, the importation of goods from a foreign source, or other economic activities not related to trade in goods between the Member in question and a third country. Thus, even assuming that "income arising from foreign economic activity may be exempted from direct taxes", we see no contradiction between that principle and the conclusion that the FSC exemptions are within the scope of item (e) because those exemptions are "specifically related to exports".

7.120 The United States contends that footnote 59 "must be read in light of a history that dates back to the inception of GATT Article XVI:4".⁶⁸³ We are mindful of the fact that footnote 59 has its origins in footnote 2 to the Illustrative List of Export Subsidies annexed to the Tokyo Round Subsidies Code, and that the Code was negotiated against the background of the four – at that time unadopted – *Tax Legislation* panel reports. Of course, reference to this historical background could at most serve as a supplementary means of interpretation within the meaning of Article 32 of the Vienna Convention⁶⁸⁴, and only to confirm the meaning of footnote 59 derived from the general rule of interpretation or to determine its meaning if application of that general rule left the meaning of footnote 59 ambiguous or obscure or would lead to a result which is manifestly absurd or unreasonable. In any event, it should be recalled that the *Tax Legislation* panel reports did not relate to a programme like the FSC, which exempts foreign-source income specifically related to exports, but rather to the general exemption of foreign-source income by three European contracting parties, and to the DISC, which did not purport to represent an exemption of foreign-source income at all. Thus, even if it could be suggested that the drafters of the Code, through footnote 59, implicitly rejected the findings of those panel reports and reflected the principle that foreign-source income need not be taxed, it can hardly be concluded from this that they authorized an exemption of foreign-source income specifically related to exports pursuant to a scheme that was not even contemplated at the time the Code was negotiated.

(d) Territorial and World-Wide Tax Systems

7.121 The United States' argumentation in this case also focuses on the differences between world-wide and territorial systems of taxation. The United States argues that world-wide systems of taxation, such as that of the United States, place exporters at a disadvantage relative to exporters from countries with territorial tax systems, because, under a territorial system, whenever activities relating to an export transaction occur outside the territory of the taxing jurisdiction, income from such activities is not taxed. In the view of the United States, however, a WTO Member is free to maintain a world-wide or territorial tax system, or one that incorporates elements of each. Thus, and "[i]n recognition

⁶⁸³ Paragraph 4.378, *supra*.

⁶⁸⁴ *European Communities – Measures Affecting the Importation of Certain Poultry Products*, WT/DS69/AB/R, Report of the Appellate Body adopted on 23 July 1998, paragraph 83.

of principles of tax sovereignty, a country using a worldwide system is free to incorporate elements of a territorial system (or *vice versa*), so that a foreign subsidiary, or particular kinds of foreign subsidiaries, such as a FSC, are taxed in a manner similar to foreign corporations under a territorial system (exemption of income plus an exemption for dividends) or are taxed like a foreign branch might be taxed under a territorial system (exemption)".⁶⁸⁵ In short, the United States concludes, the WTO should not penalize a country using a world-wide system for incorporating elements of a territorial system in order to obtain comparable tax treatment for its exporters.

7.122 We agree with the United States that neither the SCM Agreement specifically, nor the WTO Agreement generally, is intended to dictate the type of tax system that should be maintained by a Member. On the other hand, certain WTO rules do have implications for specific tax practices of Members. In the area of subsidies, it is clear from Article 1 of the SCM Agreement itself that tax measures of a WTO Member may give rise to subsidies subject to the disciplines of the SCM Agreement. It is further clear that, to the extent that a subsidy is contingent upon export performance, it is a prohibited export subsidy. Thus, the United States is free to maintain a world wide tax system, a territorial tax system or any other type of system it sees fit. This is not the business of the WTO. What it is not free to do is to establish a regime of direct taxation, provide an exemption from direct taxes specifically related to exports, and then claim that it is entitled to provide such an export subsidy because it is necessary to eliminate a disadvantage to exporters created by the US tax system itself.⁶⁸⁶ In our view, this is no different from imposing a corporate income tax of, say, 75 per cent, and then arguing that a special tax rate of 25 per cent for exporters is necessary because the generally applicable corporate tax rate in other Members is only 25 per cent.

7.123 Finally, we note the United States' view that, if we were to rule in favour of the European Communities and reject the principle that foreign-source income need not be taxed, the result would be to condemn not only the FSC, but also territorial tax systems, including the tax systems of EC member States. The European Communities, on the other hand, has advanced the theory that "WTO Members are not prevented by the ASCM from not taxing foreign source income if this is done on a general basis".⁶⁸⁷ Here, we must emphasize that the WTO-consistency of other Members' tax systems, whether territorial or otherwise, is outside our terms of reference. Thus, we should not and will not speculate on the implications of our findings in this dispute, if any, for other Members' tax systems. It would be up to any future panels that might be established to examine the consistency of the tax regime before it in accordance with WTO requirements.

5. Administrative Pricing Rules

7.124 In the preceding section of this Report, we conclude that the exemptions provided by the FSC scheme give rise to a subsidy within the meaning of Article 1 of the SCM Agreement which is contingent upon export performance within the meaning of Article 3.1(a) of that Agreement. The European Communities has not limited its claims to tax exemptions under the FSC scheme. The European Communities further alleges that certain administrative pricing rules relating to the FSC are a "separate prohibited subsidy" that gives rise to an "independent violation" of the SCM Agreement. In light of our ruling regarding the tax exemptions under the FSC scheme, the question arises whether we should proceed to a further and separate ruling on the WTO-consistency of these administrative pricing rules.

7.125 The European Communities considers that the Panel must make separate rulings on the administrative pricing rules and the tax exemptions under the FSC because "each could exist in the

⁶⁸⁵ Paragraph 4.320, *supra*.

⁶⁸⁶ As the Appellate Body has stated, "Members of the WTO are free to pursue their own domestic policy goals through internal taxation or regulation *so long as they do not do so in a way that violates Article III or any of the other commitments they have made in the WTO Agreement*" (emphasis added). *Japan – Taxes on Alcoholic Beverages*, WT/DS8/AB/R-WT/DS10/AB/R-WT/DS11/AB/R, Report of the Appellate Body adopted on 1 November 1996, p. 16.

⁶⁸⁷ Paragraph 4.668, *supra*.

absence of the other and it is important that both be held to be prohibited export subsidies so that both will have to be withdrawn".⁶⁸⁸ The European Communities argues that, even if the FSC exemptions were abolished, the administrative pricing rules could still give rise to revenue foregone since the combined income of the FSC and its parent could still benefit from lower effective taxation than under the general US transfer pricing rules.⁶⁸⁹

7.126 The United States contends that the FSC administrative pricing rules are not capable of giving rise to an independent violation of the SCM Agreement in the absence of the FSC exemptions. In its view, the existence of the FSC exemptions is a necessary predicate to the administrative pricing rules, and those rules would be superfluous and without effect if the exemptions did not exist. The United States further considers that the only way that the FSC exemptions could give rise to an "independent violation" would be if the Panel concluded that the FSC exemptions were permissible (because foreign-source income need not be taxed), but that the administrative pricing rules nevertheless resulted in domestic-source income escaping taxation to a significant extent.⁶⁹⁰

7.127 We consider that, having found that the exemptions provided by the FSC scheme are an export subsidy inconsistent with the SCM Agreement, it would be neither necessary nor appropriate for us to make a further and independent ruling on the consistency of that scheme's administrative pricing rules. In our view, the allegation of the European Communities is in fact that the FSC administrative pricing rules serve to increase the amount of the subsidy conferred by the FSC exemptions. For example, the European Communities refers to "both the FSC tax exemptions *per se* and the increase in the amount of those tax exemptions arising out of the application of the administrative pricing rules".⁶⁹¹ Elsewhere, the European Communities refers to the FSC administrative pricing rules as "compounding" the subsidy provided by the FSC exemptions.⁶⁹² In light of our conclusion that the FSC exemptions in their totality represent a prohibited export subsidy, and because, in our view, FSC administrative pricing rules perform no role and serve no purpose outside the functioning of those exemptions, we consider that we have discharged our duty under our terms of reference to make such findings in respect of the European Communities' Article 3.1(a) claims as will assist the DSB in making its recommendations.⁶⁹³

7.128 In our view, acceding to the European Communities' request to examine the administrative pricing rules in the case at hand would require us to perform one of two types of speculative and inappropriate analysis. First, we could disregard our conclusions regarding the WTO-consistency of the FSC exemptions themselves, and examine whether, if the United States *were* entitled to exempt from taxation foreign-source income arising from export activities, the administrative pricing rules nevertheless would give rise to an export subsidy because they treated income as foreign-source that was in fact domestic-source. We do not consider it appropriate to perform a hypothetical analysis based upon legal interpretations which we have already rejected.

7.129 Second, we could examine whether, if the United States eliminated the exemptions provided by the FSC scheme but utilised the administrative pricing rules in some other context, an export subsidy would nevertheless arise from the operation of the administrative pricing rules in themselves. We are not entitled to speculate about the WTO-consistency of such a hypothetical scheme.

⁶⁸⁸ Paragraph 4.273, *supra*.

⁶⁸⁹ Paragraph 4.1083, *supra*.

⁶⁹⁰ Paragraphs 4.1131-4.1135, *supra*.

⁶⁹¹ Paragraph 4.296, *supra*.

⁶⁹² Paragraph 4.272.

⁶⁹³ The Appellate Body has explained that a panel should address those claims on which a finding is necessary in order to enable the DSB to make sufficiently precise recommendations and rulings so as to allow for prompt compliance by a Member with those recommendations and rulings "in order to ensure effective resolution of disputes to the benefit of all Members" as provided by Article 21.1 of the DSU. *See Australia – Measures Affecting Importation of Salmon*, WT/DS18/AB/R, Report of the Appellate Body adopted on 6 November 1998, paragraph 223.

Moreover, such a hypothetical scheme has not been the subject of meaningful argumentation by the parties.⁶⁹⁴

6. Conclusion

7.130 For the foregoing reasons, we conclude that FSC exemptions constitute a subsidy which is contingent upon export performance within the meaning of Article 3.1(a) of that Agreement. Accordingly, and "[e]xcept as provided in the Agreement on Agriculture", those subsidies are prohibited.

C. CLAIMS UNDER ARTICLE 3.1(b) OF THE SCM AGREEMENT

7.131 The European Communities further claims that the FSC scheme represents a subsidy contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the SCM Agreement, in as much as tax exemptions under the FSC scheme are limited to income from the export of products "not more than 50 per cent of the fair market value of which is attributable to articles imported into the United States".⁶⁹⁵ The United States responds that, because the FSC scheme does not involve a subsidy, it cannot constitute a subsidy contingent upon the use of domestic over imported goods. The United States further argues that the FSC scheme is not prohibited by Article 3.1(b) of the SCM Agreement because, as provided by footnote 5 to the SCM Agreement, it is a measure referred to in Annex I as not constituting an export subsidy. Finally, the United States asserts that compliance with the 50 per cent requirement applies to the overall value of the exported product, and not just to the domestic versus foreign content of its component parts.⁶⁹⁶

7.132 As an initial matter, we must consider whether, in light of our finding that FSC exemptions represent an export subsidy prohibited by Article 3.1(a) of the SCM Agreement, we should further make findings regarding the European Communities' Article 3.1(b) claim. As noted above⁶⁹⁷, we should make findings with respect to a claim to the extent necessary in order to enable the DSB to make sufficiently precise recommendations and rulings so as to allow for prompt compliance by a Member. In this case, we have found that exemptions under the FSC scheme are prohibited export subsidies. The element of the definition of "export property" that is at the core of the European Communities' claim under Article 3.1(b) of the SCM Agreement serves simply to assist in defining the scope of those exemptions, and does not serve any other practical purpose.⁶⁹⁸ Consequently, we do not consider that it would be necessary or appropriate to make findings with respect to this claim.

D. CLAIMS UNDER THE AGREEMENT ON AGRICULTURE

1. Overview of the Parties' Arguments

7.133 The European Communities argues that the FSC scheme represents an export subsidy listed in Article 9.1(d) of the Agreement on Agriculture. In the view of the European Communities, the United States has provided FSC subsidies in respect of a quantity of exports in excess of the United States export subsidy commitments under the Agreement on Agriculture and has thus acted inconsistently with Articles 3.3 and 8 of that Agreement. In the alternative, the

⁶⁹⁴ The sole EC discussion of the consistency of this hypothetical scheme is comprised of a few sentences in its response to questions from the Panel after the second meeting, responses to which the United States has not had an opportunity to react. While vigorous argumentation is always important to ensure that a panel has before it all relevant considerations, this is particularly the case where legislation as complex as the US Internal Revenue Code is involved.

⁶⁹⁵ US Internal Revenue Code, Section 927(a)(1)(C).

⁶⁹⁶ See Section IV.C of this Report.

⁶⁹⁷ See *supra*, paragraph 7.127.

⁶⁹⁸ In this regard, it is perhaps no surprise that the arguments of the parties in this dispute focused on the European Communities' Article 3.1(a) claim. Although the European Communities' Article 3.1(b) claim clearly was not abandoned, the legal issues relating to that claim were not thoroughly explored by either party.

European Communities argues that the FSC scheme represents an export subsidy not listed in Article 9.1 of the Agreement on Agriculture, and that by providing FSC subsidies in excess of its export subsidy commitments under the Agreement on Agriculture the United States has circumvented its export subsidy commitments in violation of Article 10.1 of that Agreement. The United States responds that the FSC scheme is not an export subsidy under the Agreement on Agriculture, and that accordingly it has not violated its export subsidy commitments under that Agreement.

2. Article 10.3 and the Burden of Proof

7.134 It is by now well established that, in the WTO dispute settlement system, a complaining Member, as a general matter, bears the burden of presenting evidence and argument sufficient to establish a presumption of a violation of the WTO Agreement.⁶⁹⁹ In the case of claims under the Agreement on Agriculture relating to the provision of export subsidies in respect of a product in a quantity in excess of a Member's reduction commitments for that product, however, there is a specific provision, Article 10.3, which relates to the issue of burden of proof. Accordingly, we must consider the relevance of that Article for the allocation of the burden of proof in this case.

7.135 Article 10.3 of the Agreement on Agriculture provides as follows:

"Any Member which claims that any quantity exported in excess of a reduction commitment level is not subsidized must establish that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports in question."

7.136 We consider it evident, and the parties do not dispute, that Article 10.3 has the effect of shifting from the complaining to the defending Member the burden of demonstrating that no export subsidies have been granted with respect to any quantity of an agricultural product exported in excess of the reduction commitment level of that Member, if the defending Member claims – as does the United States – that that quantity is not subsidized. In this case, therefore, the European Communities having alleged that the FSC is an export subsidy available with respect to agricultural products, and once the European Communities has established that the United States has exported a quantity of an agricultural product in excess of its reduction commitment level, it is up to the United States to present evidence and argument sufficient to establish that no export subsidy has been granted with respect to the quantity in question. The United States could fulfill this burden by submitting evidence and argument sufficient to establish that the FSC scheme does not represent an export subsidy, that FSC benefits are not granted with respect to a quantity of the product in question in excess of its reduction commitment level, or both.

7.137 The parties do not agree, however, as to which products are subject to a "reduction commitment level" and thus subject to this reversal in the burden of proof. In the view of the United States, a product is subject to a reduction commitment only if it is listed in Section II, Part IV of a Member's schedule; and that unscheduled products as such are not subject to a reduction commitment. The European Communities, on the other hand, considers that both scheduled and unscheduled products are subject to reduction commitments; in the case of an unscheduled product, the reduction commitment level is zero. Because the European Communities has alleged that the United States has breached its "reduction commitment levels" with respect to both scheduled and unscheduled products, we must resolve whether Article 10.3 is applicable in the case of unscheduled products before examining the substance of the claims before us.⁷⁰⁰

⁶⁹⁹ See, e.g., *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India*. WT/DS33/AB/R, Report of the Appellate Body adopted on 23 May 1997, pp. 13-14.

⁷⁰⁰ Although the parties also disagree as to whether products which appear in a Member's schedule but at a zero level are subject to "reduction commitments", none of the products in the US schedule are scheduled at a zero level. See Schedule XX – United States of America, Section II, Part IV. Accordingly, we need not

7.138 In considering this issue, the question before us is whether products which do not appear in a Member's schedule are subject to "reduction commitment" within the meaning of Article 10.3. In our view, a Member which has not scheduled a given product may well have a *commitment* with respect to that product, in as much as it is precluded by Article 3.3 of the Agreement from providing export subsidies listed in Article 9.1 with respect to that product. We do not consider, however, that the Member has a *reduction* commitment with respect to an unscheduled product.

7.139 The term "reduction commitment" in its ordinary meaning suggests that the Member was granting export subsidies with regard to the product in the relevant base period when it prepared its schedule but committed that it would reduce the quantity of the product benefiting from Article 9.1 export subsidies during the implementation period. In the case of unscheduled products, however, the Member's commitment is that it will not *provide* any export subsidies with respect to that product, rather than that it will *reduce* the quantity of the product with respect to which it provides the subsidy. Thus, the term "reduction commitment" in its ordinary meaning would not apply to unscheduled products.

7.140 Our conclusion is confirmed when the term "reduction commitment" as used in Article 10.3 is read in its context. In this respect, we note that the title of Article 10 is "Prevention of Circumvention of Export Subsidy Commitments". While Article 10.3 refers to *reduction commitment* levels, Article 10.1, like the title of Article 10, refers more generally to circumvention of export subsidy *commitments*. We cannot assume that this distinction between two provisions in such close proximity within the same Article was inadvertent. Rather, it would appear that Article 10 distinguishes between "export subsidy commitments", a broad term that refers to commitments with respect both to scheduled and unscheduled products, and "reduction commitments", a narrower term relating specifically to scheduled products.

7.141 Further, we note that Article 3 of the Agreement on Agriculture, titled "Incorporation of Concessions and Commitments", deals with export subsidy obligations in respect of both scheduled and unscheduled products. If the term "reduction commitments" were applicable to both scheduled and unscheduled products, the title of that Article could have been expected to refer to "reduction commitments" rather than merely to "commitments". Again, this would appear to confirm that the phrase "reduction commitment" refers to that subcategory of "commitments" which relates to scheduled products.

7.142 Finally, we note the European Communities' view that there is no reason why Article 10.3 should apply to scheduled but not to unscheduled products. We can however imagine a number of reasons why the drafters might have made such a distinction. In particular, it is reasonable to assume that Article 10.3 places on the defending Member the burden of proof to establish that no export subsidy has been granted in respect of any quantity of a product exported in excess of its reduction commitment level because of concern that a complainant will generally not have access to information necessary to make a *prima facie* case of a violation. It should however be easier, in most cases, for a complainant to establish that an export subsidy had been provided with respect to exports of a particular product, irrespective of amount – as would be the case with respect to unscheduled products, for which the commitment under Article 3.3 is not to provide any export subsidies listed in Article 9.1 – than to demonstrate that an export subsidy has been provided with respect to a quantity of product in excess of some given level.⁷⁰¹

decide whether products which are scheduled at a zero level are subject to "reduction commitments" within the meaning of Article 10.3.

⁷⁰¹ The difficulties would be particularly great in cases where a number of different export subsidies are granted with respect to a product subject to some non-zero level of commitment. In this case, even if the complaining Member knew the quantity of exports benefiting from each export subsidy, it would not know whether the different export subsidies were being provided with respect to the same exports or whether different export subsidies were being provided with respect to distinct exports.

7.143 In conclusion, we consider that Article 10.3 of the Agreement on Agriculture places the burden on the United States to present evidence and argument sufficient to establish that no export subsidy has been granted in respect of any quantity of a product exported in excess of the reduction commitment levels found in its Schedule for that product. In the case of unscheduled products, however, the burden remains with the European Communities to present evidence and argument sufficient to establish that export subsidies have been provided with respect to that product.

3. Claim Under Article 3.3 of the Agreement on Agriculture

7.144 We now turn to the European Communities' claim that the United States has acted inconsistently with Article 3.3 of the Agreement on Agriculture by providing FSC subsidies in excess of its reduction commitments under that Agreement.

7.145 Article 3.3 of the Agreement on Agriculture provides as follows:

"Subject to the provisions of paragraphs 2(b) and (4) of Article 9, a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitment levels specified therein and shall not provide such subsidies in respect of any agricultural product not specified in that Section of its Schedule."

7.146 A violation of Article 3.3 of the Agreement on Agriculture may be found to exist if it is determined (a) that a Member is providing "export subsidies listed in paragraph 1 of Article 9 of that Agreement"; and (b) in respect of a scheduled product, that those export subsidies are being provided in excess of the budgetary outlay and/or quantity commitment levels specified in its Schedule, or, in respect of an unscheduled product, that it is providing any such subsidies.

(a) Is the FSC Scheme an Export Subsidy Listed in Article 9.1 of the Agreement on Agriculture?

7.147 Turning to the first issue identified above, the European Communities argues that the FSC scheme gives rise to export subsidies within the scope of Article 9.1(d) of the Agreement on Agriculture. Article 9.1(d) provides as follows:

"The following export subsidies are subject to reduction commitments under this Agreement:

.....

(d) the provision of subsidies to reduce the costs of marketing exports of agricultural products (other than widely available export promotion and advisory services) including handling, upgrading and other processing costs, and the costs of international transport and freight."

7.148 In order for the FSC scheme to fall within the scope of Article 9.1(d), two criteria must be fulfilled. *First*, there must be "the provision of subsidies". *Second*, the provision of those subsidies must be "to reduce the costs of marketing exports of agricultural products". We will consider each of these criteria in turn.

(ii) *Is the FSC scheme a "subsidy" within the meaning of the Agreement on Agriculture?*

7.149 With respect to whether the FSC scheme is a subsidy within the meaning of the Agreement on Agriculture, we note that, although the term "export subsidy" is defined in Article 1(e) of the Agreement on Agriculture, the term "subsidy" is nowhere defined in that Agreement. Accordingly, the parties have referred to the term "subsidy" as defined in the SCM Agreement – and, in the case of the United States, to the concept of subsidy as used in Article XVI of GATT 1994 – as relevant

context for the interpretation of that term as used in the Agreement on Agriculture. In effect, the parties have relied upon the arguments they presented in the context of the European Communities' claims under the SCM Agreement as the basis for their views regarding whether a "subsidy" exists within the meaning of the Agreement on Agriculture.

7.150 We agree with the parties that Article 1 of the SCM Agreement, which defines the term "subsidy" for the purposes of the SCM Agreement, represents highly relevant context for the interpretation of the word "subsidy" within the meaning of the Agreement on Agriculture, as it is the only article in the WTO Agreement that provides a definition of that term. This is not of course to say that the definition of "subsidy" in the SCM Agreement, which applies "[f]or the purpose of this [i.e., the SCM] Agreement", is directly applicable to the Agreement on Agriculture. In particular, we cannot preclude *a priori* that there could be cases where relevant provisions of the Agreement on Agriculture might lead a panel to conclude that the term "subsidy" as used in the Agreement on Agriculture has a different meaning in a particular context from that ascribed to it by Article 1 of the SCM Agreement. As a general matter, however, and subject to any provision of the Agreement on Agriculture under which the contrary is to be inferred⁷⁰², we consider that a measure which represents a subsidy within the meaning of the SCM Agreement will also be a subsidy within the meaning of the Agreement on Agriculture.

7.151 In Section VII.B.3 of this Report, we considered in detail whether the FSC scheme confers subsidies within the meaning of Article 1 of the SCM Agreement, and we concluded that it does. In light of our views regarding the relevance of Article 1 of the SCM Agreement to the interpretation of the term "subsidy" as used in the Agreement on Agriculture, and in the absence of any argumentation by the parties that any provision of the Agreement on Agriculture suggests a different interpretation, we consider that the FSC scheme confers a subsidy within the meaning of the Agreement on Agriculture.⁷⁰³

(iii) *Do FSC subsidies "reduce the costs of marketing exports of agricultural products"?*

7.152 Having determined that the FSC scheme confers subsidies within the meaning of the Agreement on Agriculture, we must next consider whether those subsidies are provided "to reduce the costs of marketing exports of agricultural products" within the meaning of Article 9.1(d).

7.153 The European Communities argues that, by reducing the tax liability rising out of foreign sales, the FSC scheme reduces the costs of marketing exports. The European Communities points out that FSC subsidies are by their nature related to the distribution or marketing of exports, because marketing means advertising, sales promotion and solicitation and these are all activities the FSC is required to perform or be responsible for. The United States responds that the FSC scheme does not reduce marketing expenses, but merely reduces a FSC's tax liability; the costs incurred by a firm do not change depending on whether or not the firm files an income tax return as a FSC. The United States further argues that the drafters of the WTO Agreement knew how to distinguish between tax-related and non-tax-related subsidies, and that, if the drafters of Article 9.1(d) had intended that that item apply to tax-related measures, they would have specifically provided to that effect.

⁷⁰² For instance, a measure which is listed as an export subsidy in Article 9.1 of the Agreement on Agriculture is an export subsidy for the purposes of the Agreement on Agriculture independently of the definition of "subsidy" in the SCM Agreement.

⁷⁰³ The United States argued that the term "subsidy" as used in the Agreement on Agriculture must be interpreted in light both of Article 1 of the SCM Agreement and Article XVI:1 of GATT 1994. It is however the SCM Agreement, and not Article XVI of GATT 1994, that contains a definition of the term "subsidy". Further, we have already rejected the United States' arguments that the 1981 understanding is part of GATT 1994 or that, in any event, Article 1 must be interpreted in light of that understanding not to encompass the FSC scheme. Accordingly, we see no basis to consider that the 1981 understanding should control our interpretation of the term "subsidy" as used in the Agreement on Agriculture.

7.154 In considering this question, we note first that FSC subsidies are provided with respect to "marketing exports of agricultural products". In this respect, we note that the term "marketing" has been defined, *inter alia*, as "an aggregate of functions involved in transferring title and in moving goods from producer to consumer including among others buying, selling, storing, transporting, standardizing, financing, risk bearing and supplying market information".⁷⁰⁴ Under US law, the activities that must be performed by a FSC in order for income to be eligible for FSC exemptions with respect to a transaction relate to advertising and sales promotion, processing of customer orders and arranging for delivery of export property, transportation, the determination and transmittal of foreign invoices, and the assumption of credit risks.⁷⁰⁵ These activities in our view fall squarely within the ordinary meaning of the term "marketing". While a FSC may of course perform additional functions with respect to the sale of export property overseas, it is difficult to imagine any function that a FSC might perform overseas with respect to export property that did not fall within the concept of marketing.

7.155 While FSC subsidies are provided with respect to marketing, are they provided to "reduce the costs of marketing exports of agricultural products"? We consider that they are. In this respect, we note that, as a practical commercial matter and in ordinary parlance, income taxes are a cost of doing business. Because FSC subsidies reduce an exporter's income tax liability with respect to marketing activities, they effectively reduce the cost of marketing agricultural products.

7.156 In any event, a subsidy such as the FSC, which is provided to offset costs of marketing agricultural products, should be considered to reduce the costs of marketing agricultural products. In our view, the language "to reduce the costs of marketing exports of agricultural products" relates to the purpose and role of the subsidies in question, rather than to their form. To conclude otherwise would in our view distinguish between subsidies based upon the way in which they are provided, thereby elevating form over substance. This would effectively deprive Article 9.1(d) of any operational meaning. Under the purely formalistic interpretation proposed by the United States, the only conceivable ways in which the costs of marketing exports of agricultural products could be reduced would be through changes in either the efficiency of the firms concerned or the marketing cost structure which those firms face in the marketplace. Consequently, even the provision by a government of marketing services at subsidized prices would not, on this reading, be deemed to *reduce* the costs of marketing, but would be deemed to merely shift some of those costs from the exporter to the government.

7.157 In our view, it is necessary to read Article 9.1(d) in a manner which renders it operationally effective. From this perspective, the *exporter's* costs are reduced whether the government provides the exporter with services at subsidized prices, grants subsidies to a third party so that the third party provides the exporter with marketing services at reduced prices, or provides the exporter with subsidies to offset a portion of the costs of marketing.

7.158 Finally, we note the apparent view of the United States that Article 9.1(d) cannot include tax-related subsidies. We see no sound basis for this view. Article 9.1(d) simply refers to subsidies, a term which applies to a wide range of financial contributions which confer a benefit, whether in the form of a direct transfer of funds such as a grant, revenue foregone, the provision of goods or services or the purchase of goods. If the drafters of the Agreement on Agriculture had intended to limit the scope of Article 9.1(d) to non-taxed-based measures, we presume that they would have said so.⁷⁰⁶

⁷⁰⁴ *Webster's Third International Dictionary*, Vol. II.

⁷⁰⁵ US Internal Revenue Code, Section 924(e).

⁷⁰⁶ The United States further suggests that, under the European Communities' interpretation, Article 9.1(d) would apply to rebates of VAT. Value-added taxes, however, are not related primarily to marketing, but rather relate to the entire chain of production. In any event, the non-excessive rebate of VAT would of course not be a subsidy within the meaning of the SCM Agreement pursuant to footnote 1 to Article 1 of that Agreement, a conclusion we presume – but which we need not decide – would be equally applicable in the context of the Agreement on Agriculture.

7.159 For the foregoing reasons, we find that the FSC scheme involves the provision of a subsidy to reduce the costs of marketing exports of agricultural products within the meaning of Article 9.1(d) of the Agreement on Agriculture.⁷⁰⁷

(b) Are FSC Subsidies Provided for Scheduled Products in Excess of the United States' Quantity Commitment Levels?

7.160 In the previous section, we have found that FSC subsidies are export subsidies listed in Article 9.1 of the Agreement on Agriculture. Under the first limb of Article 3.3 of that Agreement, a Member shall not provide such subsidies "in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule [i.e., its Schedule of export subsidy commitments] in excess of the . . . quantity commitment levels specified therein."

7.161 We have further seen that, with respect to scheduled products, it is only once the complainant has established that an agricultural product has been exported in excess of its reduction commitment level that Article 10.3 reverses the burden of proof such that the defending Member must present evidence and argument sufficient to establish that no export subsidy has been granted in respect of the quantity of an agricultural product exported in excess of the reduction commitment level for that product specified in that Member's Schedule.

7.162 In this case, the European Communities has presented evidence with respect to the level of exports of only one scheduled product, wheat. This data, which is derived from a UN data base, shows a quantity of wheat exports during each of the years 1995, 1996 and 1997 which substantially exceeds the United States' quantity commitment levels for those years as indicated in its Schedule.⁷⁰⁸ The United States has not contested the accuracy of this data, nor has it asserted that a situation as described in Article 9.2(b) of the Agreement on Agriculture exists. Thus, the European Communities has in our view presented evidence and argument sufficient to establish that the United States exported wheat in excess of its quantity commitment levels for those years.

7.163 In light of the evidence and argument submitted by the European Communities, it is incumbent upon the United States pursuant to Article 10.3 of the Agreement on Agriculture to present sufficient evidence and argument to establish that no export subsidies, including FSC subsidies, were granted in respect of wheat exported in excess of its reduction commitment levels in any of the years 1995 through 1997. The United States has however presented no evidence regarding the use of FSC subsidies with respect to wheat nor with respect to the volume of wheat exported without the benefit of export subsidies.⁷⁰⁹ Thus, the United States has failed to present evidence and argument sufficient to establish that no export subsidies have been granted in respect of wheat exported by the United States in excess of the reduction commitment level specified in its Schedule.

7.164 The European Communities has not presented any evidence that the United States has exported any other agriculture product in a quantity in excess of the reduction commitment levels specified in its Schedule. Thus, and for the reasons discussed in Section VII.D.2 of the Report, the

⁷⁰⁷ The European Communities has not alleged that the FSC scheme represents an export subsidy listed in any other item of Article 9.1 of the Agreement on Agriculture. Consequently, although we do not preclude the possibility that the FSC scheme might also represent an Article 9.1(a) export subsidy, we need not and do not resolve that question here.

⁷⁰⁸ The relevant data is summarised below:

Year	Exports (1,000 tons)	Quantity commitment levels (1,000 tons)
1995	32,413	20,238
1996	31,131	19,095
1997	25,744	17,952

Source: Comext2 – Comtrade (HS).

⁷⁰⁹ In fact, the only evidence on the record relating to the use of FSC subsidies with respect to wheat indicates that, in 1992, twenty-seven FSC returns were filed with respect to "grains and soybeans". Daniel S. Holick, *Foreign Sales Corporations* (1992), Table 1, EC exhibit 12.

reversal of the burden of proof under Article 10.3 does not come into play with respect to these products, and there is accordingly no basis for us to find that export subsidies have been granted in respect of scheduled products other than wheat in excess of the United States' reduction commitment levels.

7.165 For the foregoing reasons, we find that the United States has provided export subsidies listed in Article 9.1 of the Agreement on Agriculture in respect of wheat during the years 1995 through 1997 in excess of the quantity commitment levels specified in its Schedule, contrary to its obligations under the first limb of Article 3.3 of that Agreement.⁷¹⁰

(c) Are FSC Subsidies Provided in Respect of Unscheduled Products?

7.166 Under the second limb of Article 3.3 of the Agreement on Agriculture, a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of any agricultural product not specified in that Member's Schedule of export subsidy commitments.

7.167 In Section VII.D.3(a) of this Report, we have concluded that FSC subsidies are export subsidies as listed in Article 9.1 of the Agreement on Agriculture. We have further concluded in Section VII.D.2 of this Report that the reversal of the burden of proof provided for in Article 10.3 of the Agreement only applies in the context of an alleged violation of export subsidy reduction commitments under the first limb of Article 3.3. Accordingly, the European Communities bears the burden of presenting evidence and argument sufficient to establish that the United States, contrary to the second limb of Article 3.3, provides FSC subsidies in respect of unscheduled products.

7.168 The European Communities argues that the simple availability of FSC subsidies with respect to any unscheduled agricultural product is in itself a violation of the Agreement on Agriculture. The United States contends that the mere availability of an export subsidy does not constitute a violation of the Agreement on Agriculture. Accordingly, we must consider whether the availability as such of FSC subsidies in respect of unscheduled products constitutes a violation of the obligations of the United States under the second limb of Article 3.3 of the Agreement on Agriculture. In this regard we note that the United States has not contested that FSC subsidies are in fact available to FSCs which are engaged in the marketing for export of any agricultural product, nor does it contest that a FSC which satisfies the relevant requirements thereby has entitlement under the relevant provisions of the US Internal Revenue Code to FSC subsidies.

7.169 In addressing this issue, the main question which we must examine is whether, in the prohibition in the second limb of Article 3.3, that a Member shall not "provide" export subsidies listed in paragraph 1 of Article 9 in respect of any agricultural products not specified in that Member's Schedule of export subsidy commitments, the term "provide" is to be interpreted to mean making such export subsidies available, rather than just in the more restrictive sense of actually granting or paying such subsidies in respect of exports of unscheduled agricultural products. In accordance with Article 31 of the Vienna Convention, we have to resolve this question in accordance with the ordinary meaning to be given to the term "provide" in its context and in the light of the object and purpose of the provisions of the Agreement on Agriculture as they relate to the use of export subsidies.

⁷¹⁰ The European Communities does not contend, in respect of *scheduled* products, that the *availability* of FSC subsidies – as opposed to their actual grant – represents the provision of export subsidies listed in Article 9 in excess of the United States' reduction commitments and thus gives rise to a violation of the first limb Article 3.3 of the Agreement on Agriculture. To the contrary, the European Communities – in response to a question from the Panel – states that:

"[g]iven the fact that there are agricultural products for which the US has a commitment of zero level the mandatory availability of FSC to any agricultural product (i.e. the fact that anybody who wants to export any agricultural product is entitled to FSC subsidies) is in itself a violation of Article 3 and 8."

We also recall that none of the products listed in the US schedule are scheduled at a zero level. Accordingly, we need not and do not decide this issue.

7.170 In our view, the ordinary meaning of the term "provide" includes the notion of making something available, as well as that of actually granting or paying that thing (in the present case export subsidies listed in Article 9.1 of the Agreement on Agriculture). Moreover, the following definition in the *Shorter Oxford English Dictionary* confirms that the term "provide" is not restricted in its ordinary, current usage to actually granting or paying such subsidies: "6 *v.t.* Supply or furnish for use; make available ...".⁷¹¹

7.171 We note the argument of the United States that in several of the provisions of the Agreement on Agriculture relating to export subsidies, including the first limb of Article 3.3, language is employed which could be taken to suggest that, in and by itself, the availability of an export subsidy does not constitute a violation of the provisions of the Agreement on Agriculture.⁷¹² With one exception, however, each of the provisions cited by the United States in support of its proposition that the availability of an export subsidy, in and by itself, does not constitute a violation of the Agreement on Agriculture, relates to the permitted use of export subsidies in the distinct context of reduction commitments with respect to scheduled products.⁷¹³ The one exception concerns the anti-circumvention provision in Article 10.1. However, this provision deals only with export subsidies *not* listed in Article 9.1, whereas Article 3.3 deals only with export subsidies that *are* listed in Article 9.1.

7.172 We further note the United States' argument that the language of Article 10.3 uses the term "grant" with reference to the use of subsidies in excess of commitment levels and that this language in Article 10.3 could be taken to imply that the term "provide" in the first limb of Article 3.3 has to be given a more restrictive meaning, namely, that of actually granting. However, even if this were so⁷¹⁴ – an issue we need not and do not decide in this dispute⁷¹⁵ – we do not consider that any such narrower construction of "provide" as used in the first limb of Article 3.3 would in any case necessarily control the meaning of the term "provide" as used in the second limb thereof.

7.173 With respect to object and purpose, we consider that the second limb of Article 3.3 establishes a prohibition on the provision in respect of unscheduled products of export subsidies listed in Article 9.1. This prohibition reflects the long-term objective of the Agreement on Agriculture, as expressed in its preamble,

"to establish a fair and market-oriented agricultural trading system and that a reform process should be initiated through the negotiation of commitments on support and

⁷¹¹ *The New Shorter Oxford English Dictionary* (1993), at p. 2393.

⁷¹² The provisions cited by the United States in this regard are:

- (a) the first limb of Article 3.3, which provides that a Member: "shall not provide export subsidies ... in excess of the budgetary outlay and quantity commitment levels specified [in the Member's Schedule]";
- (b) Article 9.2(a)(ii), which refers to: "... the maximum quantity ... in respect of which such export subsidies may be granted in that year.";
- (c) Article 10.1, which states that: "Export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments; ..."; and
- (d) Article 10.3, which refers to the need to "... establish that no export subsidy ... has been granted in respect of the quantity of exports in question".

⁷¹³ In respect of Article 10.3, please refer to our conclusion in paragraph 7.143 above that Article 10.3 applies only in the context of *scheduled* products.

⁷¹⁴ In this respect, however, we note that the *Shorter Oxford English Dictionary* reflects a variety of definitions of the term "grant", including: "3. An authoritative bestowal or conferring of a right, etc.; a gift or assignment of money, etc. out of a fund". Further, it cannot simply be assumed *a priori* that Article 10.3 serves to define the scope of the first limb of Article 3.3, much less that it defines the scope of the second limb of that Article.

⁷¹⁵ See footnote 710, *supra*.

protection and through the establishment of strengthened and more operationally effective GATT rules and disciplines".

7.174 In our view a restrictive interpretation of "provide" in the second limb of Article 3.3 would be problematic from the point of view of the enforcement of this prohibition, since other Members would not be able to assert their rights to challenge export subsidies when they were made available but only after they had been actually granted and the damage done.

7.175 On the basis of the foregoing examination, we conclude that the second limb of Article 3.3 of the Agreement on Agriculture prohibits *making available* export subsidies listed in Article 9.1 in respect of unscheduled products.

7.176 The United States has not contested that FSC subsidies are in fact available to FSCs which are engaged in the marketing of any agricultural product, nor does it contest that a FSC which satisfies the relevant requirements thereby has entitlement to FSC subsidies under the relevant provisions of the US Internal Revenue Code. Accordingly, the Panel finds that the United States has acted inconsistently with its obligations under the second limb of Article 3.3 of the Agreement on Agriculture by making FSC subsidies available in respect of agricultural products not subject to reduction commitments in its WTO Schedule.

4. Claim Under Article 8 of the Agreement on Agriculture

7.177 Article 8 of the Agreement on Agriculture provides that "[e]ach Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement". We have found that the United States has acted inconsistently with its obligations under Article 3.3 of the Agreement on Agriculture in respect of wheat and in respect of all unscheduled products. Consequently, we find that the United States also has acted inconsistently with its obligations under Article 8 of that Agreement.⁷¹⁶

VIII. CONCLUSIONS AND RECOMMENDATIONS

8.1 In light of the above findings, we conclude that, through the FSC scheme:

(a) the United States has, except as provided in the Agreement on Agriculture, acted inconsistently with its obligations under Article 3.1(a) of the SCM Agreement by granting or maintaining export subsidies prohibited by that provision;

(b) the United States has acted inconsistently with its obligations under Article 3.3 of the Agreement on Agriculture (and consequently with its obligations under Article 8 of that Agreement):

- by providing export subsidies listed in Article 9.1(d) of the Agreement on Agriculture in excess of the quantity commitment levels specified in the United States' Schedule in respect of wheat;
- by providing export subsidies listed in Article 9.1(d) of the Agreement on Agriculture in respect of all unscheduled products.

8.2 Since Article 3.8 of the DSU provides that "[i]n cases where there is an infringement of the obligations assumed under a covered agreement [including the SCM Agreement and the Agreement on Agriculture], the action is considered *prima facie* to constitute a case of nullification or impairment", we conclude that – to the extent the United States has acted inconsistently with the SCM

⁷¹⁶ In light of our finding that the FSC scheme is an export subsidy listed in Article 9.1 of the Agreement on Agriculture, we need not address the European Communities' alternative claim under Article 10.1 of that Agreement.

Agreement and the Agreement on Agriculture – it has nullified or impaired benefits accruing to the European Communities under these Agreements.

8.3 With respect to our conclusions regarding the SCM Agreement, we *recommend*, pursuant to Article 4.7 of that Agreement, that the DSB request the United States to withdraw the FSC subsidies without delay.

8.4 With respect to our conclusions regarding the Agreement on Agriculture, we *recommend* that the United States bring the FSC scheme into conformity with its obligations in respect of export subsidies under that Agreement.

8.5 In regard to our recommendation pursuant to the SCM Agreement, Article 4.7 of that Agreement provides that "the panel shall specify in its recommendation the time-period within which the measure [*i.e.*, the measure found to be a prohibited subsidy] must be withdrawn".

8.6 The European Communities requests that the Panel specify that the United States withdraw its FSC subsidies by the beginning of the fiscal year 2000. The United States responds that any changes to the FSC scheme would require legislative rather than administrative action, and that consequently a longer period may be necessary. The United States further notes that its fiscal year 2000 begins on 1 October 1999, and that, should this Report be appealed, the appeal would still be pending as of that date. In response, the European Communities suggests that the Panel specify two separate dates, one of which would apply in the case of an appeal and the other in the absence of an appeal.

8.7 In considering this question, we first note that Article 4.7 of the SCM Agreement requires a Member to withdraw a prohibited subsidy "without delay" and "in this regard" a panel must specify a time-period within which the measure must be withdrawn. Accordingly, the specified time-period must be consistent with the requirement that the subsidy be withdrawn "without delay".

8.8 Given that implementation of the Panel's recommendation will require legislative action (a fact recognized by the European Communities), that the United States fiscal year 2000 starts on 1 October 1999, and that this Report is not scheduled for circulation to Members until September 1999 (and, if appealed, might not be adopted until as late as early spring 2000), it is not in our view a practical possibility that the United States could be in a position to take the necessary legislative action by 1 October 1999. That being so, and acting in good faith, there is no way that this could be described as a "delay". However, this objective timing constraint would not be present with effect from the following fiscal year (2001), which commences on 1 October 2000. As this would be the first practicable date by which the United States could implement our recommendation, it satisfies the "without delay" standard set forth in Article 4.7. Accordingly, we specify that FSC subsidies must be withdrawn at the latest with effect from 1 October 2000.
