

ANNEX A

First Submission by the Parties

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ANNEX A-1

FIRST WRITTEN SUBMISSION OF THE EUROPEAN COMMUNITIES

(17 January 2001)

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1. INTRODUCTION

1. The *FSC Repeal and Extraterritorial Income Exclusion Act of 2000* (the “FSC Replacement Act”), adopted on 15 November 2000 as US Public Law No 106-519, is the measure taken by the US ostensibly to comply with the recommendations and rulings of the DSB following the earlier proceedings before the Panel.¹ It does not however bring the US into compliance with those recommendations and rulings for the reasons the EC will explain in detail below. Although the FSC Replacement Act states that it repeals the FSC scheme, this scheme will continue to be available to all existing FSC scheme until 1 January 2002 and to apply to certain of their transactions for an indefinite period. Also, for those transactions where the FSC scheme no longer applies, the FSC Replacement Act makes available an alternative scheme that increases and extends the subsidies that were available under the FSC scheme without removing the contingency on export performance or on the use of domestic over imported goods.

2. The description of the factual background (Section 2) is limited to the essential information. More detail about the US measure is provided as and when needed during the legal analysis (Section 3). Before concluding, the EC will ask the Panel to clarify the rights of third parties in this proceeding by means of a request for a preliminary ruling (Section 4).

2. FACTUAL BACKGROUND

3. The Panel is well aware of the background of this dispute through its work on the original Panel Report, which was upheld by the Appellate Body in virtually all respects except for a change in the reasoning relating to the violation of the *Agreement on Agriculture*. The recommendations of the Panel were adopted by the Dispute Settlement Body on 20 March 2000.²

4. Initial US proposals for complying with the recommendations of the DSB, for example by reducing the level of the tax deductions, were rejected by US business groups that lobbied vigorously to maintain their benefits. According to *Inside US Trade* of 24 March 2000:

Large companies that stand to lose billions of dollars in tax benefits if the FSC were changed have taken a very hard line on rolling back FSC benefits. They hope the EU will agree to a cosmetic change of the FSC ...³

5. Accordingly, the US decided to attempt to comply with the DSB recommendations by replacing the FSC scheme with other tax provisions that would maintain the same benefits.

6. The first official communication of US intentions came on 2 May 2000 when the US Deputy Secretary of the Treasury, Mr Eizenstat, came to Brussels to outline a proposal to the EC Commission.

7. This initial US proposal would have involved a repeal of the current FSC scheme and its replacement by an elective tax regime that would tax the “qualifying foreign income” of “eligible corporations” at a rate of 12.17 per cent or 24.5 per cent. The text of this proposal is Exhibit EC-2.

8. This new elective tax regime would have been very similar in effect to the FSC scheme. The tax rate of 12.17 per cent applied only if the “safe haven method” for calculating “qualifying foreign income” was used and corresponded to the FSC benefit using administrative pricing rules (12.17 per

¹ *United States – Tax Treatment for “Foreign Sales Corporations.”* Reports of the Panel (WT/DS108/R, 8 October 1999) and by the Appellate Body on (AB-1999-9, WT/DS108/AB/R, 24 February 2000) adopted by the DSB on 20 March 2000.

² Doc. WT/DS108/10 of 24 March 2000.

³ The relevant extract is Exhibit EC-1.

cent being equivalent to 8/23 of 35 per cent) and the rate of 24.5 per cent, applied in other cases (24.5 per cent being about double 12.17 per cent).

9. Also, an "eligible corporation" would have been defined as a foreign corporation that
- (i) is managed outside the United States, and
 - (ii) conducts economic activity outside the United States with respect to its "qualifying foreign income."⁴

and "qualifying foreign income" would have had to be earned by an "eligible corporation," from the sale, lease, or rental of goods

- (i) manufactured by an "eligible manufacturing corporation,"
- (ii) sold, leased, or rented for use, consumption, or disposition outside the United States, and
- (iii) not more than 50 per cent of the fair market value of which is attributable to foreign content.⁵

10. The main change compared with the FSC scheme was that the benefit of the new scheme would also have become available to foreign sales of certain foreign manufactured goods (of which not more than 50 per cent of the fair market value was attributable to foreign content).

11. In the view of the US, the enlarged application of the elective regime to both export foreign sales (involving US manufacturing) and non-export foreign sales (involving foreign manufacturing) would have rendered this scheme non export contingent.

12. On 26 May 2000, by a letter of Commissioner Lamy to Mr Eizenstat, the EC made clear its view that this proposal was unacceptable as it did not fulfil the conditions for WTO compatibility (Exhibit EC-3).

13. On 28 July 2000, US Deputy Secretary of State Eizenstat wrote to Commissioner Lamy to inform him about the passage by the House Ways and Means Committee on 27 July of the legislation to replace the FSC scheme. The bill submitted to Congress removed some of the ancillary elements of the 2 May proposal, like the need to create a foreign corporation to channel sales, but the US nonetheless persisted with the same basic scheme, developing its form to make it, in the US view, more easily defensible within the WTO, while still maintaining equivalent benefits for FSC beneficiaries.

14. Commissioner Lamy wrote to US Deputy Secretary of State Eizenstat on 31 August 2000 to express his concerns about the content of the bill as according to him it failed to remove the WTO violations that were present in the FSC scheme (Exhibit EC-4).

15. The bill was ultimately signed into law on 15 November 2000 as an Act of the US Congress entitled *FSC Repeal and Extraterritorial Income Exclusion Act of 2000*. The text of this Act is attached as Exhibit EC-5. An explanation of its provisions is contained in the US Congress Joint Committee on Taxation, *Technical Explanation of the Senate Amendment to H.R. 4986, the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000" (JCX-111-00)* of 1 November 2000 (Exhibit EC-5A).

⁴ See page 2 of the US proposal in Exhibit EC-1.

⁵ See page 2 of the US proposal in Exhibit EC-1.

16. The intent to continue the effect of the FSC scheme is apparent in particular through the statement⁶ in the Joint Committee on Taxation explanation that during the “gap period” pending the issuance of administrative guidance on the application of the new scheme, taxpayers may apply the principles of present law regulations and other administrative guidance under the FSC scheme.

17. The title of this law is misleading in a number of ways. First, it does not entirely repeal the FSC scheme, but allows it to continue for an indefinite period, as the EC will explain in more detail in Section 3.9 below. Second, it does not concern “extraterritorial” income in any real of that word. The income to which it relates can be earned entirely in the US. It seems that the US is using the word “extraterritorial” to mean “export” or “derived from sales for foreign consumption”. Finally, the word “exclusion” is confusing because the Act does nothing other than exempt a certain amount of income from tax, in a manner that is different in form but not in substance from the FSC scheme. For these reasons the EC will refer to the Act as the “FSC Replacement Act”.

18. The nature of the new scheme introduced by the FSC Replacement Act (and which the EC will refer to as the “FSC Replacement scheme” to distinguish it from its predecessor) is well summarised in a Congressional Research Service Report on *Foreign Sales Corporation Tax Benefit for Exporting and the World Trade Organization* as follows:⁷

H.R 4986 begins by exempting "extraterritorial income" from US tax, and continues by defining "extraterritorial income" and a chain of other concepts in a way that confines its exemption to a firm's US exports and a matching amount of income from foreign operations. The initial link in the chain of definitions is "qualifying foreign trade property", which is generally products manufactured, produced, grown, or extracted within or outside the United States. Generally, this is the full range of US exports, but the bill explicitly excludes the same items as FSC: certain intangibles, oil and gas, raw timber, prohibited exports, and property in short supply. Unlike FSC, however, military products would apparently qualify for the same benefit as other exports. And unlike the parallel FSC concept of export property, qualifying foreign trade property can be partly manufactured outside the United States. However, not more than 50 per cent of the value of qualified property can be added outside the United States.

The next link in the chain is "foreign trade gross receipts", which the bill defines as income from sale or lease of qualifying trade property, and which parallels the FSC concept of gross receipts. As with FSC, a firm would only be treated as earning foreign trading gross receipts if it conducts economic processes abroad. However, FSC's foreign management requirements (see page 4, above) would be dropped.

The bill next defines "foreign trade income" as taxable income attributable to foreign trading gross receipts. The bill terms a specified part of this foreign trade income "qualifying foreign trade income", and grants such income a tax exemption. The bill sets qualifying foreign trade income (and thus the exclusion) equal to either 1.2 per cent of foreign trading gross receipts, 15 per cent of foreign trade income, or 30 per cent of the income attributable to the foreign economic processes undertaken under the foreign trading gross receipts requirements. (The rule exempting 30 per cent of income is similar in its effect to the FSC rule that applies to firms that use arm's

⁶ Exhibit EC-5A, p. 20.

⁷ Congressional Research Service Report on Foreign Sales Corporation Tax Benefit for Exporting and World Trade Organization *The Foreign Sales Corporation FSC Tax Benefit for Exporting and the WTO* David L. Brumbaugh Specialist in Public Finance. Government and Finance Division (Updated 22 September 2000) - Exhibit EC-6.

length pricing.) As with FSC and the May proposal before it, the arithmetic result of the rules is that a firm can exempt somewhere between 15 per cent and 30 per cent of qualified income from US tax.

19. The main features of the FSC Replacement scheme compared with the FSC scheme to which the EC would draw attention at this point are:⁸

- The FSC Replacement scheme preserves the tax benefits available under the FSC scheme and envisaged in the initial US proposal in May 2000, that is an exemption of between 15 per cent and 30 per cent of export income. The formulae for calculating the exclusion from income are arithmetically equivalent to those available under the FSC scheme (as the EC will explain below).
- The FSC Replacement scheme is however simpler and easier to use than the FSC scheme. The need for a separate foreign corporation to earn the exempted income has been removed and the maximisation of tax benefits by using the most favourable method for calculating qualifying foreign trade income can now be conducted by the US tax authorities;
- The FSC Replacement scheme is available under certain circumstances for income earned from the sale of goods by foreign corporations that elect to be treated as domestic US corporations;
- The 50 per cent foreign content limitation that exists under the FSC scheme has been adapted to the features of the new law so as to include foreign direct labour costs.

20. The FSC Replacement Act therefore does nothing to meet the concerns of the EC, the Panel, the Appellate Body or the DSB about the export subsidies granted by the US tax system. It is an attempt to disguise them. Indeed its purpose is, as US Deputy Secretary of State Eizenstat intimated when urging the US Senate to pass the bill, to prevent immediate retaliation and to give the US “a chance to ‘re-litigate’ the dispute”.⁹

21. The Congressional Budget Office estimated that the FSC Replacement Act would increase tax expenditures compared to the existing FSC scheme by the following amounts:¹⁰

Estimated Budget Effects of H.R. 4986, The ‘FSC Repeal And Extraterritorial
Income Exclusion Act of 2000,’ as Reported by the Committee on Finance

[Fiscal Years 2001– 2010, in millions of dollars]

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2001-05	2001-10
Extra-territorial income	Generally ta	-141	-305	-340	-378	423	-466	-514	-566	-623	-687	-1,587	-4,443

Exclusion: FSC Repeal 9/30/00

Legend for “Effective” column: ta = transaction after.

Note: Details may not add to totals due to rounding.

⁸ For a fuller explanation of the differences between the FSC scheme and the FSC Replacement scheme, the Panel is referred to the annexed documents. The EC will describe the provisions of the Act in more detail as and when necessary below.

⁹ US Deputy Secretary of State Eizenstat speaking during the Senate Finance Committee passing of the bill on 19 September 2000 and reported in Inside US Trade, 22 September 2000, page 26 (Exhibit EC-7).

¹⁰ Taken from the Senate Report of 20 September 2000. The Congressional Budget Office Cost Estimate of 13 September 2000 (Exhibit EC-8) contained slightly higher estimates.

Source: Joint Committee on Taxation.

22. Despite its disappointment with the fact that the US has refused to comply with the recommendations of the DSB, the EC has endeavoured to de-escalate this dispute in the hope that a calm political environment would facilitate the task of the US in ultimately coming into compliance. For this reason, it has entered into a procedural agreement with the US, which it has notified to the WTO¹¹ and which underlines the importance that the EC attaches to the multilateral character of the WTO dispute settlement system.

23. On 17 November 2000 the EC initiated the procedures under Article 21.5 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (“*DSU*”) by requesting the US to enter into consultations.¹²

24. Consultations were held with the US on FSC Replacement scheme in Geneva on 4 December 2000. They allowed a better understanding of the respective positions of the parties but failed to resolve the dispute.

25. Accordingly, the EC requested that the Panel be reconvened to examine this issue under Article 21.5 *DSU*.¹³ The Panel was established on 20 December 2000.

3. LEGAL ANALYSIS

3.1. Introduction

26. In the view of the EC, the FSC Replacement Act fails to bring the US into compliance with the DSB recommendations and rulings and is inconsistent with the covered agreements. The FSC Replacement scheme provides equally prohibited subsidies to US exporters as does the FSC scheme and introduces further prohibited subsidies to certain foreign corporations.

27. There is disagreement both as to the existence and the consistency with covered agreements of measures taken to comply with the recommendations and rulings of the DSB within the meaning of Article 21.5 *DSU*. The US has even refused at the consultations to accept that no measures taken to comply with the recommendations and rulings of the DSB “existed” on the date by which the DSB had fixed for them to be taken.

28. Accordingly, the mandate of the Panel pursuant to Article 21.5 of the *DSU* and in the light of Article 4 of the Agreement on Subsidies and Countervailing Measures (“*SCM Agreement*”) is to determine whether the US has withdrawn the subsidy and complied with the recommendations and rulings of the DSB by the due dates and whether the US measures (the FSC Replacement Act and its related provisions) are consistent with the covered agreements.

29. The EC will set out in the following order the reasons why it considers that the FSC Replacement Act is inconsistent with the obligations of the US under the covered agreements and that by failing to withdraw the subsidies found to be inconsistent with the *SCM Agreement* and to bring its law into conformity with its obligations under the *SCM Agreement* and the *Agreement on Agriculture*, the US has also failed to comply with the DSB recommendations and rulings in this dispute:

- that the FSC Replacement scheme results in the foregoing of tax revenue that is otherwise due, thereby conferring a benefit upon recipients. Therefore, the FSC Replacement Act

¹¹ *Understanding between the European Communities and the United States Regarding Procedures under Articles 21 and 22 of the DSU and Article 4 of the SCM Agreement*, WT/DS108/12, 5 October 2000.

¹² The request was circulated in document WT/DS108/14 of 21 November 2000.

¹³ WT/DS108/16, 8 December 2000.

provides subsidies within the meaning of Article 1 of the *SCM Agreement* and under the *Agreement on Agriculture*;

- that the FSC Replacement scheme provides subsidies which are contingent upon export performance contrary to Article 3.1(a) of the *SCM Agreement* and specifically related to export contrary to item (e) of Annex 1 of the *SCM Agreement*;
- that the FSC Replacement scheme provides subsidies which are contingent upon the use of domestic over imported goods contrary to Article 3.1(b) of the *SCM Agreement*;
- that consequently, the FSC Replacement scheme grants and maintains subsidies contrary to Article 3.2 of the *SCM Agreement*;
- that the FSC Replacement scheme provides treatment less favourable to products imported into the US that is accorded to like US products, contrary to Article III:4 of *GATT 1994*;
- that the subsidies provided by the FSC Replacement scheme are contrary to Articles 10.1 and 8 of the *Agreement on Agriculture*, or in, the alternative, Articles 3.3 and 8 in conjunction with Article 9.1 of the *Agreement on Agriculture*;
- that the FSC Replacement Act contains transitional provisions which allow companies to continue to benefit from the WTO incompatible FSC scheme beyond 30 September 2000;
- that the US has failed to comply with the DSB recommendations and rulings in *United States - Tax Treatment for "Foreign Sales Corporations"*, WT/DS108 by 1 November 2000, as specified by the DSB on 12 October 2000.

3.2. The FSC Replacement scheme continues to provide subsidies

3.2.1. The findings of the Panel and the Appellate Body on the FSC scheme

30. The Panel will recall that the FSC scheme was held to involve a financial contribution by government that confers a benefit and therefore to give rise to a subsidy because it involved the forgoing of revenue that would otherwise be due. As the Appellate Body stated in upholding the finding of the Panel:¹⁴

In our view, the "foregoing" of revenue "otherwise due" implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, "otherwise". Moreover, the word "foregone" suggests that the government has given up an entitlement to raise revenue that it could "otherwise" have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues. There must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised "otherwise". We, therefore, agree with the Panel that the term "otherwise due" implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question.

¹⁴ Appellate Body Report, para. 90.

31. The only point on which the Appellate Body's reasoning on Article 1 of the *SCM Agreement* differed from that of the Panel related to the question of whether:¹⁵

... the term "otherwise due" establishes a "but for" test, in terms of which the appropriate basis of comparison for determining whether revenues are "otherwise due" is "the situation that would prevail but for the measures in question..."

32. The Appellate Body's difficulty with this test was that it was not treaty language and would imply that changing an exception from taxation into an exclusion from taxation would imply that there was no subsidy. In the Appellate Body's words:¹⁶

It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be *no* general rule that applied formally to the revenues in question, absent the contested measures.

33. The Panel and the Appellate Body also stressed that there the *WTO Agreement* did not restrict the right (indeed "the sovereign authority") of WTO Members to tax, or not to tax, particular categories of revenue,¹⁷ so long as it respects its WTO obligations. It appears that the US will attempt to argue that the FSC Replacement Act does not give rise to a subsidy because the US has simply exercised this right and has chosen not to tax a category of income that it terms "extraterritorial" (or "qualifying foreign trade income").

3.2.2. *The changes introduced by the FSC Replacement Act*

34. The FSC Replacement Act abolishes, subject to various transitional arrangements, the FSC exemptions and replaces them with a scheme whereby certain "qualifying foreign trade income" is said to be "excluded" from taxation.

35. This "excluded" qualifying foreign trade income corresponds arithmetically to the exempt foreign trade income of FSC scheme. The text of the new Section 941(a) of the IRC, which defines this concept, merits quoting in full:

(1) IN GENERAL. The term 'qualifying foreign trade income' means, with respect to any transaction, the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest of

(A) 30 per cent of the foreign sale and leasing income derived by the taxpayer from such transaction,

(B) 1.2 per cent of the foreign trading gross receipts derived by the taxpayer from the transaction, or

(C) 15 per cent of the foreign trade income derived by the taxpayer from the transaction.

36. Thus, the new Section 941(a)(1)(A) provides an exclusion equal to 30 per cent of foreign sale and leasing income which corresponds to the 30 per cent exclusion available under in the FSC scheme applicable when the administrative pricing rules are not applied (Section 923(a)(2)). The new Section 941(a)(1)(B) provides an exclusion equal to 1.2 per cent of foreign trading gross receipts is

¹⁵ Appellate Body Report, para. 91 referring to Panel Report, paragraph 7.45.

¹⁶ Appellate Body Report, para. 91.

¹⁷ Panel Report, para. 7.122 and Appellate Body Report, para. 90.

equal to that available under the FSC scheme¹⁸ (multiplying 15/23 by 1.83 per cent yields 1.2 per cent.). The new Section 941(a)(1)(C) provides an exclusion equal to 15 per cent of foreign trade income, which is equal to that available under FSC scheme¹⁹ (multiplying 15/23 by 23 per cent yields 15 per cent).

37. The FSC Replacement Act also simplifies the availability of the benefit by removing the need for a foreign subsidiary (the FSC), removing other formalities and placing on the US Internal Revenue Service the task of identifying the formula that maximises the benefit to the taxpayer for each transaction.

38. The first basic question is therefore whether the fact that the FSC Replacement Act is expressed in terms of *excluding* certain income from taxation, whereas the FSC scheme used the term “*exempt*” (as well as the term “*excluded*”), means that there is no longer any subsidy (because WTO Members are allowed to choose what categories of income they will tax).

39. The EC will show below that the FSC Replacement scheme is just as much a subsidy as was (and is) the FSC scheme. The EC will first explain why the US is playing with words when it claims that the scheme is different from the FSC scheme by *excluding* income from tax rather than *exempting* it. The EC will then return to the terms of Article 1.1 *SCM Agreement* as interpreted by the Panel and the Appellate Body to demonstrate that the cosmetic changes which the US has made have not changed the fact that revenue that is otherwise due is forgone.

3.2.3. *It is irrelevant and misleading to refer to the FSC Replacement scheme as an “exclusion from tax” rather than an exemption*

40. The EC has already noted above²⁰ the Appellate Body’s observation that a formalistic approach based on a distinction between an “exclusion” from tax and an exemption could provide an easy but inappropriate means of circumventing the *SCM Agreement* prohibition on export contingent subsidies. Already for this reason the US device is doomed to fail. The EC will explain why the change in terminology is irrelevant and misleading.

41. Indeed, the words “exemption” and “exclusion” can and are used fairly interchangeably in tax legislation. Already the basic FSC provision, Section 921 of the IRC has as its first heading “Exempt Foreign Trade Income” and as its second “Exclusion.” It operated formally as an exclusion, since income was deemed to be “foreign source income which is not effectively connected with the conduct of a trade or business within the United States” and thus not taxable. In reality everyone recognised, and the Panel and the Appellate Body held, that the FSC scheme exempted income from tax. The confusion of terminology is nothing new, and the EC will now explain why the true nature of the FSC Replacement scheme is that of an exemption from tax.

42. The new Section 114(a) of the IRC inserted by the FSC Replacement Act provides that:

- (a) EXCLUSION. Gross income does not include extraterritorial income.

¹⁸ Sections 923(a)(3) (as modified by Section 291(a)(4) IRC) and 925(a)(1) of the IRC.

¹⁹ Sections 923(a)(3) (as modified by Section 291(a)(4) IRC) and 925(a)(2) of the IRC.

²⁰ Paragraph 31.

43. But Section 114(b) then immediately states that:

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

44. Thus, it is immediately apparent that it is only “qualifying foreign trade income” that is “excluded.” The invention of an additional category of “extraterritorial income” is largely unnecessary, misleading and irrelevant. Read together, paragraphs (a) and (b) do nothing other than provide for a limited exemption from tax of an amount of income that is later defined as qualifying foreign trade income. Reference to the definition of “qualifying foreign trade income” in Section 941(a) further shows that this amount of income is defined in terms of “the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to ...” This is exactly equivalent to an exemption of the amounts that are then listed.

45. As explained in Section 3.2.2 above, the amounts exempted are arithmetically equivalent to the amounts exempted under the FSC scheme.

46. Thus, the first reason why the FSC Replacement scheme is not really an exclusion of income from the tax base but rather a new exemption of income from taxation is that the “excluded income” is expressly defined in terms of “the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to” a defined amount.

47. Clearly, any exemption can be presented as an exclusion in this way. If a WTO Member wanted to give a 1 per cent bounty for the value of goods exported it could simply exclude from taxation “the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to 1 per cent of the value of goods exported.”

48. A second reason why the new scheme creates an exception and not an exclusion from tax liability is that it is subject to a large number of *special conditions*. These will be discussed in more detail below, and it is sufficient to note here that they are not only conditions related to export (i.e. sale for consumption outside the US) but also require, for example, that qualifying property must have less than 50 per cent foreign content. There are also numerous exceptions (for example, the scheme does not apply to the income from the export of lumber or of goods deemed to be in short supply).

49. A third reason why there is an exception and not an exclusion is that only part of the income from a given taxable event (that part which is qualifying foreign trade income) is “excluded” from tax. Indeed the US does subject the major part of what it calls “extraterritorial income” to tax. It is only that variable part of it that is designated qualifying foreign trade income and that the taxpayer chooses to bring within the exclusion that escapes tax. It is not therefore in any event possible to speak of a “category of income” being excluded from tax.

50. The US seeks to turn this argument around²¹ by saying that the *taxation* of the part of extraterritorial income which is not qualifying foreign trade income is the exception to the general rule of not taxing extraterritorial income and that, if it is allowed to exclude all the income, then surely it can exclude some of it.

51. The EC submits that this is merely playing with words. The “exception”, by its very nature, is the decision not to tax a part of such income. The fact that the majority of “extraterritorial income” (the part that is not qualifying foreign trade income) is subject to the normal rate of tax is simply evidence that there is no general rule excluding such income from taxation – this reinforces the argument that the non-taxation of qualifying foreign trade income is the exception.

²¹ [In the House Ways and Means Report of 12.9.2000 (P.10)]

52. Fourthly, the FSC Replacement scheme is *elective*. Firms can choose to avail of the FSC Replacement scheme or use the normal US tax rules until 1 January 2002,²² or, in some circumstances during the indefinite transitional period, the FSC scheme.²³

3.2.4. *The FSC Replacement scheme gives rise to revenue forgone that is otherwise due*

53. The EC submits that the factor that determines whether the FSC Replacement scheme gives rise to a financial contribution and therefore a subsidy is not whether the legislative provisions on which it is based use the word “exclude” or the word “exempt” or neither, but whether there is revenue forgone that is otherwise due within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.

54. Both the Panel²⁴ and the Appellate Body²⁵ made clear that this requires comparison of the revenue actually raised following application of the measure in question and that raised under a “benchmark” situation which would otherwise prevail under the law of the Member in question.

55. The FSC Replacement Act provides that income is partially “excluded” from taxation if all the conditions laid down by the FSC Replacement scheme are satisfied, that is, in particular:

- The income must derive from the sale of “qualifying foreign trade property” and must therefore:
 - be held for ultimate use outside the US;²⁶ and
 - have foreign content of not more than 50 per cent of the fair market value;²⁷
- The income must be “qualifying foreign trade income” (in particular, the property must not be sold for final consumption in the US);²⁸
- Elections must have been made or not made as required;²⁹
- None of the various exclusions from the benefit of the FSC Replacement scheme must apply, such as those:
 - for agricultural and horticultural cooperatives;³⁰
 - for members of groups of companies including DISCs;³¹
 - for FSCs;³²
 - for categories of foreign corporations designated by the Secretary;³³

²² See Section 942(a)(3) of the IRC.

²³ See Section 5 of the FSC Replacement Act and the explanation in Section 3.9 below.

²⁴ Panel Report, paras. 7.42-7.43.

²⁵ Appellate Body Report, para. 90.

²⁶ Section 943(a)(1)(B) of the IRC.

²⁷ Section 943(a)(1)(C) of the IRC.

²⁸ Section 941(a) of the IRC.

²⁹ E.g. under Sections 942(a)(3), 943(e).

³⁰ Section 943(g) of the IRC.

³¹ Section 943(h) of the IRC.

³² Section 5(c) of the FSC Replacement Act.

- exclusion of income by the Secretary as a consequence of participation by taxpayers in an “international boycott” and corrupt practices.³⁴

56. If these conditions are met, the income is “excluded” from taxation. If they are not met, it is not excluded (i.e. is included) and tax is due on it. Consequently, if the conditions are met, the tax revenue that would otherwise be due from this income is not raised – that is, it is forgone.

57. Thus, the “exclusion” from taxation that is effected through the operation of the FSC Replacement scheme cannot at all be assimilated to the non taxation of categories or classes of income that are not subject to taxation. The FSC Replacement Act does not *qualitatively* define a *class or category of income* that is excluded from the tax base – it lays down *conditions* for the partial non-taxation of income that otherwise would be fully taxed. The income is of the same nature whether or not the conditions are met. Part of the income from a single taxable event is taxed and part is not.

58. It is true that WTO Members are free not to tax a *general category* of income and that foreign source income may be one such general category.

59. “Extraterritorial income” is not however foreign source income. As noted in Section 2 above it may be earned entirely in the US and the only “extraterritorial” characteristic is that it is revenue from sales for final consumption outside the US. Although new Section 942(b) IRC establishes a number of foreign economic process requirements, there is no relationship between the value of these processes and the extent to which they are performed outside the US and the amount of income exempted.

60. “Extraterritorial income” (and even less so, qualifying foreign trade income) is not a general category of income that a WTO Member may choose not to tax in conformity with the *SCM Agreement*. It is no more than an artificial device designed to replicate FSC benefits in the guise of a general exclusion.

61. As explained above, what is excluded from tax is a *quantity* of income - “the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to” a predetermined amount.³⁵

3.2.5. *There are two distinguishable subsidies*

62. The novel feature of the FSC Replacement scheme is that it also applies to transactions involving certain foreign produced goods (provided they contain no more than 50 per cent foreign content).

63. The conditions applying to each are not the same and nor, as will be shown, is the analysis under the *SCM Agreement*. The main formal difference is that the subsidy relating to transactions involving certain foreign produced goods only applies if the producing company has volunteered to be subject to US taxation as a domestic company. In addition, there are many other differences of treatment arising from the fact that *formally* identical treatment is applied to differing situations, notably production outside the US rather than inside and by a foreign person rather than by a US person.

³³ Section 943(e)(4)(C) of the IRC.

³⁴ Sections 941(a)(5) of the IRC.

³⁵ See the definition of qualifying foreign trade income in Section 941(a) of the IRC.

64. The EC will refer to the subsidy granted in respect of the export of US produced goods as the “basic FSC Replacement subsidy” and that accorded to transactions involving foreign produced goods as the “extended FSC Replacement subsidy” in order to distinguish them. When there is no need to distinguish the two cases, the EC will refer to them generally as the “FSC Replacement subsidy” or the “FSC Replacement subsidies”.

65. The fact that subsidies paid to foreigners may also fall under the *SCM Agreement* has already been recognised in *Brazil – Export Financing Programme for Aircraft*,³⁶ where the subsidies were paid to non-Brazilian airlines purchasing Brazilian aircraft.

66. The availability of the FSC Replacement scheme to transactions involving foreign produced goods gives rise to revenue forgone and confers a benefit in the same way as the application of the scheme to the export of US produced goods. Indeed, it is arguably even clearer, since foreign produced goods will only be qualifying foreign trade property where the foreign producer affirmatively elects to be treated as a US domestic corporation and benefit from the scheme, whereas the scheme is supposed to apply automatically in the case of exports of US produced goods (unless the taxpayer elects to exclude receipts under Section 943(a)(3)). It is clear that the FSC Replacement scheme will not be invoked in the case of foreign produced goods unless this gives rise to a tax saving under US law.

3.2.6. *The FSC Replacement scheme also provides subsidies within the meaning of the Agreement on Agriculture*

67. In the earlier proceedings, the Panel found that a measure falling within the definition of subsidy under the *SCM Agreement* would also be a subsidy for the purposes of the *Agreement on Agriculture* when applied to agricultural products unless there were provisions of the *Agreement on Agriculture* which suggested a different conclusion.³⁷ The Appellate Body found no reason to disagree with this finding. Nothing in the FSC Replacement Act suggests that a different conclusion is called for in respect of the FSC Replacement scheme.

3.2.7. *Conclusion*

68. The EC therefore concludes that the FSC Replacement scheme created by the FSC Replacement Act gives rise to subsidies within the meaning of the *SCM Agreement* and the *Agreement on Agriculture*.

3.3. The FSC Replacement subsidy is contingent upon export performance

3.3.1. *Introduction – the FSC Replacement scheme as an export subsidy*

69. The US has signalled that its defence of the FSC Replacement scheme will concentrate on its contention that it has eliminated export contingency by making the FSC Replacement scheme available also for transactions involving goods produced outside the US (so long as the foreign content does not exceed 50 per cent).

70. This is in fact a rather extraordinary claim. It defies common sense to suggest that a measure will cease to be an export subsidy if an additional export promoting feature is added to it!

³⁶ *Brazil – Export Financing Programme for Aircraft*, Panel Report, WT/DS46/R, 14 April 1999, and *Brazil – Export Financing Programme for Aircraft*, Appellate Body Report, AB-1999-1, WT/DS46/AB/R, 2 August 1999.

³⁷ Panel Report, paras. 7.149 – 7.151.

71. The US has replaced the requirement of export with a requirement that goods not be sold “for ultimate use in the United States”.³⁸ As regards US goods, this is of course simply another way of saying that they must be exported (and indeed similar language has already been considered by the Panel because it is used in the FSC scheme³⁹). The saving grace of the FSC Replacement scheme, according to the US, is that its scope is wider and also regulates the (probably very rare) case of foreign producers who are subject to US taxation as domestic companies but who produce abroad and whose goods are sold abroad. If the prohibition on export subsidies in the *SCM Agreement* ceases to apply for such a reason, it is a very poorly designed provision indeed.

72. The EC will set out in Sections 3.3.2 to 3.3.5 below a number of detailed legal reasons why the US is wrong. First and most fundamentally, the point of comparison for considering whether a subsidy is contingent upon export performance is the treatment accorded to domestic sales, not the treatment accorded to sales of foreign produced goods. Second, the alleged alternative means of obtaining the subsidy is also export contingent, that is the extended FSC Replacement subsidy is also prohibited. Third, Article 3.1(a) expressly states that a subsidy is prohibited whether export performance is *the sole or one of several* conditions. Fourth, the consequences of an election by a foreign producer to be subject to US tax are such that it cannot be expected that the election will be used in practice.

73. The EC will also argue in Section 3.4 below that the FSC Replacement scheme is also a prohibited export subsidy because it is specifically related to exports.

3.3.2. *The tax treatment of domestic sales of domestic goods, not that of foreign sales of foreign goods, is the proper basis for comparison*

3.3.2.1. Introduction – the US argument

74. Article 3.1(a) of the *SCM Agreement* prohibits:

subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I (footnotes omitted)

75. As noted above, the US appears to be arguing that since it is possible to obtain the FSC Replacement subsidy without exporting, it is not export contingent.

76. Since the subsidy is in fact the exemption (or exclusion) of certain income from tax, the US could in fact be arguing that since it is possible to earn tax free income without exporting, exempting (or excluding) income from tax is not an export subsidy.

77. There are a number of categories of income that are not subject to tax in the US. The FSC Replacement Act operates by inserting a new Section 114 into the IRC that deems certain income to be excluded from “gross income” for US tax purposes. There are many other provisions that do exactly the same. Like the exclusion from gross income that is the starting point of the FSC Replacement scheme, they are contained in Subtitle A, Chapter 1, Subchapter B, Part III of the IRC and include certain rental income, certain interest on State bonds and compensation for sickness.⁴⁰

78. It is immediately apparent that the simple fact that tax free income – or even income that is given the name “extraterritorial” – can be earned without exporting cannot suffice to prevent an export subsidy from being present if such income can be earned contingent upon export performance.

³⁸ Section 942(a)(2)(A)(i) of the IRC.

³⁹ Section 927(a)(1)(B) of the IRC.

⁴⁰ A list of some of the provisions is contained in Exhibit EC-9.

Otherwise, it would have been sufficient to include in the exemption any other category of income which is already exempted, or which it is thought desirable to exempt from tax.

79. In order to assess whether an exemption is contingent upon export or specifically related to export, there must be a comparison with some relevant benchmark.

80. The US seems to be arguing that the relevant benchmark for the tax treatment of sales of US produced goods sold outside the US can be taken to be the tax treatment of foreign produced goods sold outside the US and then argues that the tax exemption for income from such sales of the US produced goods is not export contingent because the same treatment is given to foreign produced goods.

81. The argument is mistaken because the wrong benchmark is being used. For the reasons that will be examined in the next Section, the correct benchmark in the case of the US produced goods is the treatment accorded to domestic sales.

3.3.2.2. The correct benchmark for US produced goods

82. The EC submits that the correct benchmark must be determined by examining the terms of Article 3.1(a) in context.

Contingent

83. It is the term “contingent” that has been subject of most attention in export subsidy cases so far. The Appellate Body has explained, for the first time in *Canada – Measures Affecting the Export of Civilian Aircraft* (“*Canada - Aircraft*”), that “contingent” is the key word in Article 3.1(a). It stated that⁴¹:

...the ordinary connotation of "contingent" is "conditional" or "dependent for its existence on something else". This common understanding of the word "contingent" is borne out by the text of Article 3.1(a), which makes an explicit link between "contingency" and "conditionality" in stating that export contingency can be the sole or "one of several other *conditions*".

84. The Appellate Body has also made clear that “the legal standard expressed by the word ‘contingent’ is the same for both *de jure* or *de facto* contingency”⁴² and that it is only the evidence that differs.⁴³ In *Canada – Certain Measures Affecting the Automotive Industry* (“*Canada – Automobiles*”),⁴⁴ it went on to say that:

A subsidy is contingent "in law" upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure. The simplest, and hence, perhaps, the uncommon, case is one in which the condition of exportation is set out expressly, in so many words, on the face of the law, regulation or other legal instrument. We believe, however, that a subsidy is also properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be *de*

⁴¹ *Canada – Measures Affecting the Export of Civilian Aircraft*, Appellate Body Report, AB-1999-2, WT/DS70/AB/R, 2 August 1999, para. 166.

⁴² *Ibid.*, para. 167.

⁴³ *Ibid.*

⁴⁴ *Canada – Certain Measures Affecting the Automotive Industry*, Appellate Body Report, AB-2000-2, WT/DS139/AB/R, WT/DS142/AB/R, 31 May 2000, para. 100.

jure export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfilment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.

Export

85. The term “export” is not defined in the *SCM Agreement* despite its fundamental importance. The dictionary definition of the noun “export” is

An article that is exported⁴⁵

and the verb “export” means:

Send (esp. goods) to another country⁴⁶

86. As usual, this dictionary definition is not of much help. Guidance is available however from the context in which this word is used, that is the rest of the *SCM Agreement* and indeed the rest of the *WTO Agreement*.

87. The importance of the context is also evident when one considers that if the term “export” were taken literally to refer to any export in the abstract independently of its context then any autonomous reduction of import duties on a product by a country would be a prohibited export subsidy since there would be revenue forgone and a benefit conferred and the amount would depend, literally, on export performance (of the third country exporters). It may be assumed that this was not the intention of the WTO Members when they concluded the *SCM Agreement*. It is necessary therefore to examine the meaning of the term in its context.

88. The immediate context is of course the Illustrative List, which is expressly stated to illustrate, that is to shed light on, the meaning of Article 3.1(a). In many places in the Illustrative List it is made clear that the term “export” refers to products *destined for the market* of another country, or *for consumption in* that other country. Thus, items (d), (f), (g) and (h) all require a comparison of the conditions applicable to exports with those applying in the case of goods for domestic consumption. Item (l) includes in the Illustrative List export subsidies identified in Article XVI of *GATT 1994*, paragraph 4 of which refers to export subsidies as giving rise to bi-level pricing between markets.⁴⁷

89. Looking to the rest of the *SCM Agreement*, it may be noted that the first mention of the word “export” occurs in its footnote 1, which contrasts “exports” with “the like product when destined for domestic consumption.”⁴⁸

⁴⁵ *New Shorter Oxford English Dictionary* CD-ROM version (1997).

⁴⁶ *New Shorter Oxford English Dictionary* CD-ROM version (1997).

⁴⁷ Article XVI:4 of the *GATT 1994* provides as follows:

Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. Until 31 December 1957 no contracting party shall extend the scope of any such subsidization beyond that existing on 1 January 1955 by the introduction of new, or the extension of existing, subsidies.*

⁴⁸ The full text of footnote 1 is:

In accordance with the provisions of Article XVI of *GATT 1994* (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the exemption of an exported product from duties or

90. The fact that the term “exports” describes goods *destined* for the markets of (that is, consumption in) other countries is also clearly expressed in *GATT 1994*. Thus, Article I of *GATT 1994* associates the concepts of importation/exportation and imports/exports with the phrase “products originating in or destined for any other country”⁴⁹ and similar language is found elsewhere in *GATT 1994*. That the use of the term “destined for” in relation to exports is not accidental is shown by Article V of *GATT 1994* which does not refer to exports but defines the contrasting concept of “transit”.⁵⁰

91. Thus, the EC submits that the term “export” in Article 3.1(a) of the *SCM Agreement* refers to the sale of:

- Goods;
- Originating in the country providing the subsidy;
- Destined for the market of, that is for final consumption in, another country.

92. The EC considers that this examination of the term “export” as used in Article 3.1(a) demonstrates that the provisions are written from the perspective of goods located in the country providing the subsidy and that accordingly the basis for comparison for the treatment accorded to export transactions is that accorded to domestic transactions.

Performance

93. The fact that the perspective of the Article 3.1(a) is that of producers in the territory of the country granting the subsidy is also clear from the use of the word “performance”.

94. The primary dictionary definition of “performance” in this context is

The execution or accomplishment of an action, operation, or process undertaken or ordered; the doing of any action or work; the quality of this, esp. as observable under particular conditions;⁵¹

95. Used with the word “export”, this word implies that the link or dependency need not exist for every single transaction but that exports in general (that is the *process* of export) should be determined by the availability of the subsidy. Thus a commitment to export 50 per cent of the output resulting from a subsidised production facility would be contingent upon export performance, even though there is no requirement to export every product produced by the facility.

taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy.

⁴⁹ The full text of Article I:1 of the *GATT 1994* reads:

With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III,* any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

⁵⁰ Article V:1 provides that:

Goods (including baggage), and also vessels and other means of transport, shall be deemed to be in transit across the territory of a contracting party when the passage across such territory, with or without trans-shipment, warehousing, breaking bulk, or change in the mode of transport, is only a portion of a complete journey beginning and terminating beyond the frontier of the contracting party across whose territory the traffic passes. Traffic of this nature is termed in this article “traffic in transit”.

⁵¹ *New Shorter Oxford English Dictionary* CD-ROM version (1997).

Conclusion

96. Accordingly, the EC considers that it does not need to show that *all* subsidies granted under the FSC Replacement scheme are export dependent. It is sufficient if some of the beneficiaries receive the benefit conditional upon exporting from the US rather than selling domestically. If there are circumstances in which exportation is obligatory in order to obtain the subsidy, then the subsidy is dependent or contingent upon export in these circumstances, and must therefore be an export subsidy.

97. Thus, the notion of contingency does not exist in the abstract but must be understood in the light of the actual circumstances of a recipient and compared with the relevant alternative (in the case of export contingency sale for consumption abroad rather than sale for domestic consumption). In particular, producers (or more exactly owners) of US goods have no choice but to export in order to obtain the subsidy in respect of those goods.

98. It is true that where a subsidy is made available, for example, to all producers of shoes, some producers may in fact qualify by producing shoes which they export, but this does not make the subsidy export contingent. Each producer is free to sell on the domestic market or to export and this does not affect entitlement to the subsidy. However, in the case of the FSC Replacement scheme, the situation is different. Owners of US goods for sale in the US do not have a choice in how to obtain the subsidy. They cannot, unlike the shoe manufacturers in the above example, satisfy the conditions by selling domestically. They have to export. Thus they obtain the subsidy by performing one function, export, in preference to another, selling on the domestic market.

3.3.2.3. Application to the FSC Replacement scheme

99. The FSC Replacement Act avoids any mention of the word “export”. It uses other words to achieve the same result. (It is not uncommon for export subsidies to avoid the word “export” as the Appellate Body remarked in *Canada – Automobiles*.⁵²) The FSC Replacement scheme is only available in respect of sales of “qualifying foreign trade property.” Part of the definition of this concept limits it to goods for use or consumption outside the US. Section 943(a)(1)(B) of the IRC provides that it must be:

held primarily for sale, lease, or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States,

100. Further, the sale of qualifying foreign trade property for ultimate use in the US will prevent foreign trading gross receipts from arising. Section 942(a)(2)(A)(i) of the IRC provides that

The term ‘foreign trading gross receipts’ shall not include receipts of a taxpayer from a transaction if the qualifying foreign trade property or services are for ultimate use in the United States

101. The phrase “for ultimate use within the US” is for US goods obviously simply another way of saying “not exported”. Thus, the key distinction for the availability of the FSC Replacement subsidy is whether such property is exported. A sale of goods for ultimate use outside the US (i.e. an export) has as its consequence the availability of the FSC Replacement subsidy; a sale of goods for ultimate use in the US is deprived of the same advantage. The EC submits that that makes the availability of the subsidy contingent upon export performance.

⁵² See the quotation from the Appellate Body in the discussion of the word “contingent” in Section 3.3.2.2 above.

102. It is true that the same consequence (the availability of the FSC Replacement subsidy) can arise in other ways. One example is the provision of services outside the US. That does not diminish the fact that it is only available to US goods if they are exported, not if they are sold on the US market. It does not undermine the conclusion that this availability for export is a reward for export performance.

103. It is also true that the same consequence can arise through production and sales of certain goods outside of the US (although, as will be discussed below, this is not likely). Again, that is not the relevant point of comparison. Article 3.1(a) addresses export contingency relating to the goods of the country providing the subsidy (in this case the US) and prohibits making the availability of the subsidy contingent on export performance and therefore on whether the goods are exported.

3.3.3. The alleged alternative means of obtaining the subsidy is also export contingent, that is, the extended FSC Replacement subsidy is also prohibited

104. Another reason why the US attempt to remove the export contingency from the FSC Replacement scheme fails is that the alleged alternative means of obtaining the subsidy (the EC will explain in Section [3.3.5] below that it is unlikely to be used) also involves export contingency. In other words, the extended FSC Replacement subsidy is also prohibited.

105. If both elements of the FSC Replacement subsidy are contingent upon export performance, so, whatever interpretation of Article 3.1(a) is adopted, is the whole.

106. The export contingency of the extended FSC Replacement subsidy arises out of the requirement that the foreign produced goods be sold outside the US in conjunction with the fact that they cannot be qualifying foreign trade property and therefore cannot benefit from the FSC Replacement scheme if they have a foreign content exceeding 50 per cent.

107. As already mentioned above, the FSC Replacement subsidy is only available for the sale of “qualifying foreign trade property”. According to Section 943(a)(1) of the IRC:

The term ‘qualifying foreign trade property’ means property –

- (A) manufactured, produced, grown or extracted within or outside the United States
- (B) held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and
- (C) no more than 50 per cent of the fair market value of which is attributable to -
 - (i) articles manufactured, produced, grown, or extracted outside the United States, and
 - (ii) direct costs for labour (determined under the principles of Section 263A)

performed outside the United States.⁵³

108. In many cases, the requirement that no more than 50 per cent of the fair market value be attributable to articles manufactured, produced, grown, or extracted outside the United States, and

⁵³ Emphasis added.

direct labour costs will mean that inputs will have to be exported from the US, as the EC will now proceed to demonstrate.

109. The terms “articles” and “attributable” are not defined in the legislation. It may be that the US will clarify them during these panel proceedings and the EC may then be able to refine its argument on this point.

110. However, for present purposes, it is sufficient to note that fair market value of a product (FMV) can be considered to be made up of the sum of the following:

- The cost of “articles attributable” (hereinafter “articles”) (A), which may again be split into:
 - US articles; (A1) and
 - Foreign articles (A2);
- The direct cost of labour (B);
- The cost of other inputs (which may include energy, royalties for intellectual property used, overheads etc) (C);
- Profit (D).

111. If these categories are considered to cover all costs (with any residual costs being included in (C), $A1+A2+B+C+D$ must equal the sales price (SP). In normal cases SP will be equal to FMV.

112. Since $A2 + B$ may not exceed 50 per cent of P, (i.e. $A2 + B$ must be $=$ or $<$ $SP/2$), then mathematically,

$A1+C+D$ must constitute at least 50 per cent of SP (i.e. $A1+C+D$ must be $=$ or $>$ $SP/2$ which can be expressed as $A1 =$ or $>$ $SP/2-C-D$). This means that A1 will be positive whenever $SP/2 > C+D$

In other words, US articles must be used whenever the cost of other inputs (not articles or direct labour) (C) and profit (D) are less than 50 per cent of the selling price (or more exactly the US-assessed fair market value) of the goods.

113. This condition (and therefore the need for there to be exports of US articles) will not always be met but it will in many cases. Whether it is met or not will depend on the nature of the production process. There are a series of factors that render the condition more difficult to meet and others that render it easier to meet. Factors that will make the condition more difficult to meet include:

- A high cost of articles used in production;
- A high amount and therefore cost of foreign direct labour in production;
- A low intellectual property component;
- A low profit.

114. Correspondingly, factors that will make the condition easier to meet include:

- A low cost of articles used in production;
- A low amount and therefore cost of foreign direct labour in production;
- A high intellectual property component;
- A high profit margin.

115. The EC's point is that the importance of these factors varies between sectors and companies and there will inevitably be companies who will have to use US products. That in the EC view is sufficient to establish contingency.

116. In order to illustrate this argument, the Annex to this submission gives a series of examples of where the requirement to use US articles must arise in practice. The Annex identifies cases where the cost of "articles" used to produce finished goods exceed 50 per cent of the value of the finished product. In all these cases, some US articles will have to be used in order to produce "qualifying foreign trade property". In fact, the approach followed in the Annex is conservative since foreign direct labour costs are not taken into account in the Annex but are included in the foreign content limitation, thus further reducing the ability of producers to fulfil the condition without using US articles. In other words, for every percentage increase in the value of foreign direct labour, there is a corresponding increase in the percentage in value of US articles that must be used.

117. Even in cases where the above foreign content limitation could be met without the need for US inputs, a foreign producer who wishes his goods to benefit from the FSC Replacement scheme will still have an incentive to purchase US goods in order to make it easier to comply with the requirement and to ensure that the benefit will be available.

118. The foreign content is expressed as a fraction of the price a company can obtain from the sale of the finished product. However, the price a company expects from the sale of such finished product may not materialise due to a number of unforeseen (or not entirely foreseen) circumstances: for example price trends may dramatically change downwards so that the fair market value also decreases (and a company can no longer obtain the prices based on which it had made its production calculations). In order to minimise such risk of not being able to qualify, companies will need to reduce the value of foreign articles and direct labour to a level that will always ensure that they account for no more than 50 per cent of the price, even in case of price decreases.

119. Accordingly, the fact that the extension of the FSC Replacement scheme to foreign produced goods is subject to a foreign content requirement creates in many cases a requirement for exports to be made from the US. This renders the extended FSC Replacement subsidy also export contingent and thus prohibited.

120. Since both elements of the FSC Replacement subsidy are contingent upon export performance, so is the whole. The FSC Replacement scheme is therefore a prohibited export subsidy contrary to Article 3.1(a) of the *SCM Agreement*.

3.3.4. *Article 3.1(a) expressly states that a subsidy is prohibited whether export performance is the sole or one of several conditions.*

121. The US approach to implementation of the Panel Report has been to endeavour to hide, what is essentially the same subsidy as that before the Panel in the original proceeding, within a slightly wider subsidy. It does this by adding to the basic FSC Replacement subsidy the extended FSC Replacement subsidy.

122. The drafters of the *SCM Agreement*, were aware of the potential for such devices and expressly provided that a subsidy shall be prohibited if it is contingent "contingent, ... *whether solely or as one of several other conditions*, upon export performance."

123. In other words, a subsidy that is export contingent in some situations does not cease to be so if it can also be obtained in other situations which do not require export. A subsidy that is available to exporters and to producers of certain categories of goods is still prohibited in those situations where export is required to obtain it.

124. To take an example: suppose a subsidy programme is available to all goods produced in a certain region of a WTO Member's territory, but only available to goods produced outside that region if exported from that WTO Member's territory. It is true that it is not in all circumstances necessary to export to obtain the subsidy, since goods from the eligible region can benefit if sold domestically. But goods from outside the eligible region can only qualify for the subsidy when exported. There are no "alternative" conditions in this case - the subsidy is export contingent. The same situation arises with the FSC Replacement scheme. Although there may be cases of production outside the US that may benefit in the absence of export, goods produced in the US can only obtain the benefit in one way - if exported. In these circumstances, the subsidy is export contingent.

125. It is true that a where a subsidy is made available, for example, to all producers of shoes, some producers may in fact qualify by producing shoes which they export, but this does not make the subsidy export contingent. Each producer is free to sell on the domestic market or to export and this does not affect entitlement to the subsidy. However, in the case of the FSC Replacement scheme, the situation is different. Owners of US goods produced in the US do not have a choice in how to obtain the subsidy. They cannot, unlike the shoe manufacturers in the above example, satisfy the conditions by selling domestically. They have to export. Thus they obtain the subsidy by performing one function, export, in preference to another, selling on the domestic market.

126. That this is the correct interpretation of Article 3.1(a) is confirmed by the panel and Appellate Body reports *Canada – Aircraft*. One of the subsidies involved in that case, the Technology Partnerships Canada programme, was available to non-export sectors such as environmental technologies and "enabling technologies."⁵⁴ The fact that the subsidy was available in some situations without any export contingency did not stop the payments under the programme to the regional aircraft industry being found export contingent.

127. Thus, even if the Panel were not to agree with the position set out in Section 3.3.2 above - that the extended FSC Replacement subsidy is also export contingent, this will not prevent a finding that the basic FSC Replacement subsidy is export contingent.

128. Indeed, the above view of alternative conditions is also that adopted by the US when it applies its own countervailing duty rules on export subsidies to foreign producers. This rule (§351.514 of the US countervailing duty rules) is very similar to Article 3.1(a) of the *SCM Agreement*, read with its footnote, since it provides that:

....(a) *In general*. The Secretary will consider a subsidy to be an export subsidy if the Secretary determines that eligibility for, approval of, or the amount of, a subsidy is contingent upon export performance. In applying this section, the Secretary will consider a subsidy to be contingent upon export performance if the provision of the subsidy is, in law or in fact, tied to actual or anticipated exportation or export earnings, alone or as one of two or more conditions."

In the discussion section of its own countervailing duty rules, the US states that:⁵⁵

In situations where the government evaluates multiple criteria under a program, §351.514 would require an analysis different from that described in Extruded Rubber Thread from Malaysia, 57 FR 38472 (August 25, 1992). In that case, the Malaysian Government considered 12 criteria in evaluating whether a particular company should receive "pioneer" status. Two of these criteria addressed the export potential of a product or activity. In addition, in certain situations, companies were required to

⁵⁴ See e.g. *Canada – Aircraft*, Panel Report, para. 6.174.

⁵⁵ US Department of Commerce (International Trade Administration) Countervailing duties : Final Rule 19 CFR Part 351 (WTO Document G/ADP/N/1/USA/1/Suppl.4, G/SCM/N/1/USA Suppl.4 29.3.99 p.62)

agree to export commitments. In analyzing the Pioneer program, the Department examined the criteria being applied with respect to a particular company. If one or more of the criteria applied by the Government included favorable prospects for export, but the export criteria did not carry preponderant weight, we did not consider the award of Pioneer status to constitute an export subsidy. *However, under the new standard contained in §351.514, if exportation or anticipated exportation was either the sole condition or one of several conditions for granting Pioneer status to a firm, we would consider any benefits provided under the program to the firm to be export subsidies unless the firm in question can clearly demonstrate that it had been approved to receive the benefits solely under non-export-related criteria.* In such situations, we would not treat the subsidy to that firm as an export subsidy. (Emphasis added in italics).

129. Thus it is clear that in its countervailing duty law, the US considers that export subsidies exist for some firms even in cases where certain other firms can demonstrate that they do not need to obtain the benefits. This situation is analogous to that of the FSC Replacement scheme.

130. Indeed, the contention of the US that the *SCM Agreement* should be interpreted so as to allow the FSC Replacement scheme to escape the disciplines of the *SCM Agreement* bring to mind the words used by the US in connection with an export subsidy of another Member, when it said of an argument made by that Member:⁵⁶

If adopted, this standard would enable governments to engage in the very sorts of manipulation and modifications of subsidy programmes that the drafters of the *SCM Agreement* sought to curtail.

3.3.5. *The consequences of an election by a foreign producer to be subject to US tax are such that it cannot be expected that the election will be used in practice.*

131. The EC further considers that the addition of the extended FSC Replacement subsidy to the FSC Replacement scheme is merely cosmetic (and an attempt to hide a prohibited export subsidy) because there are a number of reasons to believe that it will rarely be used.

132. The most important of these reasons is that the extended subsidy is only available where the foreign producer makes an election to be taxed as a domestic US corporation. Section 943(a)(2) of the IRC provides that:

Property which (without regard to this paragraph) is qualifying foreign trade property and which is manufactured, produced, grown, or extracted outside the United States shall be treated as qualifying foreign trade property only if it is manufactured, produced, grown, or extracted by

- (A) a domestic corporation,
- (B) an individual who is a citizen or resident of the United States,
- (C) a foreign corporation with respect to which an election under subsection (e) (relating to foreign corporations electing to be subject to United States taxation) is in effect, or
- (D) a partnership or other pass-thru entity all of the partners or owners of which are described in subparagraph (A), (B) or (C);

⁵⁶ Panel Report, *Canada – Aircraft*, paragraph 7.143.

133. The election required by Section 943(a)(2) would create additional tax liability, reporting requirements and administrative burdens on the corporation without reducing its liability, requirements and burdens in its own jurisdiction. Foreign corporations are only likely to elect to be treated as domestic companies in the US in such situations where such an election would entail an overall tax saving (or a benefit) and thus it is only likely to be contemplated in special circumstances.

134. In addition, Section 943 (e)(1) provides that:

(e) ELECTION TO BE TREATED AS DOMESTIC CORPORATION. -

(1) IN GENERAL. - An applicable foreign corporation may elect to be treated as a domestic corporation for all purposes of this title if such corporation waives all benefits to such corporation granted by the United States under any treaty. No election under section 1362(a) may be made with respect to such corporation.

135. Any benefit that might possibly arise from being treated as a US domestic corporation and benefiting from the FSC Replacement scheme would have to weighed against the consequences of waiving *all* benefits granted by the US under *any* treaty!

136. It is true that elections under the FSC Replacement scheme can be revoked for subsequent tax years but this also brings with it serious disadvantages.

137. The additional tax consequences of elections and their revocations require some explanation. By virtue of Section 943 (e)(4)(B):

(B) EFFECT OF ELECTION, REVOCATION, AND TERMINATION. -

(i) ELECTION. - For purposes of section 367, a foreign corporation making an election under this subsection shall be treated as transferring (as of the first day of the first taxable year to which the election applies) all of its assets to a domestic corporation in connection with an exchange to which section 354 applies.

(ii) REVOCATION AND TERMINATION. - For purposes of section 367, if -

(I) an election is made by a corporation under paragraph (1) for any taxable year, and

(II) such election ceases to apply for any subsequent taxable year,

such corporation shall be treated as a domestic corporation transferring (as of the 1st day of the first such subsequent taxable year to which such election ceases to apply) all of its property to a foreign corporation in connection with an exchange to which section 354 applies.

138. This provision confirms that an election of a foreign corporation to be treated as a US domestic corporation gives rise to a deemed transfer of assets between corporation. One consequence of this is that non-distributed profits of a foreign corporation are immediately subject to US taxation when a foreign corporation elects to be treated as a US domestic corporation, which may not have been the case otherwise.⁵⁷ Another, and arguably more serious consequence, is that an election to

⁵⁷ More precisely, the regulations under Section 367(b) will require US shareholders of the foreign corporation to take into income a deemed dividend based on the undistributed earnings of the corporation accumulated prior to its election. The FSC Replacement Act has a transition provision (Section 5(c)(3)) pursuant to which earnings and profits accumulated by the domesticating corporation in taxable years ended

cease being treated as a US domestic corporation gives rise to a deemed transfer of assets out of the US. This will give rise to US tax charge not only on all its non-distributed profits but also on unrealised capital gain in the value of its assets. This latter future and uncertain tax liability on the revocation of an election is likely to be the greater barrier to the making of an election to be treated as a US domestic corporation in the first place since its importance will not be known when that election is made.

139. Electing to be treated as US domestic corporations for US tax purposes may subject foreign corporations them to reporting and other requirements inconsistent with their domestic law and possibly impact in other ways on their business. The principle behind bilateral tax treaties is that a corporation will be resident in one jurisdiction or another (even though it may be subject to tax as a non-resident in the jurisdiction where it is not resident). Traditionally, the primary purpose of such treaties is to eliminate or reduce double taxation, with the ancillary goal of determining the taxing rights of the Contracting States. As regards business income, the OECD Model Tax Convention (on which most tax treaties concluded between industrialised countries are based) provides that it is only taxable in the Contracting State in which the taxable person is resident. A Contracting State may only impose tax on the business income of a resident of the other Contracting State in so far as this has a permanent establishment in the first mentioned Contracting State. An election under the FSC Replacement scheme will disrupt this assumption and mean that corporations will start to be resident for tax purposes in two jurisdictions, which can give rise to potential conflicts. To date the consequences of such conflicts remain unknown, which is why it is also reasonable to presume that any prudent economic operator (in this case a foreign corporation) might be reluctant to elect to be treated in the US as a domestic corporation. By doing so it would assume a risk of rather adverse effects of which the significance is unknown to it at the time of the election.

140. Indeed one example of a conflict is given in apparent from the FSC Replacement Act itself. New Section 941(a)(5) IRC, for example, denies the benefit of the scheme to firms that participate in “international boycotts etc.”. Clearly, many other States may make participation in such boycotts obligatory.

141. More generally in the case of tax law, US law may require certain expenses to be written off over a period that conflicts with the period required by other jurisdictions.

142. It may also be expected that foreign governments will oppose (or refuse to acknowledge) their corporations becoming subject to all the obligations of the US tax code. The elections provided for in the FSC Replacement scheme disrupt the balance of rights and obligations, benefits and costs, on which bilateral tax treaties are concluded. Accordingly, as the treaty rights of a foreign government would be breached it might in its turn decline to respect its treaty obligations (for example, granting of double tax relief). Any prudent foreign corporation contemplating election to be treated in the US as a domestic corporation would certainly be mindful of this risk and assess its importance against any potential benefits from it could receive as a result of the election. Foreign governments may also object to corporations under their jurisdiction being required “to waive all benefits ... granted by the US under any treaty” and to way this provision may be interpreted by the US. Such objections by foreign governments could be based on the rights they have under bilateral tax treaties (which will limit the way in which the US can tax the foreign country’s corporations) and on the basis of international law principles of jurisdiction which limit the extent to which States may assert jurisdiction over foreign corporations. There is no exception to these principles that would allow corporations to “elect” to be subject to a State’s jurisdiction in return for some benefit.

143. It is clear that if a foreign government objected to corporations under its jurisdiction waiving their rights and electing to be subject to the US tax code, that election could not be made.

prior to 1 October 2000 will not be included in the income of the shareholders of the corporation. This transition provision is applicable only in those circumstances specified in the provision.

144. Additionally, as explained above, foreign corporations can in many cases only benefit from the FSC Replacement scheme if they use US articles. This is a further disincentive to using the scheme.

145. In view of these obstacles, the EC considers that even if the extension of the FSC Replacement scheme to foreign production had its intended effect of removing the *de jure* export contingency of the scheme (*quod non*), that scheme would in any event remain *de facto* export contingent and still be contrary to Article 3.1(a) of the *SCM Agreement*.

3.3.6. Conclusion

146. For all these reasons the EC considers that the FSC Replacement scheme is a prohibited export subsidy contrary to Article 3.1(a) of the *SCM Agreement*.

3.4. The FSC Replacement subsidies are specifically related to exports within the meaning of item (e) of the Illustrative List

3.4.1. Introduction

147. In this Section the EC will explain that item (e) of the Illustrative List in Annex I to the *SCM Agreement* also renders the FSC Replacement subsidies prohibited.

148. Item (e) defines as an export subsidy:

The full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises (footnotes omitted)

149. This provision is specifically designed to deal with export subsidies granted through the tax system.

150. The Panel considered Item (e) in its report in the original proceeding⁵⁸ and considered it to be applicable to the FSC scheme – in particular that the provision applied to exemptions from corporation taxes and that the beneficiary taxpayers were “industrial or commercial enterprises”.

151. Although the FSC Replacement scheme differs slightly from the FSC scheme in that part of the income is expressed as being “excluded” from tax rather than expressed as an “exemption,” it has been demonstrated in Section 3.2 above that it is in substance an exemption. The term “exports” has already been discussed in detail above. It remains to examine the meaning of “specifically related to” exports.

152. The dictionary definition of “specifically” is:

- (a) in respect of specific or distinctive qualities;
- (b) peculiarly;
- (c) in a clearly defined manner, definitely, precisely⁵⁹

and the dictionary definition of “related” is:

⁵⁸ Panel Report, para. 7.110.

⁵⁹ *New Shorter Oxford English Dictionary* CD-ROM version (1997).

Having relation; having mutual relation; connected⁶⁰

153. Accordingly, “specifically related to exports” means “having a special, precise or clearly defined relationship or connection to exports”.

3.4.2. *The FSC Replacement subsidies are caught by item (e)*

154. The EC has shown above that the FSC Replacement subsidies are *contingent* upon export performance because they are dependent upon exportation.

155. The “exports” referred to in item (e) must be understood in the same as “export” in Article 3.1(a), that is as referring to exports from the country granting the subsidy.

156. Contingency is a particular form of special relationship. Therefore any subsidy that is contingent upon export performance must, necessarily, also be “specifically related to exports” within the meaning of item (e)

157. However, the term “specific relation” is broader than the term “contingency.” The former term covers any specific link and thus would include a simple *incentive*. Thus, since the Illustrative List illustrates the meaning of Article 3.1(a), the prohibition on export subsidies must, at least, as it applies to subsidies granted through the tax measures described in item (e), also cover measures that specifically encourage exports.

158. Accordingly item (e) supports and confirms the conclusion that the FSC Replacement subsidies are prohibited under Article 3.1(a) *SCM Agreement*.

3.5. The FSC Replacement scheme provides subsidies which are contingent upon the use of domestic over imported goods contrary to Article 3.1(b) of the SCM Agreement

3.5.1. *Introduction – the US rules*

159. In the same way as the FSC scheme, the FSC Replacement scheme continues to require, as a condition for enjoying the tax benefit it provides, that the qualifying transactions concern goods produced with a foreign content not exceeding 50 per cent (which now includes direct labour costs). The EC submits that this requirement makes the FSC Replacement scheme contingent in law “upon the use of domestic over imported goods” within the meaning of Article 3.1(b) of the *SCM Agreement*. The EC submits, in the alternative, that even if the Panel considered that this requirement does not amount to contingency in law, it would still need to conclude that, for certain sectors, it *de facto* makes resort to US inputs necessary and the subsidy is therefore *de facto* contingent upon the use of domestic over imported goods.

160. The virtual identity of this requirement which with the one applicable to FSCs is immediately apparent:

⁶⁰ *New Shorter Oxford English Dictionary* CD-ROM version (1997).

<p>IRC RULES APPLICABLE TO FSC SCHEME Sec. 927. OTHER DEFINITIONS AND SPECIAL RULES</p>	<p>FSC REPLACEMENT ACT SCHEME – NEW IRC RULES Sec. 943. OTHER DEFINITIONS AND SPECIAL RULES</p>
<p>(a) EXPORT PROPERTY - For purposes of this subpart – (1) IN GENERAL. –</p>	<p>(a) QUALIFYING FOREIGN TRADE PROPERTY - For purposes of this subpart – (1) IN GENERAL. –</p>
<p>The term "export property" means property -</p>	<p>The term ‘qualifying foreign trade property’ means property –</p>
<p>(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.</p>	<p>(A) manufactured, produced, grown or extracted within or outside the United States, (B) held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and (C) no more than 50 per cent of the fair market value of which is attributable to– (i) articles manufactured, produced, grown, or extracted outside the United States, and (ii) direct costs for labour (determined under the principles of Section 263A) performed outside the United States.(emphasis added)</p>
<p>For purposes of subparagraph (C), the fair market value of any article imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation.</p>	<p>For purposes of subparagraph (C), the fair market value of any article imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation, and the direct costs for labour under clause (ii) do not include costs that would be treated under the principles of section 263A as direct labour costs attributable to articles described in clause (i).</p>

161. In addition, the rules relating to “excluded property” and other limitations to “export property” are carried over in the FSC Replacement scheme in relation to “qualifying foreign trade property”.

162. Thus, apart from some adjustments to take account of the fact that a separate legal entity in the form of a FSC is no longer required, the only innovation appears to be the addition of foreign direct labour costs to the foreign content to which the 50 per cent limitation applies.⁶¹ The EC will explain below that this difference does not appreciably change the situation which already gave rise to its claim under Article 3.1(b) of the *SCM Agreement* in respect of the FSC regime, and that its arguments developed in the original Panel and Appellate Body proceedings apply *mutatis mutandis*.

3.5.2. Article 3.1(b) of the *SCM Agreement*

163. The EC submits that, by providing for the requirement just described, the FSC Replacement scheme makes the granting of a subsidy contingent upon the use of US goods thereby violating Article 3.1(b) of the *SCM Agreement*.

⁶¹ The EC of course assumes that identical words used in different parts of the IRC will have the same meaning unless otherwise specified.

164. Article 3.1(b) prohibits:

subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods

165. The only appropriate meaning for the word “over” in this context given by the *New Shorter Oxford English Dictionary* is “in preference to”.⁶² Accordingly, the words “use of domestic over imported” mean “use of domestic *in preference to* imported” and render this provision very broad, so that it may include any form of “preference” or “incentive” or “boost” to domestic production by the Member conferring a subsidy at the expense of imported goods.

166. The Appellate Body has had one recent occasion to interpret this provision. In doing so, it has notably:

- extended its interpretation of “contingent” developed with respect to Article 3.1(a) to Article 3.1(b);⁶³
- extended its interpretation of *de iure* contingency developed under Article 3.1(a) of the *SCM Agreement* to Article 3.1(b);⁶⁴
- clarified that Article 3.1(b) covers subsidy schemes which are *de iure* contingent upon use of domestic over imported goods, but also *de facto* ones;⁶⁵
- clarified that the wording “use of domestic over imported goods” also covers value added requirements.⁶⁶

3.5.3. *The basic FSC Replacement subsidy is contingent upon use of domestic over imported goods*

167. The FSC Replacement scheme does not impose explicitly an obligation to “use domestic over imported goods”, but rather an obligation not to exceed a certain proportion of foreign articles or labour. Nevertheless, the cost of articles and labour are amongst production costs - indeed still the main ones in the production of many goods – that are reflected in the “fair market value” of the finished product.

168. Just as in the case of the FSC scheme, the foreign content limitation under the FSC Replacement scheme must in principle be satisfied for each transaction for which the benefit is sought. The difference with the FSC scheme lies in the fact that the foreign content limitation is also imposed on companies producing goods outside the US that make an election to be treated as a domestic US corporation pursuant to Section 943(e) of the IRC. In this respect, the FSC Replacement Act makes clear that the foreign content limitation applies not only to foreign articles but also to direct costs for labour performed outside the US. The inclusion of foreign direct costs for labour in the foreign content limitation appears to be of no practical significance to goods produced in the US since these will, by definition, not contain any “foreign direct costs for labour performed outside the US.” In any event, if foreign direct labour costs were ever relevant in assessing the foreign content of *US produced* goods, this would further reduce the scope for using foreign articles and thus make it more

⁶² *New Shorter Oxford English Dictionary* CD-ROM version (1997).

⁶³ *Canada – Aircraft*, Appellate Body Report, para. 166; *Canada – Automobiles*, Appellate Body Report, para. 123.

⁶⁴ *Canada – Aircraft*, Appellate Body Report, para. 100; *Canada – Automobiles*, Appellate Body Report, para. 123.

⁶⁵ *Canada – Automobiles*, Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R, para. 143.

⁶⁶ *Id.*, para. 130.

difficult to respect the 50 per cent foreign content limitation. The foreign content limitation would therefore be more restrictive than is the case under the FSC scheme.

169. In Section 3.3.2 above, it was explained how the foreign content limitation applied to foreign produced goods would often require the use of US “articles” and in other cases would require that US articles be used in order to ensure that the foreign content limitation was not exceeded. For analogous reasons, the foreign content limitation applied to US produced goods will also often require the use of US articles and in other cases would require that US articles be used in order to ensure that the foreign content limitation was not exceeded.

170. The use of US articles will be required whenever the cost of inputs other than articles, any foreign direct labour and profit amount to 50 per cent or less of the selling price (or more exactly the fair market value) of the finished goods. In such cases the cost as articles will exceed 50 per cent of the total value of the product and the FSC Replacement subsidy will not be available if the articles are all foreign.

171. This condition (and therefore the need for US articles to be used) will not always be met but it will in many cases. The EC listed in Section 3.2.2 some factors that affected whether this condition would be met.

172. Further, the foreign content is expressed as a fraction of the price a company can obtain from the sale of the finished product. However, the price a company expects from the sale of such good may not materialise due to a number of unforeseen (or not entirely foreseen) circumstances: for example price trends may dramatically change downwards so that the fair market value also decreases (and a company can no longer obtain the prices based on which it had made its production calculations). In order to minimise such risk of not being able to qualify, companies will be induced to reduce the cost of foreign articles and labour to a level that will always ensure that they account for no more than 50 per cent of the price, even in case of price decreases.

173. For reasons analogous to those set out in Section 3.3.2, the fact that some companies will have to use US articles is sufficient to establish contingency. The examples in the Annex (cases where materials exceed 50 per cent of the final value of the product) illustrate on a conservative basis the fact that such products exist.

174. Accordingly, the basic FSC Replacement subsidy is “contingent upon the use of domestic over imported goods” within the meaning of Article 3.1(b) of the *SCM Agreement* because using domestic US articles will often be necessary to ensure that the foreign content limitation is not exceeded, whereas using foreign articles (and foreign direct labour if possible) will often prevent this limitation from being respected and make the FSC Replacement scheme unavailable. In other cases the use of foreign articles will impair a company’s chances of respecting this limitation and the company will still be required to use US articles in order to ensure that the subsidy will be available.

175. The US has suggested that FSC Replacement scheme is not contingent upon the use of domestic over imported goods because it does not “affirmatively require” the use of US articles. In the US view, companies can respect the foreign content limitation (and thus obtain the tax benefit if the other conditions are met) without using any domestic parts and materials at all.

176. In order to establish a violation of Article 3.1(b), however, it is not necessary to show that the subsidy requires the actual use of domestic over imported goods in every case. The mere fact that in some cases a beneficiary will be required to use domestic goods instead of imported goods in order to qualify for the subsidy, if it can be demonstrated “on the basis of the *words* of the relevant legislation, regulation or other legal instrument”,⁶⁷ is sufficient to trigger the application of Article 3.1(b).

⁶⁷ Id., para. 123.

177. At any rate, assuming *arguendo* that the actual use of domestic goods had to be a necessary condition for granting the subsidy, as explained above and in Annex to this submission, the foreign content ceiling requirements have been set at such a level in the FSC Replacement Act that at least in certain sectors the beneficiaries cannot possibly meet them without using some US articles.

178. Further, the fact that a US producer may have alternative means of avoiding a breach of the foreign content limitation (e.g. by using US labour) does not *per se* rule out a violation of Article 3.1(b) of the *SCM Agreement*. Just as Article 3.1(a), and for the same anti-circumvention concerns, Article 3.1(b) foresees that the “use of domestic over imported goods” may be an alternative condition and prohibits such use “whether solely or one of several other conditions”.

3.5.4. *The extended FSC Replacement subsidy*

179. As explained above in Section 3.3.5 the EC has doubts as to whether the extended scheme *can* be used by companies located outside the US. The way in which the foreign content limitation is formulated in Section 943 of the IRC is one reason for this. As recalled above, that Section imposes the 50 per cent foreign content limitation, which is described in the following terms:

- (C) no more than 50 per cent of the fair market value of which is attributable to—
 - (i) articles manufactured, produced, grown, or extracted outside the United States, and
 - (ii) direct costs for labour (determined under the principles of Section 263A) performed outside the United States.

180. The EC has also argued above in Section 3.3.3 that, even if the extended FSC Replacement subsidy will ever be available, it will constitute a prohibited export subsidy within the meaning of Article 3.1(a) of the *SCM Agreement*.

181. Since in its view the foreign content limitation applied to foreign products leads to the extended subsidy being a prohibited export subsidy, the EC does not consider that it can also be a local-content contingent subsidy.

182. If, however, the Panel should not agree that the foreign content limitation applied to foreign producers has this effect, the EC argues in the alternative that Article 3.1(b) should be interpreted as also prohibiting the imposition of a foreign content limitation on foreign producers.

3.5.5. *Conclusion*

183. For the above reasons the EC submits that the foreign content limitation in the FSC Replacement scheme renders the basic FSC Replacement subsidy *de iure* or at least *de facto* contingent upon the use of US over imported goods contrary to Article 3.1(b) of the *SCM Agreement*.

184. The EC asks the Panel to consider the application of the foreign content limitation in the case of non-US producers only if it is of the view that this limitation does not make the extended FSC Replacement subsidy contingent upon export performance contrary to Article 3.1(a).

3.6. The FSC Replacement scheme grants and maintains subsidies contrary to Article 3.2 of the SCM Agreement

185. Article 3.2 *SCM Agreement* confirms that:

A Member shall neither grant nor maintain subsidies referred to in paragraph 1

186. It has been demonstrated above the FSC Replacement subsidies fall under paragraph 1 of Article 3. The US is therefore failing to comply with its obligations under Article 3.2 by granting and maintaining them.

3.7. The FSC Replacement scheme provides treatment less favourable to products imported into the US that is accorded to like US products, contrary to Article III:4 of GATT 1994

187. Article III:4 of *GATT 1994* provides in relevant part that

The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use [...].

188. The EC considers that the foreign content limitation contained in the FSC Replacement scheme is inconsistent with Article III:4 of *GATT 1994* in that it provides less favourable treatment to imported parts and materials than to like domestic goods with respect to their internal use in the production of goods.

189. On the other hand, the EC is making no claim about more favourable treatment in respect of the export from the US of US finished goods than of like foreign goods present on the US market, nor about more favourable treatment of exported US finished goods than like foreign goods present on the same foreign market (situations which are not covered by Article III:4).

190. In view of the terms of Article III:4, in order to rule on this claim the Panel is required to address the following issues:

- first, whether the measures at issue are “laws, regulations or requirements”;
- second, whether domestic products are “like” imported products;
- third, whether the measures “affect” the “internal use” of the products concerned; and
- fourth, whether the measures afford “less favourable treatment” to imported products than to domestic products.

3.7.1. The foreign content limitation is a “requirement”

191. By now it is firmly established that a measure need not be compulsory in order to qualify as a “requirement” for the purposes of GATT Article III:4, and that Article III:4 also applies to “measures” in the form of conditions to obtain an advantage.⁶⁸

192. In *EEC – Parts and Components* the Panel concluded that the conditions accepted by a firm in order to obtain an “advantage” granted by the EC authorities also constituted “requirements”.⁶⁹

⁶⁸ For example, in *Canada – Administration of the Foreign Investment Review Act*, adopted on 7 February 1984, BISD 39S/140 (“*Canada – FIRA*”), para. 4.5 the Panel held that the legally enforceable undertakings given by some foreign investors to the Canadian Government constituted “requirements”, even though the submission of such undertakings was voluntary.

⁶⁹ *EEC – Regulation on Imports of Parts and Components*, Panel Report, BISD 37S/132, adopted on 16 May 1990 (“*EEC- Parts and components*”), para. 5.21:

193. More recently, in *Canada – Automobiles* the Panel went even further by holding that the “letters of undertaking” submitted by certain firms at the request of the Canadian Government were “requirements”, even though they were neither legally enforceable nor a condition to obtain an advantage.⁷⁰

194. As discussed in Section 3.5 above, while the FSC Replacement scheme does not oblige US producers to use of US inputs, this is in many cases one of the necessary conditions for obtaining an advantage, the tax benefit, and in many other cases the scheme encourages the use of US goods over imported goods.

195. The EC submits that, in light of the precedents cited above, the fact that the limit on those foreign inputs is one of the conditions to obtain the tax benefit is sufficient to conclude that the foreign content limitation constitutes a “requirement” within the meaning of Article III:4 of *GATT 1994*.

3.7.2. *Domestic parts and materials are “like” the imported goods*

196. The distinction operated by the foreign content limitation relates to the origin of the products: whereas goods of US origin contribute to satisfy the foreign content limitation, imported goods do not.

197. Clearly, however, the mere fact of having US origin is not, as such, apt to confer upon goods any characteristic, property or quality which makes them, by definition, “unlike” any imported good.⁷¹

3.7.3. *The foreign content limitation “affects” the internal “use” of the products concerned*

“... Article III:4 refers to ‘all laws, regulations or requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use’. The Panel considered that the comprehensive coverage of ‘all laws, regulations or requirements *affecting* (emphasis added) the internal sale, etc.’ of imported products suggests that not only requirements which an enterprise is legally bound to carry out, such as those examined by the FIRA Panel (BISD 30S/140, 158), but also those which an enterprise voluntarily accepts in order to obtain an advantage from the government constitute ‘requirements’ within the meaning of that provision.”

The same interpretation underlies the Report on *Italian Discrimination against Imported Agricultural Machinery*, adopted on 23 October 1958, BISD 7S/60 (“*Italian Agricultural Machinery*”), where the Panel concluded that an Italian law providing special credit terms to farmers for the purchase of agricultural machinery conditional upon the purchase by the farmers of Italian machinery was contrary to Article III:4 of *GATT*.

⁷⁰ *Canada – Automobiles*, Panel Report, para. 10.122. The Panel cited the following circumstances in order to conclude that the “letters of undertaking” were “requirements”:

“(i) in making the undertakings contained in the Letters, the companies acted at the request of the Government of Canada; (ii) the anticipated conclusion of the Auto Pact was a key factor in the decision of the companies to submit these undertakings; (iii) the companies accepted responsibility *vis-à-vis* the Government of Canada with respect to the implementation of the undertakings contained in the Letters, which they described as ‘obligations’ and in respect of which they undertook to provide information to the Government of Canada and indicated their understanding that the Government of Canada would conduct yearly audits; and (iv) at least until model year 1996, the Government of Canada gathered information on an annual basis concerning the implementation of the conditions provided for in the Letters.”

⁷¹ In *Indonesia – Measures affecting the Automotive Industry*, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, adopted 23 July 1998 (*Indonesia – Autos*), the Panel noted, at para 14.113, that an

“... origin-based distinction in respect of internal taxes suffices in itself to violate Article III:2, without the need to demonstrate the existence of actually traded like products”.

See also the Panel Report on *Canada – Automobiles*, para. 10.174.

198. The term “affect” has been interpreted broadly since the early days of the GATT. According to the Panel Report in *Italian Agricultural Machinery*,

The selection of the word ‘affecting’ would imply [...] that the drafters of the Article intended to cover in [Article III:4] not only the laws and regulations which directly governed the conditions of sale and purchase but also any laws or regulations which might adversely modify the conditions of competition between the domestic and imported products on the internal market ⁷²

199. In the present case, the foreign content limitation “affects” directly the “internal use” of goods because it will in many cases determine which goods a producer will use. In order not to exceed it, US producers must, in many cases, incorporate into their products a certain amount of domestic goods.

200. In addition, as recalled above in Section [] there will e.g. be cases in which a firm will be induced to increase the value of US goods it uses to anticipate price decreases (and therefore the increase of foreign inputs value relative to price of the finished good). In other words, the content limitation will play a role on the sourcing decisions in those cases as well. In each and every case, it will be easier for a US producer to qualify for the tax benefit if it prefers domestic to foreign goods. Accordingly, the requirement “affects” the “sale ... or use” of goods within the meaning of Article III:4 of *GATT 1994*.

201. The word “affecting” must also be interpreted in the light of the object and purpose of Article III:4. As most recently recalled by the Panel in *Canada – Automobiles*,

The “no less favourable treatment obligation” in Article III:4 has been consistently interpreted as a requirement to ensure effective equality of opportunities between imported products and domestic products. In this respect, it has been held that, since a fundamental objective of Article III is the protection of expectations on the competitive relationship between imported and domestic products, a measure can be found to be inconsistent with Article III:4 because of its potential discriminatory impact on imported products. The requirement of Article III:4 is addressed to “relative competitive opportunities created by the government in the market, not to the actual choices made by enterprises in that market.” Both in relation to Article III:2 and Article III:4 it has been established that the actual trade effects of a disputed measure are not a decisive criterion in determining whether the requirements of these provisions are met in a given case. Finally, as stated by the Appellate Body, a determination of whether there has been a violation of Article III:4 does not require a separate consideration of whether a measure affords protection to domestic production. ⁷³

The Panel so ruled in respect of a requirement which it described as

⁷² Panel Report on *Italian Agricultural Machinery*, para. 12. The Appellate Body confirmed that interpretation of the term “affect” in *EC – Bananas*, WT/DS27/AB/R, para. 220.

⁷³ *Canada - Automobiles*, Panel Report, para. 10.78 (footnotes omitted). In support of its statement the Panel refers, in footnotes 842-845, to Panel Report on *US – Section 337 of the Tariff Act of 1930* (“*United States - Section 337*”), BISD 36S/395, paras. 5.11 and 5.13; Panel Report on *US – Malt Beverages*, para. 5.31; Appellate Body Report on *Japan – Alcoholic Beverages*, p. 16; Appellate Body Report on *EC – Bananas*, paras. 179 and 216. The Panel’s findings on Article III:4 were not appealed.

a measure which provides that an advantage can be obtained by using domestic products but not by using imported products⁷⁴

202. This characterization clearly also applies to the foreign content limitation contained in the FSC Replacement scheme: whereas the use of US goods will always guarantee that the content requirement can be met, and thus will not impair the prospects of obtaining the benefit, the use of non-US inputs will in many cases impair the possibility of meeting the foreign content limitation.

203. The foreign content limitation is a legal requirement that the foreign inputs and labour not be used above a certain ceiling, if a taxpayer wants to obtain the tax benefit.

204. In view of the above, the Panel in *Canada – Automobiles* considered that the measure which it had just described

has an impact on the conditions of competition between domestic and imported products and thus affects the "internal sale.... or use" of imported products, even if the measure allows for other means to obtain the advantage, such as the use of domestic services rather than products.⁷⁵

Accordingly, it concluded that

We also see no merit in Canada's argument that the CVA requirements do not in practice "affect" the internal sale or use of imported parts and materials because the CVA levels are so low that they can be easily met on the basis of labour costs alone. As discussed above, based on the ordinary meaning of the term "affecting", the CVA requirements must be considered to affect the internal sale or use of imported products because they have an effect on the competitive relationship between imported and domestic products by conferring an advantage upon the use of domestic products while denying that advantage if imported products are used. Thus, we consider that the fact that it is easier to meet the CVA requirements and thus to obtain the benefit of the import duty exemption if domestic products are used than if imported products are used is sufficient to find that these requirements affect the internal sale or use of products, and we do not believe that we need to examine how important the CVA requirements are under present circumstances as a factor influencing the decisions of motor vehicle manufacturers in Canada regarding the choice between domestic parts, materials and non-permanent equipment, on the one hand, and imported parts, materials and non-permanent equipment, on the other.⁷⁶

205. In the same way, since it will in many cases be easier to respect the foreign content limitation and thus obtain the benefit of the FSC Replacement subsidy if US products are used than if imported products are used, the competitive position of these products on the US market is "affected" and the limitation is contrary to Article III:4 of the GATT.

3.7.4. *Imported goods are afforded "less favourable treatment"*

206. Finally, by requiring in some cases the use of a minimum amount of domestic parts and materials, the foreign content limitation precludes producers wishing to benefit from the FSC Replacement scheme from using an equivalent amount of imported parts and materials and, therefore, affords "less favourable treatment" to imported products.

⁷⁴ *Canada - Automobiles*, Panel Report, para. 10.82.

⁷⁵ *Ibid.* (emphasis added).

⁷⁶ *Id.* at 10.83.

207. Furthermore, using domestic parts and materials makes it easier for the beneficiaries not to exceed the foreign content limitation and hence to qualify for the tax benefit which it is conditional upon it, than using “like” non-US products.

208. As a consequence, prospective beneficiaries will always give preference, all other conditions being equal, to US “articles” over like imported goods. Thus, in all cases the foreign content limitation affords “less favourable treatment” to imported goods than like domestic goods in respect of their use.

209. The US may try to restate also in respect of this claim its argument that it is also possible to meet the foreign content limitation other than by using US articles and therefore that requirement is not WTO-incompatible.

210. However, Article III:4 of GATT must be respected in each and every case, for each and every transaction. The fact that an analysis transaction by transaction is necessary under Article III:4 is confirmed by the panel report in *United States - Standards for reformulated and conventional gasoline*.⁷⁷ In that report the panel rejected the argument that the US measures involved in that case could be justified because imported gasoline was treated “on the whole” no less favourably than domestic gasoline. The US did not appeal this element of the panel report. The panel in the *US – Gasoline* case rejected the “on the whole” reasoning because it would mean that less favourable treatment in one instance could be offset by more favourable treatment in another instance and noted that such an approach had also been rejected under GATT 1947.⁷⁸

211. It is therefore clear that under Article III:4 an analysis has to be carried out at the level of an individual product, not at the level of the application of the law to all possible products. Any individual product must be treated no less favourably than a like domestic product – and this in all cases, for all transactions.

3.7.5. *Precedent and the TRIMs Agreement confirm that the foreign content limitation is inconsistent with Article III:4*

212. Local content requirements constitute a clear-cut violation of the national treatment requirements imposed by GATT Article III:4, which has already been condemned by GATT/WTO panels on several occasions.

213. In *Canada – FIRA*, the Panel found that the undertakings given to the Canadian Government by some foreign investors to, *inter alia*, purchase goods of Canadian origin in specified amounts or proportions was contrary to Article III:4.⁷⁹

214. Similarly, in *EEC- Parts and Components*, the Panel concluded that, by making the suspension of anti-circumvention proceedings conditional upon an undertaking to limit the use of Japanese parts and materials, the EC acted inconsistently with Article III:4.⁸⁰

215. In *Indonesia – Autos*, the Panel found that the grant of certain tax and import duty benefits to a so-called “National Car” manufacturer conditional upon meeting a certain local content percentage was in violation of Article III:4.⁸¹

⁷⁷ *United States - Standards for Reformulated and Conventional Gasoline* (“*US – Gasoline*”), Panel Report, WT/DS2/R, 29 January 1996.

⁷⁸ The Panel referred to the Panel Report on *United States - Section 337*.

⁷⁹ *Canada – FIRA*, Panel Report, paras. 5.4-5.12.

⁸⁰ *EEC – Parts and Components*, Panel Report, paras. 1.19-5.21.

⁸¹ *Indonesia – Autos*, Panel Report, para. 14.83 *et seq.*

216. Finally, in *Canada – Automobiles*, the Panel held that the grant of a customs duty exemption to certain manufacturers of motor vehicles subject to compliance with certain “Canadian Value Added” requirements was inconsistent with Article III:4.⁸²

217. The *Agreement on Trade-Related Investment Measures* (the “TRIMs Agreement”) has confirmed beyond doubt that local content requirements are inconsistent with Article III:4 of GATT. Item 1.a) of the Illustrative List of TRIMs includes, among the TRIMs that are inconsistent with Article III:4, those which require

“a) the [...] use by an enterprise of products of domestic origin [...], whether specified in terms of [...] value of products, or in terms of a proportion of [...] value of its local production”

218. As the EC has explained above in Section [3.3.2], the foreign content limitation contained in the FSC Replacement scheme amounts in many cases to a requirement to use US goods rather than imported articles. Accordingly, it is equivalent to requirements described in item 1(a) of the Illustrative List. This further confirms that it is inconsistent with Article III:4 of *GATT 1994*.

3.7.6. Conclusion

219. For the above reasons the EC submits that the Panel should find that the FSC Replacement scheme accords more favourable treatment to US than to like imported products in relation to the use of such products for the production of goods for export under the scheme, contrary to Article III:4 of *GATT 1994*.

3.8. The FSC Replacement subsidies are also inconsistent with the Agreement on Agriculture

3.8.1. Introduction

220. The US appears to have ignored the *Agreement on Agriculture* in implementing the DSB recommendations in this case. Its main argument, that there is a possibility of benefiting from the FSC Replacement scheme by producing outside the US, has no relevance to agricultural products. As the US argued itself in the original Panel proceedings:⁸³

It has to be recognised that for important exporting industries, the 50 per cent requirement has little or no practical effect. For example, in the agricultural sector that the European Communities targets in this case, the notion of incorporating imported goods into export products is impractical and artificial. Thus, for the agricultural sector, the 50 per cent requirement is largely inapplicable.

221. The US therefore agrees that by their very nature agricultural products, in particular commodities, will not satisfy the test unless produced in the US. They are indeed “grown” outside of the United States for the purposes of the condition under C) i).

222. The Panel will recall that it found⁸⁴ that the US had

acted inconsistently with its obligations under Article 3.3 of the Agreement on Agriculture (and consequently with its obligations under Article 8 of that Agreement):

⁸² *Canada – Automobiles*, Panel Report, para. 10.58 *et seq.*

⁸³ Panel Report, para. 4.1211.

⁸⁴ Panel Report, para. 8.1(b).

- by providing export subsidies listed in Article 9.1(d) of the Agreement on Agriculture in excess of the quantity commitment levels specified in the United States' Schedule in respect of wheat;
- by providing export subsidies listed in Article 9.1(d) of the Agreement on Agriculture in respect of all unscheduled products.

223. The Appellate Body however disagreed that the FSC scheme involved a reduction in the costs of marketing exports within the meaning of Article 9.1(d) of the *Agreement on Agriculture*. This was because it adopted a slightly different interpretation of the word “marketing” than had the Panel.⁸⁵

224. The Appellate Body therefore addressed the EC’s alternative claim under the *Agreement on Agriculture* and held that:⁸⁶

the United States acts inconsistently with its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture* by applying export subsidies, through the FSC measure, in a manner which results in, or which threatens to lead to, circumvention of its export subsidy commitments with respect to both scheduled and unscheduled agricultural products;

225. One consequence of the Appellate Body adoption of the alternative claim is that the distinction between scheduled and unscheduled agricultural products becomes unimportant, since Article 10.1 of the *Agreement on Agriculture* applies to both equally.

226. The EC will show in [Section 3.7.2] below that nothing has changed with the introduction of the FSC Replacement scheme and that the US still acts inconsistently with its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture* by applying export subsidies, through the FSC Replacement scheme, in a manner which results in, or which threatens to lead to, circumvention of its export subsidy commitments with respect to both scheduled and unscheduled agricultural products.

227. For the case that the US should argue or the Panel consider that the FSC Replacement scheme escapes being prohibited under Article 10.1 of the *Agreement on Agriculture* by virtue of being a subsidy within the meaning of Article 9.1 of the *Agreement on Agriculture*, the EC will also argue in the alternative in [Section 3.7.3] below that the FSC Replacement scheme will in any event be inconsistent with the obligations of the US under the *Agreement on Agriculture* for similar reasons to those given by the Panel in respect of the FSC scheme.

3.8.2. *The FSC Replacement scheme is inconsistent with Articles 10.1 and 8 of the Agreement on Agriculture*

228. The Appellate Body’s reasoning under the *Agreement on Agriculture* can be summarised as follows:

- The Appellate Body concluded that the FSC scheme involved a “subsidy contingent upon export performance” under the *Agreement on Agriculture*, for essentially the same reasons as underlay its and the Panel’s corresponding conclusion with respect to the *SCM Agreement*;⁸⁷
- The Appellate Body then reasoned that the term “export subsidy commitments”, in Article 10.1 must, when read in the light of Articles 3, 8 and 9 of the *Agreement on*

⁸⁵ Appellate Body Report, paras. 131 and 132.

⁸⁶ Appellate Body Report, para. 171(d).

⁸⁷ Appellate Body Report, paras. 136 to 142.

Agriculture, be considered to relate to both *scheduled* and *unscheduled* agricultural products;⁸⁸

- Article 10.1 of the *Agreement on Agriculture* prohibits export subsidies being “applied in a manner which *results in*, or which *threatens to lead to*, *circumvention* of export subsidy commitments.” Since the FSC scheme creates *legal entitlements* to receive unlimited amounts of export subsidies not listed in Article 9.1, both for scheduled and unscheduled products, the Appellate Body concluded that they “at the very least” threaten to lead to circumvention of the export subsidy commitments in the first and second clauses of Article 3.3 of the *Agreement on Agriculture*;⁸⁹
- Consequently, the FSC subsidies are also inconsistent with Article 8 of the *Agreement on Agriculture*, in which Members undertook not to provide export subsidies otherwise than in conformity with the *Agreement on Agriculture*.⁹⁰

229. Exactly the same reasoning applies in respect of the FSC Replacement scheme. Indeed, a circumvention of a circumvention is surely still a circumvention!

230. The EC has demonstrated above that the FSC Replacement scheme involves export subsidies. The FSC Replacement scheme also creates a legal entitlement for companies to receive these subsidies. They must therefore “at the very least” *threaten* to lead to circumvention of export subsidy commitments, that is the commitment in the first clause of Article 3.3 of the *Agreement on Agriculture* not to provide export subsidies listed in Article 9.1 on scheduled products in excess of its the budgetary outlay and quantity commitments specified in the relevant part of its Schedule and the commitment in the second clause of Article 3.3 of the *Agreement on Agriculture* not to provide export subsidies listed in Article 9.1 at all on unscheduled products. The FSC Replacement scheme is therefore also inconsistent with Articles 10.1 and 8 of the *Agreement on Agriculture*.

3.8.3. *In the alternative, the FSC Replacement subsidies are inconsistent with Article 3.3 and 8 of the Agreement on Agriculture read in conjunction with Article 9.1 of the Agreement on Agriculture*

231. Apart from maintaining that the FSC Replacement scheme does not give rise to subsidies or that they are not export contingent, it would seem that the only way in which the US could argue that the FSC Replacement subsidies escape prohibition under Article 10.1 of the *Agreement on Agriculture* would be to claim that they are export subsidies but fall under one of the categories in Article 9.1 of the *Agreement on Agriculture*.

232. Apart from Article 9.1(d) of the *Agreement on Agriculture*, which the Appellate Body has held is not applicable to the forgoing of tax receipts indirectly linked to the marketing of agricultural products, the only other provision of Article 9.1 of the *Agreement on Agriculture* that has ever been mentioned as being possibly relevant to this kind of subsidy⁹¹ is paragraph (a).

233. For the case that the US makes such an argument, the EC maintains an alternative claim that the FSC Replacement subsidies are inconsistent with Articles 3.3 and 8 of the *Agreement on Agriculture* in conjunction with whichever paragraph of Article 9.1 is considered applicable, for the same reasons, *mutatis mutandis*, given by the Panel in paragraphs 7.144 to 7.151 and 7.160 to 7.177

⁸⁸ Appellate Body Report, paras. 145 to 147.

⁸⁹ Appellate Body Report, paras. 150 and 153.

⁹⁰ *Id.*, at para. 154.

⁹¹ The Panel mentioned that Article 9.1(a) might be relevant in footnote 700 to paragraph 7.159 of the Panel Report. The US also frequently referred to it in argument to support its view that paragraph (d) was not applicable to the FSC scheme.

of the original Panel Report. There is no need for the EC to examine here the applicability of whatever paragraph of Article 9.1 is considered applicable because this is what will be established or admitted before the alternative claim can be considered at all.

3.9. The transitional provisions of the FSC Replacement Act allow companies to continue to benefit from the WTO incompatible FSC scheme beyond 30 September 2000

234. Section 2 of the FSC Replacement Act formally provides for the repeal of the FSC scheme. It states that:

Subpart C of part III of subchapter N of chapter 1 (relating to taxation of foreign sales corporations) is hereby repealed.

235. However, this repeal is something of an illusion, because FSC transactions can continue for an indefinite period.

236. While Section 5(c)(1) of the FSC Replacement Act provides in general terms that the Act applies to transactions entered into after 30 September 2000 and that no new FSC may be created after the same date, for FSC “in existence on September 30, 2000 and at all times thereafter” the amendments laid down in the FSC Replacement Act shall not apply to any transaction occurring

- before 1 January 2002, or
- after 31 December 2001, pursuant to a binding contract
 - with unrelated parties and
 - in effect on 30 September 2000.

237. Binding contracts include contract renewal options, purchase options and replacement options included in a contract. This only applies if such options are binding against the seller or lessor or equivalent.

238. There is no legal limit whatsoever to the duration of the FSC scheme through these contracts and options.

239. The EC submits that the above provision allow companies to continue to benefit from the WTO incompatible FSC scheme for an indefinite period, and thus perpetuates the violations found to result from the FSC scheme beyond the period provided for in the Panel Report and confirmed by the Appellate Body. Accordingly, the US has failed to implement the relevant DSB recommendations and rulings.

240. Furthermore, pursuant to Section 5(c)(2) of the FSC Replacement Act, FSCs can refuse this benefit by requesting immediate subjection to the new rules, if applicable, by making an “election” to this effect. This election can be made in respect of a single transaction, so that for the rest the new rules will apply. This of course offers old FSCs still an additional option to maximise their tax benefits according to the most suitable formula.

241. Accordingly, by maintaining the availability of FSC subsidies after 30 September 2000, for transactions effected by existing FSCs until 31 December 2001 (and, under certain conditions, for an indefinite period) the US has failed to withdraw the FSC subsidies as required by Article 4.7 *SCM Agreement* and the recommendations and rulings of the DSB and has also failed to comply with its obligations under Article 21 *DSU*.

3.10. The US failed to comply with the DSB recommendations and rulings within the time period specified by the DSB

242. When adopting the Panel and the Appellate Body Reports on 20 March 2000, the DSB formulated recommendations and rulings also in respect of the compliance “with effect from 1 October 2000”, that is the deadline laid down in the Panel Report and confirmed by the Appellate Body.⁹²

243. Failure of the United States to comply with the DSB recommendations and ruling within such mandatory deadline would have of course placed the US in a position of non-compliance as from 1 October 2000. It would thus have exposed the US to the risk of countermeasures and suspension of concessions or other obligations by the EC.

244. Given that it had become clear that the United States would not be able to comply within this mandatory deadline, the US requested the DSB a modification of the time period for compliance, to which the DSB acceded on 12 October 2000.⁹³

245. The EC points out that the FSC Replacement Act became law when signed by the President of the United States on 15 November 2000, that is 15 days after the deadline as extended by the DSB.

246. Accordingly, the EC submits that the US failed to comply with the DSB recommendations and rulings within the period of time specified by the DSB and has therefore also failed to comply with Article 21 *DSU*.

4. PRELIMINARY OBJECTION: THIRD PARTIES’ RIGHTS UNDER THE PANEL WORKING PROCEDURES

247. Before concluding the EC would like to bring to the attention of the Panel a difficulty concerning third parties that arises, no doubt inadvertently, out of its Working Procedures.

248. Amongst the additional Working Procedures adopted by the Panel pursuant to Article 12.1 of the DSU (and item 11 of Appendix 3 to the DSU), rule 9 regulates third parties’ access to the main parties’ submissions. It provides in relevant part that

Third parties shall receive copies of the parties’ first written submissions. Any party may decide to provide the third parties with a copy of its rebuttal or other submissions.

249. A clear distinction is therefore between access to the first submissions and to other submissions. Whereas third parties have a fully-fledged right to obtain a copy of the main parties’ first written submissions, their access to the other submissions is left to the discretion of such main parties.

250. The EC considers that the interests of third parties recognized in the DSU are not adequately protected in this case as these parties are denied a legal right to receive a copy of the parties’ submissions to the first meeting of the Panel other than the first submissions.

251. In the EC’s view this part of the Working Procedures conflicts with Article 10.3 of the DSU, which reads as follows

⁹² Panel Report, para. 8.8.

⁹³ WT/DS108/11, 2 October 2000; WT/DSB/M/90, 31 October 2000, para. 6.

Third parties shall receive the submissions of the parties to the dispute to the first meeting of the panel (emphasis added).

252. This provision is binding on the parties and the Panel; it is unambiguous and does not provide for exceptions or derogations. Panels are not free to derogate in their Working Procedures from binding provisions of the DSU that grant procedural rights to the parties or to third parties. Nor is it in the interest of a fair and objective procedure to prevent third parties from having access to some of the written submissions that are made in preparation of the first (and only) substantive meeting of the Panel with the parties and the third parties.

253. The EC would like to stress that the panel process might seriously suffer from this way of proceeding. Preventing third parties from usefully participating in the procedure will obviously not further the Panel's task of making an objective assessment of the facts and the legal issues before it. Third parties should not be forced to base their contribution to a dispute settlement procedure on guesswork or hearsay information about the arguments submitted by the parties. The Working Procedures prevent third parties from being fully informed about the arguments exchanged before this Panel by the time of the substantive meeting with the parties and the third parties. As a consequence, the limitation of the access to documents that are before the Panel at the time of the meeting with the parties and the third parties is also likely to prevent the Panel from the benefit of useful contributions by third parties which could help the Panel to make the objective assessment that it is required to make under Article 11 of the DSU.

254. The EC is aware that some other panels have adopted similar working procedures, and this is no doubt the origin of the adoption of the above provision in this proceeding. But a practice which is in conflict with the express provisions and the objectives of the DSU cannot be considered as being justified because it has also been followed in some other procedures. A procedural error cannot be healed by repeating it. As in all the other cases of a similar nature in which it was involved, the EC therefore maintains that this way of proceeding is incompatible with fundamental guarantees of procedural fairness which are implicit in the DSU and must be respected by this Panel, whatever the practice of other panels may have been.⁹⁴

255. A previous panel report under Article 21.5 of the DSU (*Australia – Salmon*)⁹⁵ has addressed this issue but has taken a different view from that set out by the EC above. The EC would make the following comments on the reasoning in the *Australia – Salmon* report.

256. The panel in that case expressly recognized that the fact of sending third parties only copies of what is - normally - the first round of submissions is a mere "practice" under Article 10.3.⁹⁶ This rather confirms that there is no legal requirement to this effect in the DSU.

257. The panel further recalled the expedited nature of proceedings under Article 21.5. The EC would however insist again that supplying third parties with all the submissions available to the panel ahead of the third party session would in no way make this process more burdensome or slower. It would be incumbent upon third parties to avail themselves of the opportunity to make a fully informed intervention before the panel within the deadline that the panel has already established.

258. In view of the foregoing, the EC requests that the Panel rule that third parties be allowed to receive all the main parties' submissions preceding the single Panel meeting. In order for this ruling

⁹⁴ Cf. para. 3.7 to 3.10 of the Panel report on "*Australia – Subsidies Provided to Producers and Exporters of Automotive Leather – Recourse to Article 21.5 of the DSU by the United States*", doc. WT/DS126/RW, 21 January 2000.

⁹⁵ *Australia – Measures Affecting Importation of Salmon – Recourse to Article 21.5 by Canada*, Panel Report WT/DS18/RW, 18 February 2000.

⁹⁶ *Ibid.*, para. 7.

to be effective, the EC requests that the Panel make its ruling, and communicate it to the parties and the third parties as soon as possible after the US has had an opportunity to comment, that is after receipt of the US first written submission and before the date for the presentation of the second written submissions.

5. CONCLUSION

259. For the above reasons the EC requests the Panel to find that:

- The FSC Replacement scheme created by the FSC Replacement Act gives rise to subsidies within the meaning of the *SCM Agreement* and the *Agreement on Agriculture*.
- The FSC Replacement scheme provides subsidies contingent upon export performance contrary to Article 3.1(a) of the *SCM Agreement*. This prohibition is supported and confirmed by the fact that these subsidies are specifically related to exports within the meaning of item (e) to the Illustrative List in Annex I to the *SCM Agreement*.
- The foreign content limitation in the FSC Replacement scheme renders the basic FSC Replacement subsidy (and the extended FSC Replacement subsidy, if this is not contrary to Article 3.1(a)) contingent upon the use of US over imported goods contrary to Article 3.1(b) of the *SCM Agreement*.
- The FSC Replacement scheme accords more favourable treatment to US than to like imported products in relation to the use of such products for the production of goods for export under the scheme, contrary to Article III:4 of *GATT 1994*.
- The FSC Replacement scheme is inconsistent with Articles 10.1 and 8 of the *Agreement on Agriculture* or, in the alternative, with Articles 3.3 and 8 of the *Agreement on Agriculture* in conjunction with Article 9.1 of the *Agreement on Agriculture*.
- By maintaining the availability of FSC subsidies after 30 September 2000, for transactions effected by existing FSCs until 31 December 2001 (and, under certain conditions, for an indefinite period) the US has failed to withdraw the FSC subsidies as required by Article 4.7 *SCM Agreement* and the recommendations and rulings of the DSB and has also failed to comply with its obligations under Article 21 *DSU*.
- By failing to withdraw the FSC subsidies and to comply with the rulings and recommendations of the DSB by the end of the period of time allowed by the DSB, the US has also failed to comply with its obligations under Article 21 *DSU*.

260. In addition, the EC requests the Panel to make a preliminary ruling to the effect that third parties are entitled to receive all written submissions of the parties submitted prior to the meeting of the Panel and to make this preliminary ruling and communicate it to the parties and the third parties as soon as possible after receipt of the US first written submission and before the date for the presentation of the second written submissions.

ANNEX

The cost of materials a percentage of the fair market value of products

Section 943(1)(C) of the IRC, introduced by the *FSC Repeal and Extraterritorial Income Exclusion Act*, defines qualifying foreign trade property to be, *inter alia*,

property—

- (C) not more than 50 per cent of the fair market value of which is attributable to—
 - (i) articles manufactured, produced, grown, or extracted outside the United States, and
 - (ii) direct costs for labour (determined under the principles of section 263A) performed outside the United States.

The cost of materials as a percentage of the final price of any product varies according to a number of factors, e.g. the market price of the materials, the relative cost of other factors of production (e.g. labour, overheads, depreciation), the level of integration of the producer concerned, and the expected level of profit.

Nevertheless, there are some products, produced or assembled in certain ways, for which the materials are so important an input that it is difficult to believe that their contribution to fair market value could ever be below 50 per cent.

The EC's main legal argumentation in respect of this requirement is developed in the text of its submission to the Panel. In addition, and for purely illustrative purposes of that general argumentation, the EC gathered some data relating to the production in certain sectors (and has cross-checked them with information obtained from certain European industries and in the course of various trade investigations).

The most obvious examples will be fairly basic products, with little or no brand value, having a low level of processing and attracting a low profit margin. Some examples are as follows.

1. The Steel industry

(a) Hot-rolled coils

Hot-rolled coils are manufacturing in steel mills and are the pre-material for many types of steel products e.g. wide and narrow strips, cold-rolled products, tubes. The normal cost of production (including SGA expenses) of hot-rolled coils is around 207 Euro per tonne; on this basis fair market value is around 220 Euro per tonne.

The cost of materials involved in production is:

Iron	109 Euro per tonne
Steel scrap	15 Euro per tonne
Others	8 Euro per tonne
Total	132 Euro per tonne

The contribution of materials to the fair market value of hot rolled coils is 60 per cent.

(b) *Heavy Steel Plate*

The normal cost of production (including SGA expenses) of heavy plate is 290 Euro per tonne ; on this basis the fair market value is around 310 Euro per tonne.

The cost of materials involved in production:

Steel slab	200 Euro per tonne
Steel scrap	-10 Euro per tonne (recovered)
Total	190 Euro per tonne

The contribution of materials to the fair market value of steel plate is 61 per cent.

(c) *Stainless Steel Fasteners*

The raw material for making stainless steel fasteners is stainless steel wire rod. The cost of the raw material accounts for between 55 and 61 per cent of the fair market value (normal selling price) of the final product.

2. Other metal products

(a) *Aluminium household foil*

The main raw material for aluminium household foil is aluminium slabs. The cost of the raw material accounts for between 58 and 63 per cent of the fair market value (normal selling price) of the final product.

3. Woven glass fibre fabrics

The raw material for producing woven glass fibre fabrics is glass fibre yarn. The cost of the raw material accounts for between 55 and 60 per cent of the fair market value (normal selling price) of the final product.

4. Chemicals and synthetic fibres

(a) *Polyethylene Terephthalate Bottle Resin*

The raw materials for producing this product, which is used for the production of plastic bottles, are purified terephthalic acid, mono ethylene glycol, di-ethylene glycol and isophthalic acid. Together these account for up to 70 per cent of the fair market value (normal selling price) of the final product.

5. Aircraft

The engines of an aircraft can account for 30 per cent of the final price of the finished product. Similarly, the avionics on a modern aircraft can also cost 30 per cent of the final value.

Engines and avionics are typically purchased from outside suppliers. Together they can account for 60 per cent of the final price.

NOTE

Assembly always involves direct labour costs which can be quite high. This means that, to take the example of aircraft where bought-in engines and avionics account for 60 per cent of the final

value, the 10 per cent that must be sourced in or from the US in order not to exceed the 50 per cent limitation is increased by the amount of the foreign direct labour costs also incurred by the producer.

List of Exhibits

- EC-1 Extract from Inside US Trade, 24 March 2000 (page 9).
- EC-2 The initial US proposal to replace the FSC scheme.
- EC-3 Letter of Commissioner Lamy to US Deputy Secretary of State Eizenstat of 26 May 2000.
- EC-4 Letter of Commissioner Lamy to US Deputy Secretary of State Eizenstat of 31 August 2000.
- EC-5 *FSC Repeal and Extraterritorial Income Exclusion Act of 2000* (the “FSC Replacement Act”).
- EC-5A *Technical Explanation of the Senate Amendment to H.R. 4986, the “FSC Repeal and Extraterritorial Income Exclusion Act of 2000* (JCX-111-00) of 1 November 2000.
- EC-6 Congressional Research Service Report on Foreign Sales Corporation Tax Benefit for Exporting and World Trade Organization *The Foreign Sales Corporation FSC Tax Benefit for Exporting and the WTO* David L. Brumbaugh Specialist in Public Finance. Government and Finance Division.
- EC-7 Report of US Deputy Secretary of State Eizenstat speaking during the Senate Finance Committee passing of the FSC Replacement Bill on 19 September 2000, Inside US Trade, 3 November 2000 (Article starts on page 26 and continues on pages 24 and 25. The quoted text is on page 25).
- EC-8 The Congressional Budget Office Cost Estimate of 13 September 2000.
- EC-9 List of provisions in Subtitle A, Chapter 1, Subchapter B, Part III of the IRC excluding certain income from US tax.

ANNEX A-2

FIRST WRITTEN SUBMISSION OF THE UNITED STATES

(7 February 2001)

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I. INTRODUCTION

1. The European Communities (“EC”) has initiated these proceedings to challenge the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (“the Act”).¹ In doing so, the EC claims that the new law is essentially the same as the former US Foreign Sales Corporation (or “FSC”) tax provisions it replaced, and the EC proposes novel interpretations of WTO rules. The United States presents the Panel with this submission to explain how the new law works and why it is consistent with WTO rules.

2. The EC’s efforts to paint the Act with the same brush it used on the FSC is inappropriate given that the Act was specifically designed to remedy defects found by the *FSC* Panel and the Appellate Body. The Act differs from the FSC in many ways, but two are particularly significant. First, unlike the FSC, the Act changes the United States’ general rule – or normative benchmark – for taxation of foreign income and does not create a tax-saving exception to an otherwise applicable revenue-raising general rule. Thus, the Act does not confer a subsidy. Second, because the Act applies to a broad category of income, it is not export-contingent. Thus, the Act does not – as the Panel and Appellate Body found in the case of the FSC – create a situation in which a WTO Member, “having decided to tax a particular category of income . . . carve[s] out an export contingent exemption from . . . its other rules of taxation.”² In fact, the Act has no such export contingency, and it does not “carve out” any income that would be “taxed . . . under other rules” at all.

3. Instead, the Act represents a major change in the way the United States approaches the taxation of income derived from the sale, lease and rental of goods outside its borders and the method by which the United States avoids double taxation of such income. Previously, the United States relied on a worldwide approach, taxing all income of US individuals and corporations wherever

¹ Public Law 106-519, 114 Stat. 2423 (2000), copy attached as Exhibit US-1.

² *United States - Tax Treatment for “Foreign Sales Corporations” (“FSC (AB))*, WT/DS108/AB/R, Report of the Appellate Body adopted 20 March 2000, para. 99; and *United States - Tax Treatment for “Foreign Sales Corporations” (“FSC (Panel))*, WT/DS108/R, Report of the Panel, as modified by the Appellate Body, adopted 20 March 2000, para. 7.108.

earned. In the context of this worldwide approach to taxation, the United States relied principally on tax credits to offset foreign taxes paid in order to avoid taxation of the same income by two taxing authorities. With the Act, the United States has moved away from a system that relies principally on tax credits to relieve double taxation. The Act avoids double taxation by virtue of the fact that income is not subject to US tax in the first place. By excluding income from US taxation rather than employing tax credits to relieve double taxation, the Act in many respects adopts an approach to relieving double taxation that is similar to territorial exemptions for foreign-income provided by a number of countries around the world.

4. As troubling as the EC's mischaracterization of the Act may be, its recasting of WTO rules is even worse. With regard to the definition of "subsidy", the EC ignores what the Appellate Body said about the meaning of a "defined, normative benchmark" against which to compare "the contested measure and revenues that would be due in some other situation."³ Rather than adhering to these words, the EC asks the Panel to reverse the Appellate Body's analysis by treating the *revenue-raising exception* in the Act as the "defined, normative benchmark" and to compare it against the new US *general rule* of excluding extraterritorial income from US taxation.

5. In addition, the EC proposes a new standard for defining an export subsidy. The EC claims that the test is not whether a subsidy is conditioned or dependent for its existence on export performance, as the Appellate Body has said, but rather whether exports are treated differently than like domestic transactions. Such a test is not grounded in the language of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement") or in panel or Appellate Body reports interpreting that agreement. The EC even goes so far as to argue that the Illustrative List of Export Subsidies – which merely provides examples of prohibited export subsidies – broadens the prohibition beyond subsidies that are "contingent . . . upon export performance".

6. The EC's attempts to ignore the significant ways in which the Act differs from the FSC, to transform the Act into something it is not, and to reshape WTO provisions in ways they do not bend, suggests that the EC cannot quite fit the Act neatly into any pre-existing paradigm for establishing a WTO inconsistency, and that it cannot explain why the Act is an export subsidy but comparable measures of its own member states are not. In effect, the EC is saying that while it might not be able to define what a subsidy or export subsidy is, it knows one when it sees one.

7. For this reason, the EC not only attacks the 50 per cent limitation on certain foreign value in the Act (the "50 per cent rule"), but also attempts to rely on its own erroneous interpretation of that limitation to infect all other provisions of the Act. Specifically, the EC argues that, even if the other provisions of the Act do not constitute subsidies or export subsidies in and of themselves, the 50 per cent rule taints the whole Act and causes it to be an export subsidy. The 50 per cent rule, however, limits only certain kinds of foreign value, and does not disadvantage imported products as the EC contends. It certainly does not taint the rest of the Act in the way the EC claims.

8. The EC's pliable approach to adjudication is inappropriate. Interpretation and application of treaties under public international law require a strict adherence to the language of an agreement, as well as a clear explanation of the reasons why a contested measure does or does not conform to that language. The United States respectfully requests the Panel to resist the EC's outcome-determinative approach and instead to apply a principled mode of analysis that is faithful to the language of the relevant WTO provisions. The United States submits that such an analysis will lead to the conclusion that the Act is consistent with these provisions.

³ *FSC (AB)*, para. 90.

II. PROCEDURAL BACKGROUND

9. This proceeding concerns measures taken by the United States to comply with the recommendations and rulings of the DSB in WT/DS108.

10. The procedural history of this dispute up through the initial panel phase is set forth in paragraphs 1.1-1.7 of *FSC (Panel)*. On 8 October 1999, the Panel circulated its final report. The Panel found that the FSC tax exemption constituted a prohibited export subsidy that was inconsistent with US obligations under Article 3.1(a) of the SCM Agreement.⁴ The Panel also found that the FSC tax exemption constituted an export subsidy within the meaning of Article 9.1(d) of the Agreement on Agriculture and that the United States had acted inconsistently with its obligations under Articles 3.3 and 8 of that Agreement.⁵ Pursuant to Article 4.7 of the SCM Agreement, the Panel specified that “FSC subsidies must be withdrawn at the latest with effect from 1 October 2000.”⁶

11. Both the United States and the EC appealed certain of the Panel’s findings. The Appellate Body circulated its report on 24 February 2000. The Appellate Body affirmed the Panel’s findings under the SCM Agreement, but modified the Panel’s reasoning somewhat. The Appellate Body reversed the Panel’s findings under the Agreement on Agriculture, finding instead that the United States had acted inconsistently with its obligations under Articles 10.1 and 8 of that Agreement.⁷

12. On 20 March 2000, the DSB adopted the reports of the Panel and the Appellate Body. On 7 April 2000, the United States informed the DSB of its intention to implement the recommendations and rulings of the DSB in a manner consistent with its WTO obligations.

13. Notwithstanding its best efforts, for a variety of reasons the enactment of corrective legislation took longer than anticipated.⁸ Accordingly, on 29 September 2000, the United States requested that the DSB extend the time period for withdrawing the FSC to 1 November 2000.⁹ On 12 October 2000, the DSB granted this request. Also on 29 September, the United States and the EC entered into a procedural agreement applicable to the follow-up to the *FSC* dispute.¹⁰ Essentially, this agreement provides for panel and Appellate Body review of the WTO-consistency of the Act before any consideration of the appropriate amount, if any, of countermeasures or suspension of concessions under Article 22.6 of the DSU.

14. On 15 November 2000, the Act was signed into law. The provisions of the Act were made effective with respect to transactions after 30 September 2000.

15. On 17 November 2000, the EC initiated proceedings under Article 21.5 of the DSU by requesting consultations with the United States regarding the Act.¹¹ On the same day, the EC requested authorization from the DSB to take appropriate countermeasures and suspend concessions

⁴ *FSC (Panel)*, para. 8.1(a).

⁵ *Id.*, para. 8.1(b).

⁶ *Id.*, para. 8.8.

⁷ *FSC (AB)*, para. 177(b)-(d).

⁸ The United States notes that the EC has referred to discussions between U.S. and EC officials regarding initial legislative proposals to comply with the DSB’s recommendations and rulings. *EC First 21.5 Submission*, paras. 4-14. The legislation ultimately passed by the United States, the Act, differs substantially from these initial proposals and, in fact, addresses certain concerns raised by the EC. Considering these differences, these initial legislative proposals, while reflecting the United States’ extensive efforts and good faith in attempting to address the EC’s concerns and honor U.S. WTO obligations, are irrelevant to the issues before the Panel.

⁹ WT/DS108/11 (2 October 2000).

¹⁰ WT/DS108/12 (5 October 2000).

¹¹ WT/DS108/14 (21 November 2000).

pursuant to Article 4.10 of the SCM Agreement and Article 22.2 of the DSU.¹² On 27 November 2000, pursuant to Article 4.11 of the SCM Agreement and Article 22.6 of the DSU, the United States objected to the appropriateness of the countermeasures and the level of suspension of concessions proposed by the EC, thereby resulting in a referral of the matter to arbitration.¹³

16. The United States and the EC consulted on 4 December 2000, but were unable to resolve the matter. On 7 December 2000, the EC requested the establishment of a panel under Article 21.5.¹⁴ On 20 December 2000, the DSB established a panel.¹⁵

17. In accordance with the 29 September procedural agreement, on 21 December 2000, the United States and the EC submitted a joint request that the arbitration proceeding under Article 4.11 and Article 22.6 be suspended until the adoption of the Article 21.5 panel report or, in the event of an appeal, the adoption of the Appellate Body report.¹⁶ As a result, the arbitration was suspended.¹⁷

18. Following the establishment and composition of the Panel, on 21 December 2000, the Panel held an organizational meeting with the parties and presented the parties with a draft schedule and Working Procedures. The draft schedule called for the simultaneous filing of written rebuttal submissions by both parties. At the organizational meeting, the United States observed that if written rebuttals were simultaneous, the United States essentially would have nothing to say, given that in its first submission it already would have responded to the EC's first submission. The EC, on other hand, would be able to respond in its rebuttal to the first US submission. Effectively, the EC would be given the opportunity to file two written submissions, while the United States would be limited to one. Accordingly, the United States requested that rebuttal submissions be staggered, so that the EC would file its rebuttal submission first, followed by the US rebuttal submission.

III. FACTUAL BACKGROUND

19. In this section, the United States describes the Act and the territorial limitation on US taxing authority that it creates. This section then compares the Act to European systems that provide a territorial exemption for income earned in export transactions. Finally, this section distinguishes the Act from the former FSC regime.

A. DESCRIPTION OF THE ACT

20. The Act accomplishes two primary objectives. First, to comply with the DSB's recommendations, section 2 of the Act repeals the FSC provisions in sections 921 through 927 of the US Internal Revenue Code ("IRC").¹⁸ Second, section 3 of the Act establishes a new regime for the treatment of extraterritorial income.¹⁹ Under the new regime, extraterritorial income is excluded from gross income for US tax purposes, and, as explained below, is thereby placed outside the taxing jurisdiction of the United States. The rationale for, and details of, this exclusion are explained below.

¹² WT/DS108/13 (17 November 2000).

¹³ WT/DS108/15 (27 November 2000).

¹⁴ WT/DS108/16 (8 December 2000).

¹⁵ See WT/DS108/19 (5 January 2001).

¹⁶ WT/DS108/19 (5 January 2001).

¹⁷ WT/DS108/18 (21 December 2000).

¹⁸ The Act § 2.

¹⁹ The Act § 3.

1. Objectives of the Act and Its Effect on the US Tax System

21. Reports of the relevant committees of the US Congress form essential parts of the legislative history of the Act, and explain the underlying intent of Congress.²⁰

(a) Compliance with the Panel and Appellate Body Reports

22. The legislative history makes clear that one of the objectives of the Act was to comply with the findings contained in the *FSC* Panel and Appellate Body reports.²¹ The Act accomplishes this objective in two ways. First, the Act repeals the *FSC* provisions with effect from 1 October 2000. From that date, no corporation may elect to be treated as a *FSC*.²² In addition, subject to reasonable and customary transition rules, the *FSC* provisions cease to have any application with respect to post-effective date transactions through existing *FSCs*.

23. Second, the Act also remedies the defect in the *FSC* found by both the Panel and the Appellate Body – namely, that the *FSC* tax exemption was an exception to otherwise applicable tax rules that applied only to exports. Rather than providing unique or special treatment for export-related income, the Act treats all foreign sales and all taxpayers alike. Under the Act, as under many EC and other tax systems, the income that is outside the US tax jurisdiction is in no way limited to income earned through exporting. Thus, taxpayers receive the same US tax treatment with respect to income derived from foreign transactions regardless of whether exports are involved. Moreover, the Act's exclusion of income applies without regard to whether the income is earned by a US or foreign individual, a US or foreign corporation, or a partnership or other pass-through entity.

(b) A New US Approach to Taxation of Foreign Income

24. In addition to implementing the DSB's recommendations, the Act also was intended to rationalize the treatment of foreign income under the US system of taxation. Wholly apart from the *FSC* dispute, the United States Senate had begun a process of reviewing the international provisions of the IRC with hearings early in 1999. Among the issues identified was the need to re-examine the US tax treatment of foreign income.²³

25. Although the timing of the Act certainly was affected by the *FSC* dispute, the substance of the Act was influenced by ongoing congressional review. By excluding extraterritorial income from the definition of "gross income", the Act fundamentally changes the way the United States taxes foreign income.²⁴ As the legislative history of the Act makes clear, the definition of "gross income," as modified by the Act, defines the outer limits of US tax jurisdiction.²⁵ Whereas the United States previously operated under the principle that all income of US persons is within the US taxing jurisdiction, the Act creates a new general rule under which excluded extraterritorial income earned by US taxpayers is outside US taxing jurisdiction. In recognition of this, a congressional report states that the territorial limitations created by the Act "parallels the exclusions under most territorial tax systems, particularly those employed by European Union member states."²⁶

²⁰ S. Rep. No. 106-416 (2000) ("*Senate Report*") (Exhibit US-2); and H.R. Rep. No. 106-845 (2000) ("*House Report*") (Exhibit US-3).

²¹ *Senate Report*, page 5; *House Report*, page 3.

²² The Act § 5(b)(1).

²³ *Senate Report*, page 5; *House Report*, page 18.

²⁴ *Senate Report*, page 17.

²⁵ *Id.*, page 16.

²⁶ *Id.*, page 5.

(c) A Measure to Avoid Double Taxation

26. Finally, the Act provides a method for avoiding double taxation.²⁷ The legislative history makes clear that Congress intended that the Act's exclusion serve as a means of avoiding double taxation of excluded income.²⁸ Because the exclusion avoids double taxation, the Act disallows foreign tax credits and deductions that otherwise might be allocable to excluded extraterritorial income.²⁹ By excluding certain foreign income, the Act adopts an internationally-accepted method for avoiding double taxation, a method employed by a number of EC member states and other countries.

2. Description of Excluded Extraterritorial Income

27. Turning to the details of the Act, under section 114(a) of the IRC, as added by the Act, extraterritorial income is excluded from "gross income." Thus, extraterritorial income is placed outside the limits of US taxing jurisdiction.

28. The Act provides a detailed definition of the term "extraterritorial income." The definition is contained primarily in new sections 114, 941, 942, and 943 of the IRC. These sections are included in Exhibit US-1 and are summarized here.

29. There are three main aspects to the definition of extraterritorial income. Extraterritorial income generally is defined as (1) qualifying foreign trade income (2) attributable to foreign trading gross receipts (3) with respect to which the taxpayer has performed certain foreign economic processes.³⁰ This definition contains both a qualitative and a quantitative component. The qualitative component relates to the type of transactions subject to an exclusion, while the quantitative component relates to the amount of the exclusion. Each of these components is described below.

(a) The Qualitative Component of Excluded Income: Its Extraterritorial Nature

30. The first and perhaps most basic element of extraterritorial income is that it arises from extraterritorial transactions – *i.e.*, foreign – sales, leases and rentals. The Act provides that extraterritorial income must derive from one of five categories of foreign transactions.³¹ These five categories include:

- (1) the sale of qualifying property for its use or disposition outside the United States,
- (2) the lease of qualifying property for use by the lessee outside the United States,
- (3) the provision of services related and subsidiary to the first two categories,
- (4) the provision of managerial services performed for unrelated persons in connection with the first three categories, and
- (5) the provision of engineering or architectural services for projects located outside the United States.³²

The Act makes the extraterritorial nature of excluded income clear by providing that the goods or services sold or leased are ultimately not to be used or performed in the United States, and may not be for the use of the United States itself or any instrumentality thereof.³³

²⁷ *Id.*, pages 2, 6.

²⁸ *House Report*, page 18 ("the extraterritorial income excluded by this legislation from the scope of US income taxation is parallel to the foreign-source income excluded from tax under most territorial tax systems").

²⁹ The Act § 3, amending IRC § 114(c)-(d).

³⁰ The Act § 3, amending IRC §§ 114(b)-(e) and 942(b)(1).

³¹ To be precise, under section 114(e), extraterritorial income is defined as gross income attributable to "foreign trading gross receipts." "Foreign trading gross receipts", in turn, is defined by section 942(a) as gross receipts derived from one of five categories of foreign transactions listed here. *See id.*

³² The Act § 3, amending IRC § 941(a)(1).

31. In addition, the Act requires that the gross receipts from which excluded extraterritorial income arises must have a nexus with activity occurring in a foreign jurisdiction. Excluded extraterritorial income can be derived only from transactions with respect to which the taxpayer (or a related person) engages in solicitation, negotiation, or contracting activities in a foreign jurisdiction, and incurs a certain threshold amount of costs associated with economic activities in a foreign jurisdiction.³⁴ These foreign economic activities (or “processes”) may consist of one or more of the following five categories:

- (1) advertising and sales promotion,
- (2) processing of customer orders and arranging for delivery,
- (3) transportation outside the United States in connection with delivery to the customer,
- (4) billing activities, and
- (5) the assumption of credit risk.³⁵

The threshold amount of costs is 50 per cent of the aggregate total costs incurred in all five categories or 85 per cent of the total costs incurred in any two of the five categories.³⁶ These foreign economic processes must be performed, and the threshold requirements met, with respect to every foreign transaction giving rise to excluded extraterritorial income.

32. The Act also provides that no more than 50 per cent of the fair market value of any goods involved may be attributable to articles produced outside the United States and direct labour costs incurred outside the United States.³⁷ Goods can meet this requirement even if 100 per cent of the fair market value of their inputs or content is foreign.

(b) The Quantitative Component of Excluded Foreign Trade Income

33. In addition to the qualitative component of excluded income described above, the Act provides three different methods for identifying “excluded income”. Specifically, “qualifying foreign trade income” is the amount of income from covered transactions, which, if excluded, would reduce the taxpayer’s taxable income by the greatest of: 15 per cent of foreign trade income, 1.2 per cent of total gross receipts, or 30 per cent of foreign sale and leasing income.³⁸ Different methods are needed because different taxpayers use different business models, and the use of only one method could lead to disparate results among businesses engaged in similar foreign business activities. Accordingly, taxpayers may choose the method for quantifying excluded income that is most appropriate to their business circumstances.³⁹

3. Evenhanded Treatment of Taxpayers

34. The Act applies equally to individuals, partnerships, and corporations that earn excluded extraterritorial income. The Act applies to these taxpayers irrespective of whether they are located in

³³ The Act § 3, amending IRC § 942(a)(2).

³⁴ The Act § 3, amending IRC §§ 942(b)(1), 942(b)(2)(A).

³⁵ The Act § 3, amending IRC § 942(b)(3).

³⁶ The Act § 3, amending IRC § 942(b)(2)(A)(ii) and (B).

³⁷ The Act § 3, amending IRC § 943(a)(1)(C).

³⁸ The Act § 3, amending IRC § 941(a)(1).

³⁹ The Act § 3, amending IRC § 941(a)(2). Of the three calculations used to determine “qualifying foreign trade income”, one is a percentage of overall “foreign trade income”, one is a percentage of total receipts, and the third – involving “foreign sales and leasing income” – is a percentage of a subset of “foreign trade income”. In other words, “foreign sales and leasing income” is a type of foreign trade income. “Foreign sales and leasing income” is “foreign trade income” that is attributable to the lease or sale of certain types of property, and that is directly tied to the performance of the prescribed foreign economic processes described above. The Act § 3, amending IRC § 941(c).

the United States or abroad, the only requirement being that these persons be subject to US taxation.⁴⁰ As explained by the legislative history,

the bill requires that property manufactured outside of the United States be manufactured by (1) a domestic corporation, (2) an individual who is a citizen or resident of the United States, (3) a foreign corporation that elects to be subject to US taxation in the same manner as a US corporation, or (4) a partnership or other pass-through entity all of the partners or owners of which are described in (1), (2), or (3) above.⁴¹

This requirement is intended to equalize treatment of US taxpayers operating abroad in branch form with the treatment of US taxpayers operating abroad in corporate subsidiary form.⁴² To reinforce this evenhanded treatment, the Act provides that property may be the subject of a qualifying transaction even if it is produced outside of the United States.⁴³

35. In addition, the Act permits a foreign corporation to elect to be treated as a domestic corporation to ensure that property produced outside the United States need not be produced by a US person (*e.g.*, a US corporation).⁴⁴ This election is similar to other elections given to taxpayers that would not otherwise be subject to US tax jurisdiction.⁴⁵

4. The Act's Effective Date

36. The Act is effective for transactions after 30 September 2000.⁴⁶ All provisions of the Act have effect from this date. Thus, no FSCs may be created after 30 September 2000.⁴⁷ A foreign corporation created after 30 September 2000, will be treated under general rules applicable to all foreign corporations. None of the rules under the former FSC provisions, including the special "dividends-received deduction", will be available to such a corporation or its US parent. In addition, subject to reasonable and customary transition rules, described below, the FSC provisions cease to have any application with respect to post-effective date transactions.

5. The Act's Transition Rules

37. Transition relief is common under US tax law in order to avoid undue hardship or confusion with respect to pre-existing business arrangements entered into under pre-existing law. Section 5(c) of the Act provides that the Act's amendments do not apply to a transaction in the ordinary course of a trade or business of a FSC already in existence as of 30 September 2000, which occurs: (1) before 1 January 2002,⁴⁸ or (2) after 31 December 2001, pursuant to certain binding contracts.⁴⁹ The only

⁴⁰ The Act § 3, amending IRC § 942(a)(2).

⁴¹ *Senate Report*, page 10.

⁴² *Id.*

⁴³ The Act § 3, amending IRC § 943(a)(1)(A).

⁴⁴ The Act § 3, amending IRC § 943(e)(1).

⁴⁵ For example, a foreign corporation may elect to be treated as a US corporation under IRC § 953(d) (relating to foreign insurance companies), IRC § 897(i) (relating to foreign corporations with US real property interests), and IRC § 1504 (relating to foreign corporations formed solely for foreign law purposes). *See* Exhibit US-4.

⁴⁶ The Act § 5(a).

⁴⁷ The Act § 5(b)(1).

⁴⁸ The Act § 5(c)(1)(A).

⁴⁹ The Act § 5(c)(1)(B).

binding contracts to which the transition rules may apply are transactions between a FSC (or a related person) and an unrelated person that are already in effect on 30 September 2000.⁵⁰

38. At any time during the transition period, a taxpayer may elect to apply the Act to a transaction that would otherwise be eligible for transition relief.⁵¹ Such an election would be effective for the taxable year for which it was made and for all subsequent taxable years.⁵² Under no circumstances is a taxpayer permitted to apply the FSC provisions and the Act to the same transaction or transactions.⁵³ The Act automatically applies (without any election or other notification) to transactions not covered by the transition rules.⁵⁴

B. THE ACT MOVES THE US APPROACH TO TAXATION OF FOREIGN INCOME CLOSE TO THE EUROPEAN MODEL

39. The US Congress recognized that by excluding extraterritorial income from gross income, the Act “parallels the foreign-source income excluded under most territorial tax systems, particularly those employed by European Union member states.”⁵⁵ In this regard, many European countries impose income taxes on a territorial basis, at least in part. Subject to numerous exceptions, European governments applying a territorial approach do not tax income earned outside their borders. European territorial exemptions extend not only to income earned by resident corporations and offshore branches, but also to income earned by foreign subsidiaries and dividends paid to domestic parents by foreign subsidiaries.

40. European tax exemptions for offshore income apply to three types of transactions: imports, wholly foreign transactions, and exports. In most cases, European countries do not require the foreign tax rate to be equal to or greater than the home country rate and, in some instances, no minimum foreign rate is required at all. Thus, European companies with overseas operations in low tax jurisdictions can receive a tax benefit from a territorial exemption. Insofar as the sale of goods is concerned, European manufacturers operating in these types of tax regimes may obtain the benefits of a territorial exemption only by exporting.

41. As indicated above, no EC member state now provides a blanket exemption for foreign-source income. In fact, as the EC explained to the Panel in the initial proceeding, EC member states providing an exemption for foreign-source income do so only partially, and most generally treat foreign-source income as an exception to the general rule that the worldwide income of a domestic corporation is subject to taxation in its country of residence.⁵⁶ Thus, just as the Act has introduced an element of territoriality into the US system of taxation, European systems themselves are a mix of worldwide and territorial principles.

42. This confluence of worldwide and territorial approaches is perhaps most striking in the Dutch tax system. As the Panel may recall from the initial proceeding, as a general matter, Dutch resident companies are liable for corporate income tax on a worldwide basis. However, the income of foreign branches of Dutch resident companies generally is not taxed. Even in the absence of a treaty, income

⁵⁰ The Act § 5(c)(1)(B)(i)-(ii). A binding contract for this purpose includes “a purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor.” The Act § 5(c)(1).

⁵¹ The Act § 5(c)(2).

⁵² *Id.*

⁵³ *Senate Report*, page 21.

⁵⁴ The Act § 5(a).

⁵⁵ *Senate Report*, page 5.

⁵⁶ EC Second Written Submission to the FSC Panel, Annex EC-2, para. 2, attached as Exhibit US-5.

earned by a foreign branch of a Dutch company that is subject to *any* income tax in a foreign country is also exempt from Dutch tax.⁵⁷

43. In addition, the income of a foreign subsidiary of a Dutch company is not subject to Dutch income tax, even in the case of income from export activities, so long as the subsidiary does not have substantial activities in the Netherlands. Moreover, any Dutch shareholder that owns 5 per cent or more of a foreign corporation may generally exempt from tax 100 per cent of the dividends paid by the foreign corporation to that shareholder.

44. As with a foreign branch, income from a foreign subsidiary will qualify for the exemption so long as the subsidiary is subject to *any* national-level income tax in its country of residence. Thus, a subsidiary that is resident in a low-tax jurisdiction such as the Netherlands Antilles is generally exempt from Dutch tax on income earned outside the Netherlands. Moreover, a Dutch parent corporation will, subject to certain requirements, receive a 100 per cent participation exemption (dividends-received deduction) on dividends from that subsidiary, even though the income may be subject to tax in the Netherlands Antilles at a very low rate of tax (two or three per cent).

45. To appreciate how the Dutch system operates, assume that a Dutch manufacturing company and its Netherlands Antilles sales subsidiary engage in an export transaction in which the subsidiary acts on the parent company's behalf to sell items exported from the Netherlands, and the companies together earn a total of \$100,000.⁵⁸ Further assume that each company earns the equivalent of \$50,000 under arm's-length transfer pricing principles. The Netherlands Antilles subsidiary's income from the transaction – that is, \$50,000 – would be fully exempt from taxation by the Netherlands and, at a 3 per cent rate, would owe tax of only \$1,500 to the Netherlands Antilles.

46. Due to the 100 per cent participation exemption, the Dutch parent corporation would not pay taxes upon the repatriation of the exempt income earned by the foreign subsidiary. On the other hand, the Dutch parent company would be liable for taxes in the Netherlands, at a rate of 35 per cent, on the income it earned from the transaction; *i.e.*, the other \$50,000. The taxes on this income would amount to \$17,500. The overall taxes on the total export income of \$100,000 would be \$19,000 – or an effective tax rate of 19 per cent – resulting in a tax savings of \$16,000 (\$35,000-\$19,000) as compared to the tax that would have been incurred if the same transaction had involved a domestic sale.

C. THE ACT IS FUNDAMENTALLY DIFFERENT FROM THE FSC

47. Throughout its First Submission, the EC portrays the Act as “essentially the same subsidy” as the FSC.⁵⁹ This portrayal is erroneous, because it ignores the fundamental ways in which the Act differs from the FSC, as described below.

1. The FSC Was a Relatively Narrow Exception to US General Rules of Worldwide Taxation for Export-Related Income

48. Prior to adoption of the Act, the US tax system operated principally on a worldwide basis. The United States asserted the right to tax all income earned by US citizens and residents (including US corporations), as well as income earned by nonresidents conducting activity within US borders. The US system treated all income earned by US persons as taxable, even if earned outside the United States. The United States generally exempted from direct taxation, however, all income earned outside the United States by foreign corporations.

⁵⁷ *FSC (Panel)*, para. 4.809.

⁵⁸ For a more detailed discussion of this example, see *FSC (Panel)*, paras. 4.809 and 4.1042.

⁵⁹ *See, e.g.*, First EC 21.5 Submission, para. 121.

49. This exemption applied even if the foreign corporation was owned by a US person. Subject to certain anti-deferral rules, the United States generally taxed the US shareholders of foreign corporations at the time income was distributed to the US shareholder. Thus, as a general matter, US shareholders of foreign corporations benefitted from the deferral of US tax on income earned through a foreign corporation.

50. Notwithstanding this general rule, the United States has adopted a series of “anti-deferral” regimes that constitute limited exceptions to the general norm of deferral and that, in general, respond to specific concerns about potential tax avoidance by US corporations through foreign affiliates. One of these regimes is found in subpart F of the IRC. Subpart F limits the availability of deferral for certain types of income earned by certain controlled foreign subsidiaries of US companies.⁶⁰ Pursuant to subpart F, a US shareholder that controls a foreign corporation must pay US tax on certain types of income earned by the foreign corporation at the time the income is earned by such foreign corporation, and without regard to whether the income is distributed to the shareholder.

51. As the Panel and Appellate Body found in *FSC*, the FSC operated as an exception to these general rules of US corporate taxation. It subjected the income of a foreign corporation directly to US taxation. It provided a dividends received deduction for income repatriated by a foreign subsidiary to a domestic parent. It created an exception to subpart F for income of a controlled foreign corporation that otherwise might have been deemed to be immediately taxable to the foreign corporation’s parent. And, of course, the FSC applied only to income from “export property”; *i.e.*, property manufactured in the United States and sold abroad.

2. The Act Makes a Fundamental Shift in US Tax Treatment of Extraterritorial Income

52. The Act modified the general rule of US taxation by fundamentally amending the definition of “gross income”, the term which, under US tax law, defines the boundaries of US taxing jurisdiction. In contrast to the former US worldwide approach, the Act excludes income earned in qualifying foreign transactions from the definition of gross income and, thus, modifies the extent to which the United States seeks to tax such income.

53. This new general rule applies to a substantially broader category of income than that which was exempted from tax under the FSC provisions. It applies to foreign transaction income irrespective of whether the goods in question were produced in the United States. It requires no related foreign company to be involved in the transactions in question, and it is applicable to a broader group of taxpayers, including foreign corporations.

54. Thus, unlike the FSC, the Act’s exclusion of income from US taxation is automatic. It does not result from the creation of an exception to US general rules for taxing foreign corporations, an exception to the subpart F rules, or an exception to the rules governing the dividends received deduction. Instead, the Act’s exclusion is part of the US general rules of taxation.

3. The Act Does Not Require Exportation

55. Not only is the Act broader than the FSC in terms of the rules it establishes for the US tax system and with respect to the taxpayers that may use it, it also is broader with respect to the transactions it covers. Unlike the FSC, the Act is not limited to “export property”. Instead, the Act applies to income involving property produced within or without the United States. Indeed, unlike the FSC, excluded income under the Act can arise from transactions involving property that is manufactured and sold outside the United States, and all of the value of which is comprised of 100 per cent foreign content. As in the case of European tax regimes, exporters are eligible for the exclusion, but the Act nowhere requires a taxpayer to export in order to earn excluded extraterritorial income.

⁶⁰ IRC § 951 (US-4).

IV. ISSUES RAISED IN THIS PROCEEDING

56. The following issues are raised in this proceeding for resolution by the Panel:
- (a) Whether the Act's exclusion of extraterritorial income from US taxation confers a subsidy within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.
 - (b) Whether the Act's exclusion of extraterritorial income from US taxation is contingent upon export performance within the meaning of Article 3.1(a) of the SCM Agreement.
 - (c) Whether the Act's exclusion of extraterritorial income from US taxation constitutes a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59 of the SCM Agreement and whether, for that reason, the exclusion does not constitute a prohibited export subsidy under Article 3.1(a) of the SCM Agreement.
 - (d) Whether, if the Act's exclusion of extraterritorial income from US taxation does not constitute a prohibited export subsidy by virtue of the fifth sentence of footnote 59, the exclusion is not prohibited by any other provision of the SCM Agreement by virtue of footnote 5 of that Agreement.
 - (e) Whether the Act's 50 per cent rule on certain foreign value renders the Act's exclusion of extraterritorial income from US taxation contingent upon the use of domestic goods over imported goods within the meaning of Article 3.1(b) of the SCM Agreement.
 - (f) Whether the Act's 50 per cent limitation on certain foreign value provides less favourable treatment to imported goods in comparison to the treatment afforded to like domestic goods so as to be inconsistent with Article III:4 of GATT 1994.
 - (g) Whether the Act's exclusion of extraterritorial income from US taxation is inconsistent with US obligations under Articles 10.1 and 8, or Article 3.3 and 8, of the Agreement on Agriculture.
 - (h) Whether the DSB's recommendation that the FSC subsidy be withdrawn with effect from 1 November 2000 precludes a reasonable transition period.
 - (i) Whether third parties to this proceeding have a right to the parties' rebuttal submissions.

V. ARGUMENT

A. GENERAL CONSIDERATIONS

57. Although this principle is now well-established in WTO jurisprudence, it is nonetheless worth recalling that the EC, as the complainant, bears the burden of proof both in terms of presenting a *prima facie* case and in the sense of the ultimate burden of persuasion. Thus, if the balance of evidence is inconclusive, the EC will have failed to have established its claims.⁶¹

58. It also is worthwhile to recall the principles of treaty interpretation that govern this proceeding. Article 3.2 of the DSU states that provisions of WTO agreements are to be read in accordance with "the customary rules of interpretation of public international law." The Appellate Body has frequently explained that the "general rule of interpretation" under public international law

⁶¹ See, e.g., *India - Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*, WT/DS90/R, Report of the Panel, as affirmed by the Appellate Body, adopted 22 September 1999, para. 5.120.

is set forth in Article 31(1) of the *Vienna Convention on the Law of Treaties* (“VCLT”), which provides that “[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.” As the United States demonstrates in the sections that follow, when the relevant provisions of the WTO agreements are considered in light of their ordinary meaning, context and object and purpose, it becomes clear that the Act is consistent with US WTO obligations.

B. THE EXCLUSION OF EXTRATERRITORIAL INCOME UNDER THE ACT DOES NOT CONSTITUTE A SUBSIDY UNDER ARTICLE 1 OF THE SCM AGREEMENT

59. The first issue before the Panel is whether the exclusion of extraterritorial income under the Act constitutes a “subsidy” within the meaning of Article 1 of the SCM Agreement. If it does not, it cannot be a prohibited subsidy under either Article 3.1(a) or Article 3.1(b), and the Panel need not reach any of the issues raised by Article 3 at all.⁶² In this section, the United States explains why the exclusion of extraterritorial income under the Act does not constitute a “subsidy” as that term is defined in Article 1, as construed by the *FSC* Panel and the Appellate Body.

1. Under Article 1, the Normative Benchmark Is the Member’s “Prevailing Domestic Standard”

60. Article 1 of the SCM Agreement provides that “a subsidy shall be deemed to exist if . . . there is a financial contribution by a government . . . and a benefit is thereby conferred.” With respect to tax measures, Article 1.1(a)(1)(ii) provides that a “financial contribution” exists where “government revenue that is otherwise due is foregone or not collected”. The determinative Article 1 issue in this case is thus whether, by excluding extraterritorial income from gross income – and, thus, excluding extraterritorial income from US taxing jurisdiction – the United States has “foregone or not collected” revenue that is “otherwise due”.

61. With respect to the ordinary meaning of the critical terms used in subparagraph (ii), the meaning of “revenue” most applicable to this case is “the annual income of a government or State, from all sources, out of which the public expenses are met”.⁶³ The definition of “forego” is “to abstain or refrain from” or “go without; deny to oneself”.⁶⁴ “Otherwise” is defined as “by other means; differently; in another case; in other circumstances”,⁶⁵ and “due” is defined as “an obligatory payment; a fee, a tribute, a toll; a legal charge”.⁶⁶ Taking the ordinary meaning of these terms together, the foregoing of revenue otherwise due means that a government has refrained from collecting income that in another circumstance would be legally owed to the government.

62. The classic case to which this language applies is a situation in which a company or group of companies has a legal tax obligation that the government forgives or fails to enforce. Selectively rebating a company’s taxes or failing to enforce its existing tax obligations or giving the company preferential treatment under a generally applicable law are all situations that readily fit the ordinary meaning of subparagraph (ii). Each would be an example of a government’s foregoing or not collecting taxes that are otherwise due.

⁶² *FSC (AB)*, 93 (“This definition [of subsidy] . . . applies wherever the word “subsidy” occurs throughout the *SCM Agreement* and conditions the application of the provisions of that Agreement regarding *prohibited* subsidies in Part II”) (emphasis in original); *see also FSC (Panel)*, para. 7.39 (“in order for a measure to be an export subsidy within the meaning of Article 3.1(a) of the *SCM Agreement*, it must be a subsidy within the meaning of Article 1 of that Agreement”).

⁶³ The New Shorter Oxford English Dictionary (1993).

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

63. Where the tax laws of a country themselves create a special exception from general tax obligations, that, too, may come within the language of subparagraph (ii). In the case of a statutory exception, the inquiry is again whether the income expressly excepted from tax would be “otherwise due” under other provisions of the country’s tax law. Both the *FSC* Panel and the Appellate Body found that to determine whether taxes on statutorily excepted income would be “otherwise due,” it is necessary to compare the challenged statutory measure with a “normative benchmark”. As the Appellate Body stated, under subparagraph (ii), determining whether taxes are “otherwise due” requires a “defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised otherwise”.⁶⁷

64. Moreover, both the *FSC* Panel and the Appellate Body made clear that the normative benchmark must be found in the tax regime of the Member whose measure is being challenged. As the *FSC* Panel explained, “there is in the WTO Agreement no theoretical ‘correct’ benchmark for taxes that would represent the norm for taxes and duties ‘otherwise due.’”⁶⁸ Rather, “the determination whether revenue foregone is ‘otherwise due’ must involve a comparison between the fiscal treatment being provided by a Member in a particular situation and the tax regime otherwise applied by that Member”⁶⁹ As explained by the Appellate Body, “the word ‘foregone’ suggests that the government has given up an entitlement to raise revenue that it could ‘otherwise’ have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues.”⁷⁰ Instead, it must be an entitlement established in a government’s own tax laws.

65. The *FSC* Panel applied this concept by asking whether taxes would have been collected “but for” the measure in question.⁷¹ Applying this “but for” test, the Panel considered “whether, if the *FSC* scheme did not exist, revenue would be due which is foregone by reason of that scheme.”⁷² While noting that it might not be appropriate in all cases, the Appellate Body agreed that the panel’s “but for” test was appropriate for the *FSC* case. Stressing that WTO obligations do not compel any particular kind of tax system, and that Members have the sovereign authority to tax or not to tax particular categories of revenue, the Appellate Body concluded that the comparison must be with the “prevailing domestic standard” of the Member in question.⁷³

66. Thus, the standard of subparagraph (ii), by its own terms and as construed by the *FSC* Panel and the Appellate Body, looks to whether, by virtue of a challenged measure, a government foregoes tax revenues that would otherwise be due under the normative benchmark that is the Member’s “prevailing domestic standard.” It was with reference to this WTO legal standard that the United States developed the Act.

2. By Excluding Extraterritorial Income from “Gross Income”, the Act Does Not Forego Revenue that Is Otherwise Due

67. In determining how to revise the US tax system, Congress relied on and sought to incorporate the principles articulated by the *FSC* Panel and the Appellate Body. In particular, it designed the Act to meet the articulated standard of Article 1 of the SCM Agreement. Congress achieved this result by altering the general jurisdictional rule of US taxing authority; *i.e.*, the “outer boundary” of US taxing authority.

⁶⁷ *FSC (AB)*, para. 90 (“the basis of comparison must be the tax rules applied by the Member in question”).

⁶⁸ *FSC (Panel)*, para. 7.42.

⁶⁹ *Id.*, para. 7.43.

⁷⁰ *FSC (AB)*, para. 90 (emphasis in original).

⁷¹ *FSC (Panel)*, para. 7.45.

⁷² *Id.*

⁷³ *FSC (AB)*, para. 90.

68. Incorporating limitations similar to those found in many European countries that place territorial limits on their own taxing authority, the United States restricted the statutory scope of its own taxing authority. Not unlike European countries that decline to tax certain categories of foreign income, the United States placed new limits on its own taxing authority with respect to “extraterritorial income”. To accomplish this as a technical matter under the US tax system, the United States modified the domestic standard of “gross income”, the concept that defines income that is subject to taxation for purposes of US tax law. In the words of the *FSC* Panel and the Appellate Body, the United States modified the “normative benchmark” for taxation under US law.

(a) Under US Tax Law, “Gross Income” Defines US Taxing Jurisdiction

69. Under US law, the taxing authority of the United States government is defined by the statutory definition of “gross income.”⁷⁴ “Gross income” is defined in Parts I - III of Chapter 1B, Subtitle A of the IRC, in particular section 61, sections 71 through 90, and sections 101 through 139. These provisions define items that are specifically included in and specifically excluded from the definition of “gross income”.

70. In addition to setting the outer limits of US taxing authority, “gross income” serves as the central reference point for determining the tax liability of US taxpayers. For example, it is the threshold reference point in determining whether a person or entity must file a tax return. It is the starting point for determining “taxable income,” and thus one’s tax obligations.⁷⁵ “Gross income” is the reference point for computing state and local taxes, for taking tax deductions, and for determining eligibility for certain tax benefits. In the context of prosecuting underpayment of taxes, whether the statute of limitations can be extended is based on whether the amount of omitted gross income exceeds 25 per cent of the amount of gross income reported.⁷⁶

71. The definition of “gross income” is thus the “prevailing domestic standard” for US taxation. It defines the general rule, or the jurisdictional boundary, of US taxing authority. In the words of the Appellate Body, it is the “normative benchmark” under US law against which any particular measures must be evaluated. It is the benchmark against which exemptions or deductions or allowances are figured and, therefore, is the rule that would otherwise apply “but for” any exemption, deduction, or allowance. Income that does not come within the definition of “gross income” is beyond the statutory taxing authority of the US Government.

72. By modifying the definition of “gross income” through the Act, the United States made a fundamental change in its tax structure, establishing a new “prevailing domestic standard” for US taxation. Thus, new section 114(a) of the IRC, which provides that “[g]ross income does not include extraterritorial income,” represents a significant shift in US taxing jurisdiction and the normative benchmark for US taxation of foreign income.

73. The legislative history of the Act makes clear that Congress understood that it was making just such a fundamental, jurisdictional change. The *House Report*, at pages 16-17, specifically states as follows:

[The Act] modifies the general rule of US taxation by fundamentally amending the definition of gross income. Under the Code, the definition of “gross income” defines the outer boundaries of US income taxation. The bill excludes income derived from certain activities performed outside the United States, referred to as “extraterritorial income,” from the definition of gross income and, thus, modifies the extent to which

⁷⁴ See 501-2d Tax Mgmt. (BNA), page A-1(Exhibit US-6) (“Gross income is a fundamental ingredient in the determination of federal income tax liability”).

⁷⁵ See IRC § 63 (US-4).

⁷⁶ IRC § 6501(e) (US-4).

the United States seeks to tax such income. This new general rule thus becomes the normative benchmark for taxing income derived in connection with certain activities performed outside the United States.

(b) A WTO Member Is Free to Change the Standard that Governs Its Own Taxing Jurisdiction

74. WTO Members are, of course, free to modify their own tax systems. As the Appellate Body took pains to point out, WTO obligations do not dictate what type of tax system a Member must have. Indeed, as discussed further below, there is great variety in the tax principles that Members apply and in how they apply them. So long as they do not contravene specific WTO obligations, Members have “the sovereign authority to tax any particular categories of revenue” and are “also free *not* to tax any particular categories of revenues.”⁷⁷

75. The Appellate Body thus confirmed a principle that is fundamental to the application of WTO rules to national tax measures. It must necessarily be the case that Members are free to change their policies as to what categories of revenue they choose to tax or not to tax. It could not be the case that Members are free to *expand* their taxing authority to new categories of income, but not free to *contract* their taxing authority by deciding not to tax certain previously taxed categories of income. To argue that a country’s decision *not* to tax a category of income constitutes a subsidy (because “but for” the change the income would be taxed) would mean that a country could change its general taxing authority only by expanding it. Applying the “but for” test in such an over broad manner would produce a perverse situation in which any decision to reduce taxes or reduce taxing authority would constitute a “subsidy” under Article 1 of the SCM Agreement. Such a position would be untenable and illogical.⁷⁸

76. Moreover, a Member must be free to modify its general rule of taxation in order to comply with a decision by a WTO panel or the Appellate Body. Where a Member has a measure that is inconsistent with the Article 1 subsidy standard, the Member is free to cure that failing by modifying the offending measure or by changing its general rule of taxation, or by doing both.

(c) Under the Modified US Normative Benchmark, the Income Excluded by the Act Is Not “Otherwise Due”

77. Applying the standard of Article 1, as articulated by the *FSC* Panel and the Appellate Body, the Act does not constitute a subsidy because tax on the excluded income is not “otherwise due”. Because the United States lacks statutory authority to tax anything that falls outside the definition of “gross income”, there is no general rule of taxation that would apply “but for” the definition of “gross income”.

78. This new limitation on US taxing authority is analogous to territorial limits that other governments impose on themselves in limiting their own taxing jurisdiction. Although any limitation or restraint that causes a country to exercise less than its theoretical maximum taxing authority is, in one sense, a decision to forego potential revenue, it is clear, as the Appellate Body stated, that neither the WTO Agreement in general, nor the SCM Agreement in particular, requires Members to tax all categories of potentially taxable income.

79. The Act excludes extraterritorial income from gross income. This exclusion constitutes a defined, normative benchmark for taxing income earned on foreign transactions. Because this

⁷⁷ *FSC (AB)*, para. 90.

⁷⁸ For example, assume that the United States chose to overhaul its tax system and adopt the tax regime of France (which the EC presumably maintains does not confer a subsidy, even though export transactions are treated more favourably than comparable domestic transactions). Under the EC’s reasoning, the United States has foregone revenue that is otherwise due, because “but for” the legislation establishing the new tax regime, the United States would have taxed some categories of revenue that are excluded from tax under the new regime.

exclusion constitutes a jurisdictional limitation on taxing income from foreign transactions, taxes on extraterritorial income are not “foregone” and are not “otherwise due”.

80. Under a “but for” analysis of the type the Panel undertook in *FSC*, the Act does not satisfy the Article 1 definition of a “subsidy”. Applying that analysis, it is clear that, unlike the *FSC*, the Act’s exclusion of extraterritorial income is not a narrow tax-reducing exception to a general tax-raising rule. Rather, the limitation that it places on US taxing authority is a part of the general rule of taxation itself. The exclusion does not provide an exception against a broader definition of “gross income” that would otherwise apply.

81. Indeed, under the “but for” test, the absence of the tax-raising exception would leave only the general exclusion. Section 114(a) of the IRC provides that gross income does not include extraterritorial income. Section 114(b) states that extraterritorial income does not include income that is not qualified foreign trade income. Thus, the exception found in section 114(b) raises revenue. But for section 114(b), all extraterritorial income would be excluded from gross income under section 114(a), and the exclusion would be broader.

82. Similarly, the Act meets other elements of the standard articulated by the Appellate Body. To constitute an Article 1 “subsidy”, the government must have “given up an entitlement to raise revenue” and that entitlement must be based on “some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised ‘otherwise.’”⁷⁹ Turning, as the Appellate Body directs, to the United States’ “prevailing domestic standard”, one finds that there is now no general principle that would impose tax on income now excluded by the Act. To the contrary, the general authority to tax extraterritorial income has now been eliminated from the prevailing US standard.

83. Accordingly, applying the ordinary meaning of subparagraph (ii) and the test articulated by the *FSC* Panel and the Appellate Body, the Act does not constitute a subsidy within the meaning of Article 1. No longer does the IRC contain a specific exception from a general rule that would broadly tax extraterritorial income; instead, it now contains a jurisdictional limit that places such income beyond the taxing authority of the United States. By making this change, the United States has imposed a type of territorial limit on its taxing authority that is in many respects similar to that imposed by numerous European countries. European taxing limits, many of which are defined or qualified narrowly by very specific provisions, cause certain foreign-source income to be taxed and some not to be taxed. In seeking to comply with the rulings in *FSC* by deciding not to tax a certain category of income – excluded extraterritorial income – the United States has exercised the same sovereign authority that has been exercised by numerous Members in Europe and elsewhere.

3. The EC’s Article 1 Arguments Are Inconsistent With the Text of Subparagraph (ii), as Interpreted by the *FSC* Panel and the Appellate Body

84. The EC argues that the Act’s exclusion of extraterritorial income comes within the definition of the term “subsidy” in Article 1 for reasons that are unrelated to the standard of subparagraph (ii), and for reasons that ignore the realities of tax systems around the world and in Europe, in particular. The reasons why the EC’s arguments are not legally tenable are set forth below.

(a) The EC’s Argument that the Act’s Exclusion of Extraterritorial Income Should Be Viewed as an Exemption

85. The EC argues that it is “misleading” for the Act to be denominated as an “exclusion” rather than an “exemption”. The EC then argues that the tax-raising exception in section 114(b) is the general rule and the exclusion of extraterritorial income is the exception.

⁷⁹ *FSC (AB)*, para. 90.

86. This line of argument is defective for several reasons. First, it fails to address the law that the United States did adopt. Instead, it seeks to redesign that law and then critique the redesigned version as legally insufficient. Obviously, the law before this Panel is the law that the US Congress enacted, not a different version that, had it been adopted and structured as the EC suggested, would, in the EC's eyes, be legally defective.

87. Second, whether, as a matter of US tax law, the new modifications to the term "gross income" are more appropriately designated as an "exclusion" than as an "exemption" is really a judgment that the United States Congress is in a better position to make than EC officials. Although the EC may believe that an "exemption" could be more readily challenged under Article 1 than an "exclusion," the EC cannot bootstrap itself into such an argument by claiming that the Act really should have been called an "exemption".

88. Third, and most important, the semantic distinction between an exclusion and an exemption would not, in any event, be determinative. Rather, the test under subparagraph (ii) is whether tax on the income now excluded would be otherwise legally owed to the government. Under that standard, as further explicated by the *FSC* Panel and the Appellate Body, tax on the now-excluded income is not "otherwise due" under the current prevailing standard of US taxation.

(b) The EC Argument that the Excluded Income Is a Subsidy Because the Exclusion Should Be Larger

89. The EC makes a variety of arguments to the effect that the Act confers a subsidy because the exclusion ought to be larger. For example, the EC objects to the Act on the grounds that non-qualified foreign trade income *is* taxed. It characterizes the definitional limits of "extraterritorial income" as "conditions" that narrow the scope of the exclusion, and it faults the new Act because excluded "extraterritorial income" does not include all "foreign source income". Thus, the EC contends, because the exclusion is not larger or unqualified, it must be deemed to be a "subsidy" within the meaning of Article 1.

90. Subparagraph (ii), however, does not specify that revenue that governments elect to forego can be foregone only in particularly designed categories. Members are not obliged, for example, to take an "all-or-nothing" approach with respect to the taxation of "foreign source income". If that were the standard, then most likely all Members, including EC member states, would fail that standard.⁸⁰

91. Nor are Member governments required to ignore the revenue implications of their tax policy decisions. It is both appropriate and permissible for governments to adjust their taxing policies to meet certain revenue objectives or constraints. Thus, the fact that a category of income is given a partial rather than an absolute exclusion from tax is an appropriate fiscal determination for a Member to make. It was entirely appropriate for the US Congress to determine that the revenue implications of the Act should not be drastically different from the revenue implications of the discarded *FSC*. That an exclusion is qualified or moderated, however, does not convert it into a subsidy under Article 1.

(c) The EC Argument that "Extraterritorial Income" Is Not a "General Category"

92. A variation on the EC's argument that the Act's exclusion should be larger is its argument that "extraterritorial income" is "not a general category of income that a WTO Member may choose

⁸⁰ For example, Belgium grants a 95 per cent participation exemption on distribution of earnings from a foreign subsidiary of a Belgian corporation. *FSC (Panel)*, para. 4.811, note 408. Under the EC's argument, Belgium is foregoing revenue that is otherwise due because it taxes the other 5 per cent.

not to tax”.⁸¹ This is a conclusory, circular argument that can be advanced only by studiously avoiding the scope of the Act and the tax practices in use throughout Europe and the rest of the world.

93. To support the conclusory argument that “extraterritorial income” is not a suitable category of income to exclude from tax, the EC is simply asserting that this category is not, in its view, sufficiently unqualified, or that it cannot be structured so as to calibrate the fiscal consequences of the exclusion. Again, this is an argument that finds no textual support in subparagraph (ii) or in panel or Appellate Body decisions. Even if the EC’s argument did have some basis in law, the fact remains that the Act applies generally to foreign transactions. It does so irrespective of whether goods are manufactured in the United States or abroad, and it applies to all US taxpayers who earn extraterritorial income.

94. Notwithstanding the general applicability of the Act’s exclusion, the EC’s argument that only the non-taxation of a “general” category falls outside of subparagraph (ii) would mean that most of the tax systems in Europe are subsidy schemes. In construing subparagraph (ii), it is reasonable for the Panel to consider whether the intent of the Uruguay Round negotiators was to adopt a principle under which the tax systems of most industrialized countries would be subsidies.

95. Specifically, European tax systems exclude from taxation a wide variety of categories of foreign source or extraterritorial income. However, the scope of those exclusions is by no means uniform. To the contrary, most European countries have detailed rules or conventions that allow certain income, either earned abroad or associated with foreign transactions, to escape domestic tax or to be taxed. Like the Act, these systems reflect some legislative discretion as to the size and extent of the categories that are not subject to domestic tax, and the line-drawing that occurs varies from country to country. However, it cannot be seriously contended that those systems constitute subsidies merely because they are not identical to one another. Likewise, it cannot be seriously contended that the Act constitutes a subsidy simply because the US Congress chose to draw a jurisdictional line in a place different from that chosen by European legislators.

96. To give just a few brief examples:

- In *Belgium*, resident companies are subject to Belgian corporate income taxes on profits from their activities, wherever conducted, unless specifically excluded by domestic law or as a result of a tax treaty. One such exclusion is that 75 per cent of foreign branch income generated in a country with which Belgium has not concluded an income tax treaty – whether export-related or otherwise – is exempt from Belgian tax. Another source of profit that is excluded from taxation is foreign-source dividend income. Ninetyfive per cent of dividend income from a foreign subsidiary to a shareholder owning at least 5 per cent of the shares of the subsidiary (or holding an interest in the subsidiary with an acquisition value of at least BFr 50 million) is not taxed, but the remaining five per cent is taxed. Therefore, the tax exclusion is not unqualified.
- In *France*, foreign income directly attributable to operations conducted abroad – either by a company directly or through a branch – is exempt from tax. As a result, 95 per cent of the gross amount of dividends receivable from a foreign company by either a 10 per cent shareholder or a shareholder holding an interest in the foreign company of at least FF 150 million is exempt from French tax. However, this qualified exemption is further limited. A French corporate taxpayer is required to include in its taxable income its *pro rata* share of the income of a foreign company in which it either has a direct or indirect interest of 10 per cent or more or at least FF 150 million, if the foreign company is subject to a “privileged tax regime”. A foreign tax regime is considered “privileged” if the foreign tax rate is two-thirds or less than the tax rate that would have been payable in France on the same

⁸¹ *EC First 21.5 Submission*, para. 60.

income. This “low tax exception” does not apply if the foreign company at issue has an effective commercial or industrial activity predominantly performed in the local market. The “low tax exception” also may not apply under certain tax holidays or if a tax treaty provides for different tax treatment.

- In *Germany*, companies are subject to German corporate tax on their income regardless of its source if they have their statutory seat of business or effective place of management in Germany. However, German tax authorities exclude from income dividends received from foreign branches and foreign subsidiaries of corporate shareholders in about 70 treaty countries. Nevertheless, despite this exclusion, foreign-source income is treated differently depending upon the country in which the foreign branch or subsidiary resides because the specific requirements for receiving the tax benefit vary from treaty to treaty.
- In *Italy*, resident companies are subject to corporate income tax on all sources of income. However, dividends paid to Italian shareholders are 95 per cent exempt from Italian tax, as long as (1) the company paying dividends is resident in a country included in a “parent-subsidiary directive list” (currently EC countries) and (2) the Italian shareholder (parent company) has held more than 25 per cent of the subsidiary’s capital for over one year. This exemption will also apply only if the subsidiaries are located in countries that do not have a privileged tax system.

97. These are but a few examples illustrating the point that tax systems around the world refrain from taxing foreign income in a qualified or conditional manner. Treating the Act’s exclusion as a subsidy could result in parallel measures among many, if not most, WTO Members to be deemed subsidies. This would indeed be a disturbing result, one that would come as a surprise to these Members and one that could not have been intended by the drafters of the SCM Agreement.

98. In conclusion, the EC’s arguments that the Act’s exclusion constitutes a subsidy are not based on the text of subparagraph (ii) or the standards articulated by the *FSC* Panel and the Appellate Body. Instead, the EC’s objections essentially are nothing more than that the Act did not make the US tax system sufficiently “European”.

99. The EC asserts that by adopting the Act, the US Congress was “playing with words.”⁸² What, in fact, the US Congress was doing was being exceedingly attentive to the words of subparagraph (ii) and the words of the *FSC* Panel and the Appellate Body, as US WTO obligations required it to do. Ironically, the EC’s arguments in this proceeding are not textual, but rather are based on standards that are not reflected in the SCM Agreement. However, when one applies the actual terms of subparagraph (ii) and the standards articulated by the *FSC* Panel and Appellate Body, it becomes clear that the Act’s exclusion of extraterritorial income is not a “subsidy” within the meaning of Article 1 of the SCM Agreement.

4. The EC Has Failed to Demonstrate that, as a Factual Matter, the Act’s Exclusion of Extraterritorial Income Results in the Foregoing of Revenue that Is Otherwise Due

100. As discussed above, the EC essentially argues that the determination of whether revenue is foregone depends upon a comparison of the US tax system before adoption of the Act with the US tax system after adoption of the Act. This comparison is not, and cannot be, the appropriate comparison for determining whether a measure foregoes revenue that is otherwise due, because, by that standard, any amendment to a Member’s tax laws with a net revenue cost automatically would qualify as a subsidy.

⁸² *EC First 21.5 Submission*, para. 39.

101. Even assuming *arguendo* that the legal standard articulated by the EC is correct, the EC has not established, as a factual matter, that extraterritorial income would be taxed or taxed to a greater extent absent the Act. In fact, absent the Act, income currently defined as extraterritorial income may not be subject to tax at all or taxed to a lesser extent. Indeed, without additional facts, it is unclear how excluded income would be treated under US tax rules if the Act's exclusion did not exist. The EC simply has not presented any evidence demonstrating that the Act will cause the United States to forego revenue that would be otherwise due.

102. There are a number of factors suggesting that revenue is not foregone as a result of the Act's exclusion of extraterritorial income. For example, foreign corporations are among the taxpayers that may earn excluded extraterritorial income. The existence of the Act as part of the US tax system might motivate foreign corporations to structure a portion of their operations in the United States to achieve a tax-efficient global operating structure. Without the Act, these foreign corporations might structure their operations in such a manner so as to avoid being subject to US taxation altogether. In that case, such foreign corporations might not pay any US taxes on income currently defined as extraterritorial income, and, thus, it cannot be said the Act has caused the United States to forego revenue.

103. Similarly, in the absence of the Act, US companies that otherwise would earn extraterritorial income could choose to structure their foreign sales operations through a jurisdiction that provides an exclusion for income from foreign sales similar to the exclusion currently provided by the Act (for example, by establishing the operation in a country that has adopted a territorial system). In that case, income that otherwise would have been excluded income under the Act would not be subject to US tax. Accordingly, it cannot be said that the United States has foregone any revenue.

104. Finally, because the Act does not allow for deferral, deductions, or foreign tax credits in relation to excluded income, it is possible, depending on the facts, that taxpayers would rely on such tax-reducing mechanisms in the absence of the Act.

105. All of these circumstances and variables undermine the EC's unsupported assertion that extraterritorial income excluded by the Act necessarily would be taxed absent the Act.

106. Similarly unavailing is the EC's attempt to "prove" that the United States is foregoing government revenue "otherwise due" by referring to a Congressional study on the "cost" of the Act.⁸³ The EC's reliance on this study is misplaced, because the EC misinterprets its meaning. The "cost" cited by the EC is actually a comparison of the revenue consequences under the Act versus the FSC and the former US worldwide tax system. By shifting to a territorial-like regime, the US is no longer collecting the same kinds and amounts of tax revenue that were collected under its worldwide system. This "cost" in relation to the prior US tax system is simply not relevant to an analysis under Article 1 and how the United States would capture tax "but for" the new law.

C. THE ACT'S EXCLUSION OF EXTRATERRITORIAL INCOME DOES NOT CONSTITUTE A PROHIBITED EXPORT SUBSIDY UNDER ARTICLE 3.1(A) OF THE SCM AGREEMENT

107. Even assuming *arguendo* that the Act's exclusion of extraterritorial income constitutes a subsidy, the EC's claim that this "subsidy" is a prohibited export subsidy is based on an erroneous interpretation of Article 3.1(a) and a misunderstanding of the Act. As demonstrated below, the Act's exclusion of extraterritorial income is not contingent on export performance within the meaning of Article 3.1(a), and the EC has failed to demonstrate that it is.

⁸³ *Id.*, para. 21.

1. The Meaning of Article 3.1(a)

108. Article 3.1(a) of the SCM Agreement provides in relevant part that “the following subsidies, within the meaning of Article 1, shall be prohibited: (a) subsidies contingent in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I.” Thus, assuming *arguendo* that a subsidy exists, for the EC to succeed in establishing a *prima facie* case of a prohibited export subsidy, it must establish that the subsidy conferred is contingent, as a matter of law or fact, on export performance.

109. According to the Appellate Body, the “key word” in Article 3.1(a) is “contingent”.⁸⁴ The Appellate Body has explained that the term “contingent” has an ordinary meaning of “conditional” or “dependent for its existence on something else.”⁸⁵ Thus, an export subsidy within the meaning of Article 3.1(a) is a subsidy that requires recipients to export in order to obtain it. Or, in the words of the Appellate Body, “the subsidy is available only upon fulfillment of the condition of export performance.”⁸⁶

110. It is not enough for a subsidy to be granted upon the mere expectation that the subsidy will lead to new or additional exports; the grant of the subsidy in and of itself must be conditioned on export performance. As the Appellate Body has said, “It does not suffice to demonstrate solely that a government granting a subsidy *anticipated* that exports would result. The prohibition in Article 3.1(a) applies to subsidies that are *contingent* upon export performance A subsidy may well be granted in the knowledge, or with the anticipation that exports will result. Yet, that alone is not sufficient, because that alone is not proof that the granting of the subsidy is *tied to* the anticipation of exportation.”⁸⁷

2. The Act’s Exclusion of Extraterritorial Income Is Not Contingent on Export Performance

111. The Appellate Body has stated that *de jure* export contingency can be “demonstrated on the basis of the words of the relevant legislation”⁸⁸ or “derived by necessary implication from the words actually used in the measure.”⁸⁹ As demonstrated below, the Act’s exclusion of extraterritorial income is not export-contingent expressly or by implication.

(a) The Act Does Not Expressly Condition The Exclusion of Extraterritorial Income on Export Performance

112. The starting point in determining whether a measure grants prohibited *de jure* export subsidies is the text of the legislation, regulation, or other legal instrument in dispute.⁹⁰ In sharp

⁸⁴ *Canada – Measures Affecting the Export of Civilian Aircraft* (“*Canada Aircraft (AB)*”), WT/DS70/AB/R, Report of the Appellate Body adopted 20 August 1999, para. 167. In this case, the Appellate Body held that “the legal standard expressed by the word ‘contingent’ is the same for both *de jure* and *de facto* contingency.” *Id.* The principal difference between the two is “what evidence may be employed to prove that a subsidy is export contingent.” *Id.* While it appears that the EC has confined its challenge to the Act to a *de jure* claim, the analysis of Article 3.1(a) in *de facto* cases such as *Canada Aircraft* are relevant here.

⁸⁵ *Id.*

⁸⁶ *Canada – Certain Measures Affecting the Automotive Industry* (“*Canada Autos (AB)*”), WT/DS139/AB/R, WT/DS142/AB/R, Report of the Appellate Body adopted 19 June 2000, para. 100.

⁸⁷ *Canada Aircraft (AB)*, paras. 171-172 (emphasis in original).

⁸⁸ *Id.*, para. 167.

⁸⁹ *Canada Autos (AB)*, para. 100.

⁹⁰ *Id.* By contrast, proving *de facto* export contingency requires that “the relationship of contingency, between the subsidy and export performance, must be *inferred* from the total configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case.” *Id.* (emphasis in original).

contrast to the FSC, which the Panel found explicitly required exportation in order for its tax exemption to apply,⁹¹ the Act does not require or even refer to exportation in relation to the availability of its exclusion. Indeed, the EC concedes this point.⁹²

113. In order to comply with Article 3.1(a), the Act was purposefully drafted to broaden the universe of transactions eligible for the exclusion beyond those eligible for the FSC tax exemption. The legislative history makes this point expressly:

In addition to ensuring that the FSC replacement regime is not a “subsidy,” the Committee believes that, in order to ensure WTO compatibility, it is important that the new regime not confer export-contingent benefits. To achieve this goal, the Committee has relied on the WTO Appellate Body’s interpretation of the meaning of “contingent” for purposes of the Agreement on Subsidies and Countervailing Measures in crafting this legislation. It is the Committee’s intent and belief that the exclusion of extraterritorial income from US gross income is not dependent on such income arising from export activities. Accordingly, the Committee has determined that it is appropriate to treat all foreign sales alike, whether the goods were manufactured in the United States or abroad. A taxpayer would receive the same US tax treatment with respect to its foreign sales regardless of whether it exports. As a result, the exclusion for certain extraterritorial income is not “conditional” or “dependent” on whether an entity exports; therefore, it clearly is not export contingent.⁹³

114. Thus, unlike the FSC, the Act provides an exclusion from taxation for income derived from all qualifying foreign transactions, not simply exports.⁹⁴ The Act does not require that goods that are the subject of transactions eligible for the exclusion need be manufactured or produced in the United States.⁹⁵ Instead, they may be produced outside the United States.⁹⁶ Thus, the Act does not expressly require exportation in order for its exclusion to apply.

(b) In Operation, the Act Does Not Condition the Availability of the Exclusion of Extraterritorial Income On Export Performance

115. Just as the Act does not require exportation on its face, it does not do so through its operation or application. As demonstrated below, the Act’s exclusion of extraterritorial income is available to a range of foreign transactions that do not necessarily involve exportation. In this way, the exclusion is not contingent, conditioned, or dependent for its existence on export performance.

(i) *The Act Implements an Export-Neutral Principle*

116. As previously noted, the rationale for the Act’s exclusion of extraterritorial income was to treat all foreign transactions alike, regardless of where goods are manufactured.⁹⁷ To the extent that exporting is involved in relation to the Act at all, it is merely incidental:

The Committee emphasizes that the extraterritorial income excluded by this legislation from the scope of US income taxation is parallel to the foreign-source income excluded from tax under most territorial tax systems. Under neither the US tax system as modified by this legislation nor many European tax systems is the

⁹¹ *FSC (Panel)*, para. 7.108.

⁹² *EC First 21.5 Submission*, para. 99.

⁹³ *House Report*, page 17.

⁹⁴ The Act § 3, amending IRC § 942(a)(1).

⁹⁵ The Act § 3, amending IRC § 943(a)(1)(A).

⁹⁶ *Id.*

⁹⁷ *House Report*, page 18.

income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems. While exporters may be among those who are eligible for the exclusion, this fact does not make that exclusion “export contingent”. If it did, every general exclusion from tax applicable to, among others, exporters would become a prohibited export subsidy.⁹⁸

117. Just as a production or sales subsidy could include exports, the Act’s exclusion is based on an export-neutral principle – foreign-transaction income – which can, but does not necessarily, include income derived from export transactions. That a private party might *choose* to export in order to rely on the exclusion does not mean that the exclusion is conditioned or dependent on exporting.

(ii) *Because Extraterritorial Income Arises From A Broad Range of Foreign Transactions, Taxpayers May Qualify Under the New Regime Without Exporting*

118. The Act’s exclusion of extraterritorial income can be triggered by a broad range of transactions. Irrespective of whether the goods or services involved originate in the United States, such transactions may include:

- the sale, exchange, or other disposition of qualifying foreign trade property;
- the lease or rental of qualifying foreign trade property for use by the lessee outside the United States;
- the provision of services which are related and subsidiary to any sale, exchange, or other disposition of qualifying foreign trade property;
- the provision of services which are related and subsidiary to any lease or rental of qualifying foreign trade property;
- the provision of engineering or architectural services for construction projects located (or proposed for location) outside the United States; or
- the performance of managerial services for a person other than a related person in furtherance of the production of foreign trading gross receipts.⁹⁹

119. This expansive definition permits a broad range of taxpayers to earn extraterritorial income, including US and foreign corporations, as well as individuals. In addition, US corporations may earn extraterritorial income through either domestic or offshore manufacturing operations.¹⁰⁰ For example, a US multinational manufacturer can produce qualifying merchandise in foreign plants, and US companies selling products abroad can source their goods through suppliers located outside the United States. Despite EC claims to the contrary, the goods that may be the subject of qualifying transactions can be manufactured, produced, grown, or extracted within or outside the United States,¹⁰¹ and

⁹⁸ *Id.*

⁹⁹ The Act § 3, amending IRC § 942(a)(1).

¹⁰⁰ The ability of US companies to generate excludable income from transactions taking place entirely outside of the United States refutes the EC’s contention that US corporate taxpayers “have no choice but to export in order to obtain the subsidy in respect of those goods.” See *EC First 21.5 Submission*, para. 97.

¹⁰¹ The Act § 3, amending IRC § 943(a)(1)(C).

nothing in the Act precludes a US or foreign manufacturer from producing or selling such property exclusively from foreign-produced inputs.¹⁰²

120. Thus, not only does the Act make no reference to exporting, but its exclusion of extraterritorial income is available in a broad array of circumstances. While export transactions, as one type of foreign sale, can generate extraterritorial income, no provision in the Act requires exporting, and the Act's exclusion clearly applies to income that is wholly unrelated to exporting.¹⁰³

(iii) *Under the Act, Taxpayers Can Maximize Their Excludable Extraterritorial Income Without Exporting*

121. Another factor indicating that the Act is not export-contingent is that taxpayers do not have to export in order to maximize their benefits. Taxpayers may engage in an unlimited number of non-export transactions and continue to exclude a portion of income from qualifying transactions.

122. In this sense, the Act is quite distinct from the situation addressed by the Appellate Body in *Canada Autos*, which involved the question of whether certain import-duty exemptions provided to automobile manufacturers were export contingent. One class of exemptions under consideration did not require automobile manufacturers to export in order to participate in the duty-exemption programme, but the benefits available under this class of duty exemption were limited. The Appellate Body observed that participating manufacturers could import duty-free only up to a fixed amount, and were required to export if they wanted additional duty-free import opportunities.¹⁰⁴ Because automobile manufacturers relying on this second class of duty exemption could not maximize their benefits without exporting, the Appellate Body found "a clear relationship of dependency or conditionality exists between the granting of the import duty exemption and the exportation of motor vehicles by manufacturer beneficiaries."¹⁰⁵

123. The Act does not create a "clear relationship of dependency or conditionality" between the exclusion of extraterritorial income and export performance. US and foreign businesses subject to US taxation can rely on the Act's exclusion without limitation and without engaging in a single export transaction.

(iv) *The Foreign Use Requirement Defines, in Part, a "Foreign Transaction"*

124. The EC contends that the Act's foreign-use requirement – mandating that goods that are the subject of qualifying transactions must be "held for use, consumption, or disposition outside the United States"¹⁰⁶ – renders the Act and its exclusion of extraterritorial income export-contingent.¹⁰⁷

¹⁰² The EC argues that the 50 per cent rule embodied in the definition of "qualifying foreign trade property under the Act "involves" an export contingency. *EC First 21.5 Submission*, paras. 104-120. As demonstrated below in Section V.E, the 50 per cent rule does not require the use of any goods exported from the United States.

¹⁰³ The Act thus stands in sharp contrast to the measure at issue in *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather*, WT/DS126/R, Report of the Panel adopted 16 June 1999 ("*Australia Leather*"), in which the Panel examined a series of grants provided by the Australian Government to Howe Leather, an Australian automotive leather company. At the time the grant contract was concluded, the overwhelming majority of Howe's sales were for export. The Panel concluded that, "in order to expand its sales in a manner that would enable it to reach the sales performance targets . . . set out in the grant contract, Howe would, *of necessity*, have to continue and probably increase exports." *Id.*, para. 9.67 (emphasis added). Because these facts effectively transformed the sales performance targets into export performance targets, the Panel concluded that "Howe's anticipated export performance was one of the *conditions* for the grant of the subsidies." *Id.* (emphasis added).

¹⁰⁴ *Canada Autos* (AB), para. 105.

¹⁰⁵ *Id.*, para. 108.

¹⁰⁶ The Act § 3, amending IRC § 943(a)(1).

¹⁰⁷ *EC First 21.5 Submission*, paras. 99-103.

The EC believes that not extending the exclusion of extraterritorial income to transactions involving property consumed in the United States “makes the availability of the subsidy contingent upon export performance.”¹⁰⁸ The EC’s argument is illogical, and appears to be based on a misunderstanding of the nature of the Act.¹⁰⁹

125. The Act provides for the exclusion of income arising in foreign sales transactions. The “use, consumption, or disposition” of property outside the United States is but one characteristic of a “foreign” transaction. Another is that the Act explicitly provides that the products in question need not be manufactured or produced in the United States. Thus, the foreign transactions that come within the scope of the Act’s exclusion could involve shipments from the United States, but they also could involve transactions entirely within one other nation or within multiple nations other than the United States.

126. Transactions involving property used or consumed in the United States are not covered by the Act because they are not foreign transactions. For example, products manufactured and sold in the United States cannot be said to be foreign. If the United States is obligated to include such transactions in the Act, as the EC contends, that would mean that WTO Members are not permitted to provide a tax exemption or exclusion for foreign transaction income. Yet, that is not what Article 3.1(a) is about. It is about export-*contingent* subsidies.

127. Contrary to what the EC asks this Panel to believe, the Act’s foreign-use requirement is not a “code word” for exports. As reflected in the discussion above, a broad range of foreign transactions are covered by the Act, many of which do not involve manufacturing in, or shipment from, the United States, and, thus, do not involve exportation from the United States. Accordingly, the foreign-use requirement does not render the exclusion of extraterritorial income contingent on export performance.

3. The EC’s Claim Under Article 3.1(a) Rests Upon an Erroneous Legal Standard

128. The EC’s claim under Article 3.1(a) is based on a legal standard that is unfounded in the language of the SCM Agreement.

(a) The EC Creates a New Test for Applying Article 3.1(a)

129. The EC asserts that to assess export contingency, “there must be a comparison with some relevant benchmark.”¹¹⁰ The EC goes on to say that the “correct benchmark . . . is the treatment accorded to domestic sales.”¹¹¹

130. This analytical framework is not found in Article 3.1(a) or anywhere else in the SCM Agreement, and has never been discussed or adopted by the Appellate Body in connection with Article 3.1(a). Indeed, such a comparison test is incompatible with the reasoning of the Appellate Body in prior cases involving export subsidies. As discussed above, the Appellate Body has said that a measure falls under Article 3.1(a) if, by its terms or operation, it conditions the granting of a subsidy on export performance. A comparison between treatment under one set of conditions and another – in particular between domestic and foreign sales – is irrelevant.

131. The EC’s non-textual-based theory of Article 3.1(a) turns in large part on its mischaracterization of elements of the Illustrative List of Export Subsidies in Annex I of the SCM

¹⁰⁸ *Id.*, para. 101.

¹⁰⁹ Simply as a matter of logic, if there are three possible options (A, B and C), precluding A does not compel B, because C remains an option.

¹¹⁰ *EC First 21.5 Submission*, para. 79.

¹¹¹ *Id.*, para. 81.

Agreement. The EC cites paragraphs (d), (f), (g), (h), and (l) of Annex I as instances in which treatment of exported products is to be compared to that afforded to domestic products.¹¹² However, the comparison between exported and domestic products suggested by the cited paragraphs is not to be made for purposes of determining whether or not a measure is tied to exportation or is otherwise export contingent (since the practices in these paragraphs are directly tied to exportation). Instead, this comparison is to be done for purposes of determining whether a measure that applies to exports involves a financial contribution by a government or confers a benefit.

132. Even if a comparison between treatment provided to exported and domestic products were indicated by the paragraphs of Annex I cited by the EC – which are, after all, just examples of particular kinds of export subsidies – there is no indication that this type of comparison should be made in the present dispute. The language at issue here does not reference such a comparison, and neither the *FSC* Panel nor the Appellate Body proposed such a comparison.

(b) The Act Does Not Make Export Performance “One of Several Other Conditions”

133. Unable to meet the burden imposed by the “contingent” standard, the EC attempts to rewrite it by giving an expanded meaning to the language “one of several other conditions.”¹¹³ The EC contends that this language in Article 3.1(a) prohibits measures even where exporting is one way of satisfying export-neutral eligibility criteria.¹¹⁴ The EC’s interpretation of Article 3.1(a) goes well beyond export-contingency. It extends the provision’s application to essentially any measure that has any relationship to exportation or that might result in exportation. However, the phrase “one of several other conditions” does not have such a meaning.

134. The key word in the phrase “one of several other conditions” is “other.” The EC wrongly suggests that the meaning of “other” is “alternative.”¹¹⁵ The ordinary meaning of the word “other” is “one – of two” or “[t]hat [which] follows the first, second; further, additional”.¹¹⁶ In this light, the term “other” is synonymous with the concept of being *additional*.

135. Given the ordinary meaning of the term “other,” the phrase “one of several other conditions” suggests that export performance may be an *additional* condition to others that apply, but export performance remains a condition that must be satisfied. The phrase “several other conditions” thus means a series of conditions precedent – all of which must be satisfied for something to occur. Therefore, in the context of Article 3.1(a), only where a government provides a subsidy contingent on the fulfillment of a series of conditions, one of which is export performance, is such a subsidy “contingent, . . . as one of several other conditions, upon export performance”.

136. One consequence of the EC’s reasoning would be that territorial tax exemptions used by many WTO Members, including EC member states, would be export-contingent within the meaning of Article 3.1(a). In the same way that the EC argues that the Act’s exclusion applies to exports and wholly foreign transactions – an oversimplification the United States rejects, as discussed above – tax exclusions applied by other countries with respect to offshore income can be said to apply to three types of transactions: imports, wholly foreign transactions, and exports. In the same way that the EC

¹¹² *Id.*, para. 88.

¹¹³ *Id.*, paras. 121-130.

¹¹⁴ *See id.* para. 123; *see also id.*, para. 96. At the outset, the EC’s reliance on *Canada Aircraft (AB)* as support for its interpretation is misplaced. *See id.*, para. 126. Nowhere in that case did the panel or the Appellate Body construe the phrase “one of several other conditions.” Instead, the Panel and Appellate Body concluded that the export contingency relating to subsidies given to industries other than aircraft was not relevant to its *de facto* analysis of payments given to the aircraft industry. *See Canada – Aircraft (AB)*, para. 179; and *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/R, Report of the Panel, as modified by the Appellate Body, adopted 20 August 1999, paras. 9.305-9.348.

¹¹⁵ *EC First 21.5 Submission*, para. 128.

¹¹⁶ *The New Shorter Oxford English Dictionary* (1993).

erroneously contends that US manufacturers must export in order to earn excluded income under the Act, it could equally be said that domestic manufacturers in these countries may obtain the benefits of a territorial exemption only by exporting. Income from the sale of those same manufacturers' products through a domestic distributor or directly on the domestic market is not eligible for a comparable exemption. It is difficult to imagine that this was the intent of the drafters of Article 3.1(a). Only by interpreting "several other conditions" as a series of conditions precedent can the proper effect be given to the term "contingent" in this context.¹¹⁷

4. The EC's Contention that the Exclusion Will Not Apply to Foreign Manufacturing Is Erroneous and Without Any Factual Support

137. The EC contends that the application of the Act's exclusion to foreign manufacturing is "merely cosmetic (and an attempt to hide a prohibited export subsidy)."¹¹⁸ The EC contends that the application of the exclusion to foreign manufacturing "is only available where the foreign producer makes an election to be taxed as a domestic US corporation."¹¹⁹ According to the EC, a foreign corporation would never make this "domestication election" because it allegedly would impose an additional tax liability without reducing the tax liability of the corporation in its original jurisdiction.¹²⁰ The EC's assertions are erroneous and are without any factual support.

(a) Application of the Exclusion to Transactions Involving Foreign Manufactured Goods Is Not Limited to Circumstances Where a Foreign Manufacturer Makes a Domestication Election

138. The EC asserts that the Act's application to foreign-manufactured goods is merely cosmetic because allegedly no foreign manufacturer will make an election under section 943(e)(1) of the IRC to be treated as a domestic corporation.¹²¹ However, the EC's assumes that the Act applies to foreign-manufactured goods only where there has been such an election. This assumption is incorrect.

139. In general, the Act applies to foreign branches of US businesses manufacturing outside the United States without the need for an election. This is because, under US law, a foreign branch of a US business is not treated as a separate entity for tax purposes. Thus, goods manufactured by a foreign branch of a US business are treated as goods manufactured by the related US business, which is responsible for paying US taxes on manufacturing income arising from those goods.¹²²

140. To demonstrate the point, an example may prove helpful. Assume a US corporation owns a factory in Mexico and regularly sells goods manufactured in that factory to purchasers outside the United States. Under prior US law, the US corporation generally would have been required to pay US taxes on the manufacturing income attributable to the Mexican factory. However, under the Act, income derived from these foreign transactions involving goods manufactured in Mexico by the branch would be treated as extraterritorial income of the US corporation.

141. In such a case, which is not uncommon, the Act's exclusion would apply to transactions involving foreign-manufactured goods without the need for a foreign manufacturer to elect to pay US tax. Accordingly, the EC's assertion that the Act's exclusion would never apply to foreign-manufactured goods is incorrect.

¹¹⁷ The EC discusses the US Department of Commerce's countervailing duty regulations as support for its interpretation of "one of several other conditions." *EC First 21.5 Submission*, para. 128. US countervailing duty regulations, however, cannot modify the ordinary meaning of provisions of the SCM Agreement.

¹¹⁸ *EC First 21.5 Submission*, para. 131.

¹¹⁹ *Id.*, para. 132.

¹²⁰ *Id.*

¹²¹ The Act § 3, amending IRC § 943(e)(1).

¹²² As noted above, qualifying foreign trade property includes property manufactured outside the United States. See The Act § 3, amending IRC § 943(a)(1)(A).

(b) Foreign Manufacturing Corporations May Make Domestication Elections Without Incurring Additional Tax Liability

142. In addition to this basic misunderstanding of the language of the Act, the EC also misunderstands the operation of the domestication election itself. With respect to the category of transactions for which a domestication election is required, the EC alleges that no foreign taxpayer would make such an election because it would increase its overall tax liability. This is a factual assertion for which the EC has not provided any support.

143. Moreover, the assumption underlying the EC's assertion – that a domestication election would necessarily increase a foreign corporation's tax liability – is false. In fact, there are a number of circumstances in which an election to be treated as a domestic corporation would not result in an increase in a corporation's overall tax liability.

144. For example, assume that a foreign manufacturing corporation is incorporated in country X and is the supplier to a distribution company located in the United States. Assume further that the country X tax rate is greater than or equal to the US tax rate. It is true that the corporation, upon making the election, would be subject to tax on its manufacturing income both in the United States and in country X.

145. However, under the Act, the election will cause the foreign corporation to be treated as a US corporation for all purposes of the IRC. As such, the corporation will be eligible to claim a foreign tax credit against its US tax liability with respect to any taxes paid to country X. US law would allow the foreign corporation to completely offset its US tax liability through the use of foreign tax credits. In this case, the foreign corporation will be in the same tax position as before the election, and, thus, should be indifferent to making the election. By virtue of the election, the Act's exclusion would apply to sales of goods manufactured by the foreign manufacturing company and sold abroad.¹²³

146. Thus, the EC's assertion that the domestication election typically would entail a higher tax burden for an electing corporation is false.

(c) The Domestication Election Was Intended to Equalize the Tax Treatment of US Taxpayers Operating Abroad

147. As demonstrated by the Act's legislative history, the domestication election was intended to equalize the treatment of US taxpayers abroad, regardless of whether they operate in branch or corporate form. The purpose of the domestication election was not to discourage the application of the Act to foreign-manufactured goods. As described above, the application of the Act's exclusion to foreign-manufactured goods is real and establishes that the exclusion is not export-contingent.

148. Before the Act, US taxpayers manufacturing abroad in branch form generally were subject to current tax on all of their branch manufacturing income. US taxpayers, however, generally could defer taxation of manufacturing income of their foreign corporate subsidiaries. In drafting the Act, the US Congress sought to prevent taxpayers from inappropriately invoking the Act's exclusion with respect to tax-deferred income. Accordingly, the Act provides that property manufactured outside the United States is not qualifying foreign trade property unless it is manufactured by a person that pays US tax on its manufacturing income.

¹²³ If the foreign-manufactured goods are sold abroad by the US distribution company, the exclusion would apply to the income of the distribution company, not to the income of the manufacturing company. If the manufacturing company sells the goods abroad directly, then the exclusion would apply to the manufacturing company's foreign sales income. In that case, the manufacturing company would receive US foreign tax credits only with respect to its income that is not excluded under the Act. It would not receive credits with respect to excluded income.

149. To ensure that this limitation did not cause the Act's exclusion to apply only to foreign sales by branches of US businesses, the Act permits foreign corporations – *i.e.*, subsidiaries – to elect to be treated as domestic corporations.

150. In sum, sections 942(a)(2) and 943(e)(1) of the IRC, as amended by the Act, were intended to equalize branch and corporate treatment of US taxpayers with production facilities abroad. These sections were not, as alleged by the EC, designed to discourage the application of the Act to foreign manufacturing companies or property manufactured outside the United States.

5. The EC Has Failed to Provide Evidence that the Act's Exclusion is Export-Contingent

151. The EC's new legal standards are born of necessity considering its lack of evidence demonstrating export-contingency. Even though the EC appears to be making a legal challenge, in reality, it is making factual assertions about the Act's effects on exportation that have not been substantiated. All that the EC has presented to the Panel regarding export-contingency is that, under the Act, some taxpayers may earn excluded extraterritorial income by exporting. However, as shown above, the fact that exporting is one way of satisfying a neutral standard does not render the Act export-contingent within the meaning of Article 3.1(a). The EC has not shown that there is any requirement to export in order to earn excluded income.

152. The EC has tried to point to the fact that some taxpayers who used the FSC may be eligible to earn excluded income under the Act, claiming that the export-contingency of the former proves the export-contingency of the latter. However, footnote 4 of the SCM Agreement, which is attached to Article 3.1(a), confirms that the granting of a subsidy to exporters, in and of itself, does not render a subsidy export-contingent. Footnote 4 states:

The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of [Article 3.1(a)].

Thus, the fact that exporters may earn excluded income under the Act is not sufficient proof that the granting of subsidies is *tied to* or *contingent upon* exportation.¹²⁴

153. In summary, assuming *arguendo* that the Act's exclusion of extraterritorial income constitutes a subsidy, the EC has failed to establish that this "subsidy" is contingent on export performance. Absent such a demonstration, the exclusion of extraterritorial income does not constitute an export subsidy within the meaning of Article 3.1(a) of the SCM Agreement.

¹²⁴ *Canada Autos (AB)*, para. 172. In the Article 21.5 proceeding in *Canada Aircraft*, the Appellate Body said that a subsidy granted to enterprises that export does not "compel the conclusion that there is a relationship of conditionality or dependence such that the granting of a subsidy is 'tied to' export performance." *Canada – Measures Affecting the Export of Civilian Aircraft - Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/AB/RW, Report of the Appellate Body adopted 4 August 2000, para. 48. Considering evidence that subsidies were specifically targeted to the aircraft industry because of its high export orientation, the Appellate Body said that "the targeting factors may very well be relevant to an inquiry under Article 3.1(a) of the SCM Agreement, but they do not necessarily provide conclusive evidence that the granting of a subsidy is 'contingent,' 'conditional,' or 'dependent' upon export performance. In these proceedings, we do not see the two 'targeting' factors, by themselves, as adequate proof of prohibited export contingency." *Id.*, para. 49.

D. BECAUSE THE ACT'S EXCLUSION OF EXTRATERRITORIAL INCOME IS A MEASURE TO AVOID THE DOUBLE TAXATION OF FOREIGN-SOURCE INCOME, THE EXCLUSION IS NOT A PROHIBITED EXPORT SUBSIDY BY VIRTUE OF THE FIFTH SENTENCE OF FOOTNOTE 59 OF THE SCM AGREEMENT

154. Even if the Act's exclusion of extraterritorial income could be said to be a subsidy within the meaning of Article 1, and even if that "subsidy" could be regarded as export-contingent within the meaning of the otherwise unqualified language of Article 3.1(a), it nonetheless would not constitute a prohibited export subsidy under the SCM Agreement. This is because footnote 59 of the SCM Agreement qualifies the application of the SCM Agreement's prohibition against export subsidies. More specifically, the fifth sentence of footnote 59, when read in conjunction with footnote 5 of the SCM Agreement, provides that "measures to avoid the double taxation of foreign-source income" are not prohibited by the SCM Agreement. Because the Act's exclusion of extraterritorial income is precisely such a measure to avoid double taxation of foreign-source income, it is not prohibited by the SCM Agreement.

1. The Relationship Between Article 3.1(a) and Footnote 59

155. Before discussing the meaning of the fifth sentence of footnote 59, the United States first explains how the footnote fits into the SCM Agreement in general and how it relates to Article 3.1(a) in particular.

(a) Practices Identified in Annex I as Not Being an Export Subsidy Are Not Prohibited Under the SCM Agreement

156. To clarify the meaning of Article 3.1(a), the drafters of the SCM Agreement attached to Annex I an "Illustrative List of Export Subsidies." The drafters specified in Article 3.1(a) that this Illustrative List identifies practices that come within the provision's prohibition.¹²⁵ At the same time, the drafters also made clear that practices identified by the Illustrative List as *not* constituting an export subsidy are *not* prohibited by Article 3.1(a) or any other provision of the Agreement. They did so by means of footnote 5 of the Agreement, which is attached to Article 3.1(a). Footnote 5 states that "[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement". Under this structure, if a type of measure is deemed to be an export subsidy by the Illustrative List, it is prohibited by Article 3.1(a); if a measure is deemed *not* to be an export subsidy by the List, it is *not* prohibited by *any provision* of the SCM Agreement.

(b) Paragraph (e)'s Relationship to Article 3.1(a)

157. Paragraph (e) of Annex I sets forth a general prohibition against foregoing or reducing taxes to be collected on export income. It states that "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes" is an export subsidy. The EC correctly defined the terms of paragraph (e) as "having a special, precise or clearly defined relationship or connection to exports."¹²⁶ This means that paragraph (e) applies to income tax exemptions, remissions, or deferrals that are directly connected to, narrowly or singularly tailored to, or overtly tied to income derived from export transactions.

158. Despite this definition, and in particular paragraph (e)'s use of the word "specifically," the EC argues that paragraph (e) *expands* the scope of Article 3.1(a). The EC asserts that:

¹²⁵ Article 3.1(a) states in relevant part that "the following subsidies, within the meaning of Article 1, shall be prohibited: (a) subsidies contingent in law or in fact, whether solely or as one of several other conditions, upon export performance, *including those illustrated in Annex I*" (emphasis added).

¹²⁶ *EC First 21.5 Submission*, paras. 149-153.

Contingency is a particular form of special relationship. Therefore any subsidy that is contingent upon export performance must, necessarily, also be ‘specifically related to exports’ within the meaning of item (e). However, the term ‘specific relation’ is broader than the term ‘contingency.’ The former covers any specific link and thus would include a simple incentive.¹²⁷

159. The EC’s theory of paragraph (e) is untenable, because the EC ignores the relationship between Article 3.1(a) and Annex I. Article 3.1(a) expressly states that the subsidies listed in Annex I are “illustrative” in that they provide a non-exhaustive list of export subsidies that are “contingent . . . on export performance.” For this reason, the drafters of the Agreement explained the relationship between Annex I and the prohibition against export subsidies by saying: “*including* those *illustrated* in Annex I”. (emphasis added).

160. The ordinary meaning of the term “including” confirms that the Illustrative List does not expand Article 3.1(a). “Including” means “inclusive of”, and “inclusive” means “that includes”.¹²⁸ The term “include” is defined as “contain as a part of a whole” or “place in a class or category”.¹²⁹ Thus, the export subsidies identified in Annex I are but *examples* of a class or category of “export subsidies” that come within the scope of Article 3.1(a). While they to some extent clarify the meaning of Article 3.1(a), these examples do not expand Article 3.1(a)’s application as the EC suggests. In contrast to the EC’s position, paragraph (e) does not and cannot prohibit direct tax exemptions, remissions, or deferrals that are not “contingent . . . upon export performance.” Indeed, to the extent that the contingency requirement of Article 3.1(a) does not encompass subsidies granted based on *the mere expectation of export performance* – as discussed in section C above – paragraph (e) cannot provide a backdoor way of reaching what the EC refers to as “incentives” that are not export contingent.¹³⁰

161. The essence of paragraph (e) is a ban against export-specific income tax benefits or relief. It applies to measures that forego taxes *directly* or *only* on income derived from export transactions. In order for paragraph (e) to apply, the tax benefits at issue must be export-contingent within the meaning of Article 3.1(a).

(c) Footnote 59’s Relationship to Paragraph (e)

162. Footnote 59 explains and qualifies the application of paragraph (e). Footnote 59, which is attached to paragraph (e),¹³¹ identifies certain practices that, though they involve the failure to collect direct taxes on income earned in export transactions, nonetheless fall outside the scope of paragraph (e). As noted above, by virtue of footnote 5, if footnote 59 identifies measures that are not export subsidies, such measures are not prohibited by the SCM Agreement.

(i) *The First Sentence of Footnote 59: Deferral*

¹²⁷ *Id.*, paras. 156-157.

¹²⁸ *The New Shorter Oxford English Dictionary* (1993).

¹²⁹ *Id.*

¹³⁰ The EC’s attempt to expand the meaning of Article 3.1(a) through paragraph (e) differs from its approach in challenging the FSC. As the Panel may recall, in the initial proceeding, the EC invoked paragraph (e) because the FSC applied explicitly and only to exports, alleging in its first submission to the FSC panel, para. 159, the FSC benefits were “‘specifically related to exports’ since they are *conditional* upon exportation of US goods and *limited in scope* to the extent of such exportation”. *FSC (Panel)*, para. 4.304 (emphasis added). The EC recognized then that paragraph (e) applies to a relatively narrow subset of subsidies that are contingent or “conditional” on – as well as focused on or “limited” to – exportation.

¹³¹ Unlike footnote 58, which applies to more than one paragraph of Annex I, footnote 59 is connected only to paragraph (e).

163. The first sentence of footnote 59 states that “[t]he Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected.” This sentence makes clear that, despite paragraph (e)’s otherwise unequivocal pronouncement that “[t]he full or partial . . . deferral specifically related to exports, of direct taxes” is a prohibited export subsidy, paragraph (e) does not apply to a deferral scheme if “appropriate interest” is charged.¹³²

164. Neither paragraph (e) nor footnote 59 defines what is meant by the term “deferral”, but it appears to refer to instances where taxation is delayed, perhaps indefinitely, pending the occurrence of some event.¹³³ Deferral could be applied to export income in a number of ways, but it is particularly relevant in connection with exports in situations where taxes on export income earned by an offshore related entity (*e.g.*, a foreign subsidiary) are not assessed unless and until they are repatriated to a domestic parent.¹³⁴ This means that, under the first sentence of footnote 59, a measure deferring taxes on foreign-source export income earned by an offshore subsidiary may escape the reach of paragraph (e) provided that “appropriate interest” is charged.¹³⁵

165. Thus, the first sentence of footnote 59 qualifies paragraph (e). It makes clear that at least in one circumstance, despite the otherwise unqualified language of paragraph (e), the non-taxation of export income is not prohibited by the SCM Agreement. While the Appellate Body in its FSC decision declined to comment on the meaning of the first sentence of footnote 59 because the FSC did not involve deferral, the Appellate Body did acknowledge that the first sentence is “specifically related to” and “qualifies” paragraph (e).¹³⁶

(ii) *The Fifth Sentence of Footnote 59: Avoiding Double Taxation*

166. A second area in which footnote 59 carves out an exception to paragraph (e) is with respect to measures to avoid the double taxation of foreign-source income.¹³⁷ The last sentence of the footnote states that “[p]aragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.” Footnote 59 does not define what “double taxation” means, or what types of measures appropriately serve to “avoid” it, but the ordinary meaning of this language indicates that it encompasses measures to prevent the same income from being subjected to tax twice. This understanding of the last sentence of footnote 59 derives from the fact that “avoid” means “keep off; prevent; obviate”,¹³⁸ “double” means “twice as much or as many” or “occurring twice”,¹³⁹ and “taxation” means “the imposition or levying of taxes”.¹⁴⁰

167. Significantly, the fifth sentence of footnote 59 does not apply to any type of income, but only to “foreign-source income”. The footnote does not define this term, but its ordinary meaning is as

¹³² The reason this is so appears to be that charging “appropriate interest” sufficiently negates benefits that may be conferred on exports.

¹³³ According to *The New Shorter Oxford English Dictionary* (1993), “defer” means “to put off (an action or procedure, an event, matter, or question) to some later time; to delay, postpone.”

¹³⁴ Deferral could also apply to the non-taxation of export income earned by offshore companies pending repatriation not only to domestic parents but also to shareholders in general.

¹³⁵ Deferral with interest is only one form of deferral of taxes on export income that is not an export subsidy. This is because the first sentence of footnote 59 identifies charging “appropriate interest” as but an “example” of an instance in which “deferral specifically related to exports” does not constitute a prohibited export subsidy.

¹³⁶ *FSC (AB)*, para. 97. The United States does not contend that the Act involves deferral, but discusses the first sentence of footnote 59 to illustrate the overall meaning and significance of the footnote.

¹³⁷ In the *FSC* case, the Appellate Body declined to examine the meaning of the fifth sentence of footnote 59, finding that the United States had not raised the issue before the panel. *FSC (AB)*, paras. 101-03.

¹³⁸ *The New Shorter Oxford English Dictionary* (1993).

¹³⁹ *Id.*

¹⁴⁰ *Id.*

follows: (1) “income” means “the (amount) of money or other assets received or due to be received from employment, business, investments, etc.”;¹⁴¹ (2) “foreign” means “carried on or taking place abroad” or “situated outside the country; not in one’s own land”;¹⁴² and (3) “source” means “a place or thing from which something material is obtained or originates.”¹⁴³ Thus, for purposes of footnote 59, foreign-source income would appear to include money (or other assets) originating outside the borders or territory of the WTO Member instituting a measure to avoid double taxation.

168. Foreign-source income raises the possibility of double taxation because it can be subjected to taxation by the country that is the source of income (sometimes referred to as the country of source) as well as by the country in which the taxpayer resides (sometimes referred to as the country of residence). It also can arise because two countries claim that the same taxpayer is a resident subject to their jurisdiction or the same income originates within their borders. Whatever the legal basis, the issue of double taxation of foreign-source income is significant in the context of exports because, by definition, goods or services sold in an export transaction are sold from one country to another. As a result, some or all of the income generated by an export transaction can be said to be “foreign” because the destination of the exported goods, the location of the purchaser, the transfer of title, the making of payment, or the economic activities giving rise to the sale may occur outside the seller’s country of residence. A foreign country that can lay claim to being the “source” of some or all of income earned outside of the seller’s country of residence – e.g., for one of the foregoing enumerated reasons – might seek to tax such income. At the same time, the country of residence of a taxpayer might make the same claim with respect to that same income.

169. To alleviate this and related concerns, the fifth sentence of footnote 59 permits WTO Members to refrain from taxing foreign-source income earned in export transactions. There can be no doubt that this is so, because the fifth sentence of footnote 59 narrows the scope of paragraph (e), which prohibits direct tax exemptions, remissions, or deferrals that are made available “specifically in relation to exports.” As the fifth sentence of footnote 59 states, “*Paragraph (e) is not intended to limit a Member from taking measures to avoid double taxation of foreign-source income ...*” (emphasis added).

(d) Footnote 59 Identifies Certain Measures As Not Being Export Subsidies Within the Meaning of Footnote 5

170. As demonstrated above, the first and fifth sentences of footnote 59 qualify paragraph (e). These two sentences of footnote 59 identify certain tax practices that are permissible despite the fact that they may be directly tied to exports.

171. The first sentence of footnote 59 makes clear that deferral of taxation “specifically in relation to exports” is permissible where “appropriate interest is charged”. A deferral that is not made “specifically in relation to exports” would be outside the scope of paragraph (e) and would need no qualification under footnote 59 in order to be exempt from the SCM Agreement’s export subsidy prohibition. The first sentence of footnote 59 was included by the drafters to make clear that a deferral-with-interest regime, even one that applies specifically to exports, is not a prohibited export subsidy.

172. Likewise, the fifth sentence of footnote 59 permits measures to avoid double taxation even though they might otherwise constitute export-specific tax exemptions, remissions, or deferrals of direct taxes pursuant to paragraph (e). This can be seen from the fifth sentence’s opening terms: “Paragraph e is not intended to limit a Member from taking measures to avoid . . . double taxation . . .” Indeed, if a measure to avoid double taxation were permitted only if it were *not* specifically related

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.*

to exports, then the fifth sentence would have no meaning. It would merely state what is obvious, that non-export-specific measures are not subject to paragraph (e) or Article 3.1(a) at all.

173. Measures to avoid double taxation, therefore, come within the meaning of footnote 5. That footnote provides that “[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited” The ordinary meaning of “referred” is “to assign to a thing, or class of things, as being properly included or comprehended in this; to regard as naturally belonging, pertaining, or having relation to; to attach or attribute to.”¹⁴⁴ It also can mean something as simple as “a reference in a book”.¹⁴⁵ Footnote 5 thus indicates that a measure need only be included or mentioned in Annex I in such a way as to be properly assigned or classified as not being an export subsidy. Footnote 5 does not require that the words “is not an export subsidy” appear in the Illustrative List’s description of the measure in question.

174. In so arguing, the United States is not relying on the principle of *a contrario sensu*, the doctrine of assuming that the opposite conclusion may be drawn from an affirmative rule or statement. Rather, the fact that the fifth sentence of footnote 59 explicitly provides a narrowing of paragraph (e) signals that the drafters of the SCM Agreement intended that measures to avoid double taxation should not be treated as prohibited export subsidies.

175. This is a distinction made by the panel in the *Brazil Aircraft* case.¹⁴⁶ The panel first found that “in its ordinary meaning, footnote 5 relates to situations where a measure is referred to as *not* constituting an export subsidy.”¹⁴⁷ In addition, the panel observed that the ordinary meaning of footnote 5 “could extend more broadly to cover cases where the Illustrative List contained some other form of affirmative statement that a measure is not subject to the Article 3.1(a) prohibition.”¹⁴⁸ The panel then indicated that this reasoning applied to the first and fifth sentences of footnote 59.¹⁴⁹ Thus, following this reasoning, measures to avoid double taxation are “referred” to in Annex I as not being export subsidies and, therefore, are not prohibited under Article 3.1(a) or any other provision of the SCM Agreement.

2. Measures to Avoid Double Taxation Under Footnote 59

176. In the preceding section, the United States demonstrated that under the fifth sentence of footnote 59, measures taken to avoid double taxation of foreign-source income are not prohibited by the SCM Agreement. In this section, the United States demonstrates that the non-taxation of foreign-source income is a measure to avoid double taxation for purposes of footnote 59.

(a) Non-Taxation of Foreign-Source Income Is a Widely Accepted Method of Avoiding Double Taxation

177. There does not appear to be any dispute between the EC and the United States as to whether a system of non-taxation of foreign-source income is an acceptable means of avoiding double taxation. This mutual position derives from the fact that well-established international tax disciplines have long recognized that two countries may claim the right and ability to tax the same income, leaving taxpayers with an undue burden and requiring that the respective countries take action to rectify a potential injustice. As the EC stated to the *FSC* Panel,

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Brazil - Export Financing Programme for Aircraft - Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW, Report of the Panel, as modified by the Appellate Body, adopted 4 August 2000.

¹⁴⁷ *Id.*, para. 6.36.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.* In contrast, the Panel found that there is no basis to assume that measures that merely fall outside the scope of illustrative export subsidies in Annex I are *not* export subsidies for purposes of footnote 5. *Id.*

When a resident of a country earns income from outside the country (foreign-source income), the claim of that country to tax the income based on its worldwide residence jurisdiction may overlap the claim of a foreign country to tax revenue based on source jurisdiction. Consequently, foreign-source income earned by a resident of a country may be taxed by both the country of source and the country of residence, absent relief provisions to prevent double taxation. The necessity for relief is clear on grounds of equity and economic policy.¹⁵⁰

178. While the WTO has not defined the types of measures that may be used to avoid double taxation of foreign-source income, two general categories of measures are well accepted and used around the world for this purpose. They are the exemption (or non-taxation) method and the credit method. Both have been endorsed by the two leading model tax treaties, prepared under the auspices of the Organization for Economic Cooperation and Development (“OECD”) and the United Nations (“UN”).¹⁵¹ Indeed, the EC cited both to the Panel as establishing proper ways of avoiding double taxation.¹⁵²

(b) An Explanation of the Exemption (Non-Taxation) Method for Avoiding Double Taxation: the OECD Model Rules

179. Both the OECD and the UN model treaties expressly allow countries to use either exemption (non-taxation) or credits to avoid double taxation of foreign-source income. Though their relevant provisions differ on the details, the two model treaties achieve the same ends for present purposes. To explain what the exemption method is and how it operates to avoid double taxation, the United States will refer to the OECD Model Convention’s provision on exemption.¹⁵³ The OECD Convention is the model treaty that most EC member states rely on, and it makes clear how exemption (non-taxation) may be employed to avoid double taxation.

180. The OECD Model Convention provides in pertinent part:

METHODS FOR ELIMINATION OF DOUBLE TAXATION

Article 23A

EXEMPTION METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.¹⁵⁴

¹⁵⁰ Annex EC-2, page 1 (US-5).

¹⁵¹ *Model Tax Convention on Income and Capital* (OECD 1992) (“OECD Model Tax Convention”) (Exhibit US-7); see also *United Nations Model Double Taxation Convention Between Developed and Developing Countries*, Pub. No. ST/ESA/102 (1980).

¹⁵² Annex EC-2, page 2 (US-5).

¹⁵³ In doing so, the United States does not rely on the OECD Model Convention as an authoritative source for interpreting WTO rules. The United States cites the Convention solely as an example.

¹⁵⁴ The rest of Article 23A states:

2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 and 11 [involving cross-border dividend and interest income, respectively], may be taxed in the other Contracting State, the first mentioned state shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from the other state.

* * * * *

Article 23B

CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:

- (a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;
- (b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.¹⁵⁵

181. The Commentary to the OECD Model Convention explains that both the exemption method and the credit method serve to avoid double taxation in the context of foreign-source income.¹⁵⁶ The Commentary makes clear that exemption applies not only to foreign-source income earned directly by a resident of the taxing country, but also to dividend and interest income that is repatriated to the taxing country.¹⁵⁷ The Commentary further makes clear that countries are free to adopt one or both methods and the means by which they are implemented may vary from country to country.¹⁵⁸

182. In addition, the Commentary provides that, “[u]nder the principle of exemption, the state of residence R does not tax the income which . . . may be taxed in [another country].” Thus, the term “exemption” for purposes of double tax avoidance does not mean only the establishment of a legal exception to an otherwise applicable revenue-raising general rule. “Exemption” in this context means

3. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

¹⁵⁵ Article 23B has a second paragraph, which provides that “[w]here in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of excess tax on the remaining income or capital of such resident, take into account the exempted income or capital.”

¹⁵⁶ *OECD Model Tax Convention*, p. C(23)-3 (US-7) (“Articles 23A and 23B apply to the situation in which a resident of State R [residence] derives income from, or owns capital in, the other Contracting State S [source] . . . and that such income or capital, in accordance with the Convention, may be taxed in such other State S.”).

¹⁵⁷ Commentary to the *OECD Model Tax Convention*, p. C(23)-14 (US-7) (“In Articles 10 and 11 the right to tax dividends and interest is divided between the States of residence and the State of source. In these cases, the State of residence is left free not to tax if it wants to do so . . . and to apply the exemption method also to the above-mentioned items of income.”). The second paragraph of Article 23A, however, imposes limitations on the exemption method with regard to these types of income that do not apply to other types of income.

¹⁵⁸ *Id.*, page C(23)-14 (“In view of the wide variety of fiscal policies and techniques in the different States regarding the determination of tax, especially deductions, allowances and similar benefits, it is preferable not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique.”).

the non-taxation of income subject to double tax.¹⁵⁹ As long as income “may be taxed” in another country, the Commentary states that a country of residence must not tax that same income.¹⁶⁰

(c) The Exemption Method May Allow for An Overall Tax Reduction for Some Taxpayers

183. An important distinction between the exemption (non-taxation) method and the credit method is that the former operates on an *ex ante* basis while the latter operates on an *ex post* basis. The exemption method does not tax income that potentially may be subjected to the tax systems of two sovereign nations. It does so in general and “before the fact” – that is, without regard to the particular income or foreign tax that is involved. This stands in contrast to the tax credit method, which only offsets foreign taxes actually paid on specific income “after the fact”. International principles of taxation recognize these differences, but embrace both.

184. While tax credits are capped by the amount of foreign taxes paid – and can provide only partial relief where exceptions apply – the overall tax liability of a given taxpayer under the exemption method is determined by the tax rate applied by the source country. To the extent that the tax rate applied by the source country is *higher* than that of the country of residence, a taxpayer *will pay more* in taxes on the income in question than if that income were earned in the country of residence. Conversely, if the source country applies a *lower* rate, then a taxpayer *will pay less* than if the income were earned exclusively within the country of residence.

185. That the exemption method may result in an overall tax reduction in no way undermines the validity of the method under accepted international tax norms. Neither the OECD nor the UN model treaty requires treaty parties to impose any minimum level of tax under an exemption system. The model treaties leave to individual countries the determination of whether a minimum level of taxation by a treaty party is necessary for exemption to apply under their national laws. In fact, the OECD Commentary specifically provides that the state of residence must “give exemption whether or not the right to tax is in effect exercised by the other States.”¹⁶¹ The Commentary explains that this method is the most practical, “since it relieves the State of residence from undertaking investigation of the actual taxation position of the other States.”¹⁶²

186. The EC has acknowledged this feature of the exemption system. Because the exemption method of avoiding double taxation is not calibrated to the tax paid to a foreign country, the EC has explained, “[t]o the extent that foreign taxes are lower than domestic taxes, resident taxpayers with exempt foreign-source income are treated more favourably than other residents.”¹⁶³

3. The Act’s Exclusion of Extraterritorial Income Is a Measure to Avoid Double Taxation Within the Meaning of Footnote 59

187. By operation and design, the Act is a measure to avoid double taxation of foreign-source income for purposes of footnote 59.

(a) The Act Relies on Non-Taxation Rather than Tax Credits as a Double Tax Avoidance Mechanism

188. The Act expressly relies on the non-taxation method to avoid double taxation of foreign-source income. The legislative history accompanying the Act makes the point explicitly: “Because the exclusion of such extraterritorial income is a means of avoiding double taxation, no foreign tax

¹⁵⁹ *Id.*, page C(23)-4.

¹⁶⁰ *Id.*, page C(23)-11.

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ Annex EC-2, page 6 (US-5).

credit is allowed for income taxes paid with respect to such excluded income.”¹⁶⁴ The legislative history further explains that, in shifting from a worldwide tax system to a more territorial approach, the United States was, through the Act, embracing an exemption (or non-taxation) method of avoiding double taxation typically employed under territorial systems. The Act’s exclusion would take the place of foreign tax credits, which ordinarily serve under the IRC as the mechanism for avoiding double taxation. The legislative history states:

It is important to note that each type of system [worldwide versus territorial] generally uses a different method to avoid double taxation of foreign-source income. Although this is an oversimplification, in a worldwide system, the “credit method” typically is used; that is, a tax credit is provided for taxes paid to foreign governments on income earned abroad. In a territorial system, the “exemption method” is used; that is, income earned abroad is simply not subject to tax. While tax policy arguments can be used to justify the superiority of one method over the other, both methods are accepted internationally, and it also is accepted internationally that a country is free to use either method or both.¹⁶⁵

189. The Act achieves double taxation avoidance through the exclusion of extraterritorial income. In addition, section 114(d) of the IRC, as added by the Act, provides that “no credit shall be allowed under this chapter for any income, war profits and excess profits taxes paid or accrued to any foreign country or possession of the United States with respect to extraterritorial income which is excluded from gross income under subsection (a).” The Act also provides that deductions are not allowed with respect to excluded income.¹⁶⁶

(b) The Act Provides a Partial Exclusion for Foreign-Source Income

190. By creating a general exclusion from US taxation for extraterritorial income in section 114(a), and then establishing limited exceptions that allow for tax on a portion of such income in section 114(b), the Act provides a partial exclusion for foreign-source income within the meaning of the fifth sentence of footnote 59. As noted above, the ordinary meaning of the term “foreign-source income” is profits or proceeds originating outside the borders or territory of the WTO Member instituting a measure to avoid double taxation. The essential characteristics that would indicate whether profits or proceeds originate outside the borders or territory of a country might include one or more of the following: the goods or services in question are sold outside the territory of the taxing authority, the purchaser is located outside the territory of the taxing authority, title to the merchandise is transferred outside the territory of the taxing authority, payment is made or issued outside the territory of the taxing authority, or economic activities giving rise to the sale occur (at least in part) outside the territory of the taxing authority.

191. “Extraterritorial income” under the Act involves these foreign attributes. The central premise of the Act is to provide a tax exclusion for income from foreign sales.¹⁶⁷ With regard to the types of transactions that may generate excludable income, the Act provides that the goods involved must be used, consumed, or disposed of outside the United States.¹⁶⁸ As such, the purchasers of these goods typically will be located outside the United States, they generally will authorize or make payment for the goods in another country, and in many instances title will pass in that country as well. The goods may be produced outside the United States,¹⁶⁹ and certain required levels of foreign economic

¹⁶⁴ *House Report*, page 10; *see also Senate Report*, page 2.

¹⁶⁵ *House Report*, page 13.

¹⁶⁶ The Act § 3, amending IRC § 114(c).

¹⁶⁷ The Act § 3, amending IRC § 114(e), defines “extraterritorial income” as the proceeds generated from qualifying foreign sales.

¹⁶⁸ The Act § 3, amending IRC § 943(a)(1)(B).

¹⁶⁹ The Act § 3, amending IRC § 943(a)(1)(A).

activities must be performed with respect to the sales and distribution functions associated with qualifying transactions.¹⁷⁰

192. It is because of these considerations that income excluded under the Act may properly be characterized as extraterritorial and, thus, “foreign-source.” Although the EC complains that the Act “does not concern ‘extraterritorial’ income in any real [sense] of that word”,¹⁷¹ the EC acknowledges that the Act applies to income “derived from foreign sales.”¹⁷² As discussed above, “extraterritorial income” under the Act is income derived from non-domestic sources. As such, it comes within the ordinary meaning of “foreign-source.”

(c) The Act’s Exclusion Is Akin to Territorial Exemptions Under EC Member State Systems

193. The exclusion established by the Act was designed to parallel aspects of the territorial exclusions or exemptions used by EC member states. The Act’s legislative history makes this plain:

The Committee emphasizes that the extraterritorial income excluded by this legislation from the scope of US income taxation is parallel to the foreign-source income excluded from tax under most territorial tax systems. Under neither the US tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems. While exporters may be among those who are eligible for the exclusion, this fact does not make that exclusion “export contingent.” If it did, every general exclusion from tax applicable to, among others, exporters would become a prohibited export subsidy.¹⁷³

194. The exclusion provided under the Act is similar to the practice of a number of EC member-state tax systems in exempting foreign-source income from taxation.¹⁷⁴ Like the Act, these EC systems do not tax at least a portion of the income generated by foreign sales. Among EC tax systems that apply the territorial principle of taxation, the form and extent of each country’s application of that principle vary. Some countries, such as France, have historically exempted all income earned outside their borders. However, no EC country now provides a blanket exemption for foreign-source income. In fact, as the EC explained to the *FSC* Panel, EC member states providing an exemption for foreign-source income do so only partially, and most generally treat foreign-source income as an exception to the general rule that the worldwide income of a domestic corporation is subject to taxation in its country of residence.¹⁷⁵ Just as the Act moves the United States toward a more territorial approach to its system of taxation, EC systems are a mix of worldwide and territorial principles.

4. Conclusion

195. For the foregoing reasons, the exclusion of extraterritorial income under the Act is a measure to avoid double taxation within the meaning of footnote 59. Therefore, pursuant to footnote 5 of the SCM Agreement, the exclusion does not constitute a prohibited export subsidy for purposes of Article 3.1(a).

¹⁷⁰ The Act § 3, amending IRC § 942(b).

¹⁷¹ *EC First 21.5 Submission*, para. 17.

¹⁷² *Id.*

¹⁷³ *House Report*, page 18.

¹⁷⁴ These are discussed in more detail in the “Factual Background” section above.

¹⁷⁵ EC Annex-2, page 2 (US-5).

E. THE 50 PER CENT RULE ON CERTAIN FOREIGN VALUE DOES NOT RENDER THE ACT'S EXCLUSION OF EXTRATERRITORIAL INCOME INCONSISTENT WITH ARTICLE 3.1(B) OF THE SCM AGREEMENT

196. The EC argues that the 50 per cent rule on certain foreign value in the Act violates Article 3.1(b) of the SCM Agreement.¹⁷⁶ The Panel need not reach this issue for two reasons. First, as demonstrated above, the Act's exclusion does not constitute a subsidy within the meaning of Article 1.1(a)(1)(ii). Second, footnote 5 provides that measures not constituting export subsidies under Annex I are not prohibited under any provision of the SCM Agreement, including Article 3.1(b). Should the Panel find that Article 3.1(b) is applicable to this dispute, however, the EC's claim nonetheless fails because it rests on a misunderstanding of the 50-per cent rule and a failure to demonstrate that the Act's exclusion is "contingent" on the use of domestic over imported goods.

1. The EC's Claim Under Article 3.1(b) Is Rendered Moot By Footnote 5 of the SCM Agreement

197. As demonstrated above in connection with Article 3.1(a), footnote 5 to the SCM Agreement states that "[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this *or any other* provision of this Agreement." Footnote 5 thus provides an immunity from all prohibitions in the SCM Agreement - including the one established under Article 3.1(b) - provided that the terms of the footnote are met. As also demonstrated above, the Act's exclusion of extraterritorial income is a measure to avoid double taxation within the meaning of footnote 59 of Annex I. Therefore, because the exclusion is a "[m]easure referred to in Annex I as not constituting [an] export subsid[y]", it is not prohibited under any provision of the SCM Agreement, including Article 3.1(b). Accordingly, the Panel need not address the EC's claim under Article 3.1(b).

2. The Meaning of Article 3.1(b)

198. If the Panel determines that the exclusion of extraterritorial income falls outside the scope of footnote 5, then analysis of the EC's claim under Article 3.1(b) must begin with the text of that provision. In this regard, Article 3.1(b) prohibits "[s]ubsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods." The Appellate Body has stated that the legal standard embodied by the term "contingent" applies equally under Articles 3.1(a) and 3.1(b) of the SCM Agreement.¹⁷⁷ Thus, for purposes of Article 3.1(b), the Appellate Body has confirmed that "contingent" means "conditional" or "dependent for its existence on" something else.¹⁷⁸ For a subsidy to be "contingent . . . on the use of domestic over imported goods," it must be conditioned on or dependent for its existence on the use of domestic goods instead of imported goods.

3. The EC Misunderstands the 50 Per cent Rule

199. The EC's claim reflects a basic misunderstanding of the 50 per cent rule. The EC suggests throughout its First Submission that the Act contains a domestic *content* requirement that precludes manufacturers from using more than a fixed amount of imported inputs in their production operations.¹⁷⁹

200. However, the Act neither precludes manufacturers from using more than a fixed amount of imported articles nor requires the use of any US manufactured articles for a transaction to earn excludable extraterritorial income. Instead, the Act provides that up to 50 per cent of the fair market value of goods involved in a transaction may be attributable to articles produced outside the United

¹⁷⁶ *EC First 21.5 Submission*, paras. 159-184.

¹⁷⁷ *Canada Autos (AB)*, para. 123.

¹⁷⁸ *Canada Aircraft (AB)*, para. 167.

¹⁷⁹ *E.g.*, *EC First 21.5 Submission*, paras. 55, 69, 106, 159 and 179.

States and direct labour costs incurred outside the United States.¹⁸⁰ Under this rule, a good can meet this requirement even if 100 per cent of its content is foreign.

201. The 50 per cent rule takes into account only the value of foreign articles and foreign direct labour costs used in producing a finished product. It does not limit other foreign value. Thus, the remaining 50 per cent of fair market value of the finished product can be attributed to non-tangible elements, including intellectual property rights, goodwill, capital, marketing, distribution, and other services, which may be of either US or foreign origin. The articles used in manufacturing, whatever their origin, account for only part of the total value.

202. The operation of the 50 per cent rule can be illustrated through an example. Assume a product consists of 100 per cent foreign articles and is manufactured using only foreign direct labour. Assume further that the sum of value of the foreign articles and foreign direct labour costs is \$200. Assume also that, because of significant foreign brand name value and foreign capital costs, the fair market value of the product (i.e., the price at which it can be sold to consumers) is \$450. The sale of such a product qualifies for the exclusion under the Act, notwithstanding the fact that no US goods are involved, because \$200 is less than 50 per cent of \$450.

203. The practical effect of the 50 per cent rule is further diminished by the principle of origin applicable to components incorporated into manufactured products. An input sourced from a US supplier may be deemed US-origin for purposes of the 50 per cent rule, despite the fact that the goods from which that component was manufactured may have been primarily, or even entirely, imported goods. In such circumstances, there is no preference for domestic over imported goods because the finished component typically is deemed to be a US-origin good.¹⁸¹

4. Canada Autos Confirms that the Exclusion of Extraterritorial Income Is Not Contingent Upon the Use of Domestic Over Imported Goods

204. The foregoing discussion of why the Act's 50 per cent rule does not violate Article 3.1(b) is confirmed by the Appellate Body report in *Canada Autos*. In that case, the Appellate Body found that even a 60-per cent value-added requirement does not necessarily raise a presumption of inconsistency with Article 3.1(b) of the SCM Agreement. The Appellate Body concluded that only where there is evidence that a manufacturer actually will be *required* to use domestic over imported goods will the prohibition in Article 3.1(b) be implicated.

(a) The Appellate Body's Decision

205. In *Canada-Autos*, the panel and the Appellate Body considered whether a Canadian value-added requirement rendered the subsidy at issue contingent on the use of domestic over imported goods.¹⁸² Under the applicable measure, a Canadian motor vehicle manufacturer was entitled to benefit from an import duty exemption if, *inter alia*, that manufacturer's total Canadian value-added with respect to a class of vehicles reached a certain proportion of the final product's total value. Canadian value added (CVA) could be established through various elements. These elements, while including the costs of parts produced in Canada, also consisted of transportation costs; wages paid for non-production labour in Canada; cost of materials used in the production operation but not incorporated in the final product; overhead costs; worker's compensation and insurance; real estate

¹⁸⁰ The Act § 3, amending IRC § 943(a)(1)(C).

¹⁸¹ The EC provides a comparison between the 50 per cent rule and the limitation on articles imported into the United States contained in the repealed FSC statute. *EC First 21.5 Submission*, paras. 159-162. This comparison, and any reference to the FSC rules, is irrelevant to the issues before this Panel. It should be noted, however, that in the initial proceeding, the United States provided a detailed explanation as to why the FSC provision was consistent with Article 3.1(b) of the SCM Agreement, but neither the *FSC Panel* nor the Appellate Body reached this issue.

¹⁸² A description of the measure in question can be found in *Canada Autos (AB)*, paras. 124-129.

taxes; and a capital cost allowance. One manufacturer was eligible for the import duty exemption if 60 per cent of the total value added by the manufacturer was Canadian. The record did not show the particular CVA requirements for other manufacturers.

206. In analyzing the Canadian CVA requirements, the Appellate Body stated that “[t]he precise issue under Article 3.1(b) is whether the *use* of domestic over imported goods is a ‘condition’ for satisfying CVA requirements, and, therefore, for receiving the import duty exemption.”¹⁸³ The Appellate Body considered that the required CVA level, or percentage, was relevant to whether a particular manufacturer might be able to satisfy its specific CVA requirements without using any Canadian parts and materials in its production.¹⁸⁴ The Appellate Body found that, even where the CVA requirement was 60 per cent, a manufacturer could satisfy the requirement without having to use domestic goods.¹⁸⁵ According to the Appellate Body, where there is a “*multiplicity of possibilities* for compliance” with a value-added requirement, it is not enough to show that “use of domestic goods [is] only one *possible* means (means which might not, in fact, be utilized) of satisfying [such] requirements.”¹⁸⁶

207. The Appellate Body emphasized the importance of establishing “how they [the required CVA levels] operate for individual manufacturers.”¹⁸⁷ Without this “vital information,” a panel cannot know “enough about the measure to determine whether the CVA requirements were contingent ‘in law’ upon the use of domestic over imported goods.”¹⁸⁸ For this reason, the Appellate Body concluded that the 60 per cent CVA requirement did not raise a presumption of inconsistency with Article 3.1(b). Thus, in order to prevail, a complaining party must demonstrate “how [value-added] requirements would *actually* operate” to substitute domestic goods for imported goods.¹⁸⁹

(b) The Application of *Canada-Autos* to the Act

208. Based on the Appellate Body’s analysis in *Canada Autos*, the EC has not met its burden of showing that the exclusion of extraterritorial income under the Act is contingent on the use of domestic over imported goods. As with the CVA requirements at issue in *Canada Autos*, the 50 per cent rule can be satisfied without the use of any domestic goods. In fact, the 50 per cent rule does not require *any* US value in general, or US goods in particular. Because more than 50 per cent of the fair market value of any property sold in a transaction generating extraterritorial income may be attributable to elements other than goods – including intellectual property content, overhead, and other costs unrelated to goods – a manufacturer can earn extraterritorial income by selling products that consist entirely of imported goods.

209. In the words of the Appellate Body, the “multiplicity of possibilities for compliance” with the Act’s 50 per cent rule suggests that the “use of domestic goods [is] only one *possible* means (means which might not, in fact, be utilized) of satisfying the . . . requirements.” As the Appellate Body made clear in *Canada Autos*, such a showing, without more, is simply insufficient to warrant a finding that a measure is “contingent” upon the use of domestic over imported goods.

210. In this case, the EC has offered no evidence that the Act’s 50 per cent rule conditions the exclusion of extraterritorial income on the use of domestic over imported goods. The only “evidence” proffered by the EC in this case is an annex that purportedly describes products of which more than

¹⁸³ *Canada Autos (AB)*, para. 126 (emphasis in original).

¹⁸⁴ *Id.*, para. 130.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* (emphasis in original). By contrast, where the CVA requirements are set “very high,” the Appellate Body stated that “the use of domestic goods may well be a necessity and thus be, in practice, required as a *condition* for eligibility for the import duty exemption.” *Id.* (emphasis in original).

¹⁸⁷ *Id.*, para. 131.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* (emphasis added).

50 per cent of their value derives from inputs or tangible articles.¹⁹⁰ The basis for these descriptions are “some data relating to the production in certain sectors . . . cross-checked . . . with information from certain European industries and in the course of various trade investigations.”¹⁹¹ This “evidence”, though, does not describe how the Act’s 50 per cent rule actually operates with respect to US taxpayers that are eligible to exclude extraterritorial income. Based on the teaching of the Appellate Body in *Canada Autos*, only through evidence showing that the 50 per cent rule actually requires the use of domestic goods can the EC make a viable claim under Article 3.1(b).

F. THE ACT’S 50 PER CENT RULE IS NOT INCONSISTENT WITH ARTICLE III:4 OF GATT 1994

211. The EC claims that the 50 per cent rule of the Act provides less favourable treatment to imported products than to like domestic products in violation of Article III:4 of GATT 1994.¹⁹² Similar to the claim it makes in relation to Article 3.1(b) of the SCM Agreement, the EC’s argument under Article III:4 rests on an inaccurate description of the 50 per cent rule and suffers from insufficient proof to establish a *prima facie* violation.

1. The Meaning of Article III:4

212. Article III:4 provides in relevant part that:

The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use

To establish a violation of Article III:4, the EC must demonstrate the existence of: (a) a law, regulation or requirement affecting the internal sale, offering for sale, or distribution of an imported product; and (b) treatment accorded in respect of the law, regulation or requirement that is less favourable to the imported product than to like products of national origin.¹⁹³ The requirement of Article III:4 that imported products be accorded treatment “no less favourable” than that accorded to like products of national origin has been interpreted to ensure “effective equality of opportunities between imported products and domestic products.”¹⁹⁴

2. The EC Inaccurately Describes the 50 Per cent Rule

213. The EC’s argument regarding Article III:4 is littered with erroneous descriptions of the 50 per cent rule contained in the Act. To start with, the EC states that “the limit on . . . foreign inputs is one of the conditions to obtain the tax benefit.”¹⁹⁵ The EC also claims that the Act contains a “legal requirement that the foreign inputs and labour not be used above a certain ceiling, if a taxpayer wants to obtain the tax benefit.”¹⁹⁶ The EC maintains that the Act “requires in some cases the use of a minimum amount of domestic parts and materials . . . [and] precludes producers wishing to benefit . . . from using an equivalent amount of imported parts and materials.”¹⁹⁷ Finally, the EC asserts that the

¹⁹⁰ *EC First 21.5 Submission*, Annex.

¹⁹¹ *Id.*

¹⁹² *EC First 21.5 Submission*, paras. 187-219.

¹⁹³ *Japan - Measures Affecting Consumer Photographic Film and Paper* (“*Japan Film*”), WT/DS44/R, Report of the Panel adopted 22 April 1998, para. 10.369.

¹⁹⁴ *Canada - Certain Measures Affecting the Automotive Industry* (“*Canada Autos (Panel)*”), WT/DS139/R, WT/DS142/R, Report of the Panel, as modified by the Appellate Body, adopted 19 June 2000, para 10.78.

¹⁹⁵ *EC First 21.5 Submission*, para. 195.

¹⁹⁶ *Id.*, para. 203.

¹⁹⁷ *Id.*, para. 206.

Act requires “the . . . use by an enterprise of products of domestic origin . . . , whether specified in terms of . . . value of products, or in terms of a proportion of . . . value of its local production.”¹⁹⁸

214. These statements simply do not accurately describe the Act. As discussed throughout this submission, including the immediately preceding section, the Act does not require the use of any US-origin goods for a transaction to earn excluded extraterritorial income. Instead, the Act provides that up to 50 per cent of the fair market value of goods involved in a transaction may be attributable to articles produced outside the United States and direct labour costs incurred outside the United States.¹⁹⁹ Goods can meet this requirement even if 100 per cent of the fair market value of their inputs is foreign. Thus, contrary to the EC’s arguments,

- the Act does not place a “limit on foreign inputs”;
- there is no “legal requirement that the foreign inputs and labour not be used above a certain ceiling”;
- the Act does not “require[] in some cases the use of a minimum amount of domestic parts and materials”; and
- the Act does not require “the . . . use by an enterprise of products of domestic origin”.

215. Certainly, a claim of inconsistency under Article III:4 cannot rest upon such an erroneous description of the contested measure. For this reason alone, the EC has not made a *prima facie* case of inconsistency with Article III:4.

3. The EC Proffers No Evidence To Support Its Claim Under Article III:4

216. In addition to inaccurately describing the measure it seeks to invalidate, the EC has presented no evidence supporting its claim under Article III:4. The EC states that, “*in many cases*,” the Act requires the use of US-produced inputs.²⁰⁰ The EC also states “there will be *cases* in which a firm will be induced to increase the value of US goods it uses”²⁰¹ Moreover, the EC claims that the Act will “*in many cases* determine which goods a producer will use”,²⁰² and “it will *in many cases* be easier” to meet the 50 per cent rule if US products are used.²⁰³ Finally, the EC claims that “prospective beneficiaries will *always* give preference, all other conditions being equal, to US ‘articles.’”²⁰⁴

217. Despite the rhetoric, nowhere does the EC cite to a single case where a class of imported goods will be accorded less favourable treatment than a class of domestic “like products.” In fact, the EC has not described one product that would be “affected” by the 50 per cent rule contained in the Act, thereby undermining the EC’s own interpretation of Article III:4 as requiring an examination of “individual products” rather than “all possible products.” Simply asserting that “many cases” of less favourable treatment exist does not make the assertion true and does not suffice to support a claim under Article III:4. In fact, the EC itself has acknowledged that, “an analysis [under Article III:4] has

198 *Id.*, para. 217, quoting the Agreement on Trade-Related Investment Measures, Illustrative List, Item 1.a.

199 The Act § 3, amending IRC § 943(a)(1)(C).

200 *EC First 21.5 Submission*, para. 194 (emphasis added).

201 *Id.*, para. 200 (emphasis added).

202 *Id.*, para. 199 (emphasis added).

203 *Id.*, para. 205 (emphasis added).

204 *Id.*, para. 208 (emphasis added).

to be carried out at the level of an individual product, not at the level of the application of the law to all possible products.”²⁰⁵

218. Many of the GATT and WTO panel cases cited by the EC involve laws, regulations, and requirements explicitly applicable to a particular class or category of imports.²⁰⁶ In such cases, it is not difficult to consider how such imports would be “affected” by those measures. However, in cases involving a generally applicable measure, there must be a heightened evidentiary burden for the complaining party. Measures of general application, like the Act, do not necessarily affect imported goods. Evidence must be introduced to establish a “meaningful nexus” between such a measure and adverse effects on competitive conditions for a like class of imported goods before determining that the measure accords less favourable treatment to imports.²⁰⁷

219. The foregoing discussion demonstrates that the EC has failed to make a *prima facie* case of inconsistency with Article III:4. By inaccurately portraying the measure it seeks to invalidate and by failing to provide adequate evidence to substantiate its conclusions, the EC has not proven its claim that the Act is inconsistent with Article III:4.

G. THE ACT’S EXCLUSION OF EXTRATERRITORIAL INCOME DOES NOT VIOLATE US OBLIGATIONS UNDER THE AGREEMENT ON AGRICULTURE

220. The EC contends that the Act’s exclusion of extraterritorial income violates Article 10.1 of the Agreement on Agriculture, as read together with Article 8 of that Agreement, or, in the alternative, Articles 3.3 and 8, in conjunction with Article 9.1, of the Agreement.²⁰⁸ For the following reasons, the EC’s claim lacks merit.

221. Article 10.1 of the Agriculture Agreement provides that “[e]xport subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments” In the *FSC* case, the Appellate Body relied upon the definitions of subsidy in Article 1 of the SCM Agreement and export contingency in Article 3.1(a) of the SCM Agreement as context in considering what is an “export subsidy” under the Agriculture Agreement.²⁰⁹ For the same reasons already discussed by the United States that the Act’s exclusion does not constitute an export subsidy within the meaning of Articles 1 and 3.1(a) of the SCM Agreement, the exclusion does not constitute an export subsidy within the meaning of Article 1(e) of the Agriculture Agreement. Thus, the exclusion of extraterritorial income under the Act does not violate US obligations under the Agriculture Agreement.²¹⁰

²⁰⁵ *Id.*, para. 211.

²⁰⁶ See, e.g., *Canada Autos (Panel)*; and *United States - Standards for Reformulated and Conventional Gasoline*, WT/DS2/R, Report of the Panel, as modified by the Appellate Body, adopted 20 May 1996.

²⁰⁷ See, e.g., *Japan Film*, para. 10.381.

²⁰⁸ *EC First 21.5 Submission*, paras. 222-233; see also *id.*, paras. 67-68. The EC provides an extraneous and seemingly irrelevant description of the 50 per cent rule in its discussion of the Agriculture Agreement. *Id.*, paras. 220-21. Because the EC has failed to make any legal claim under the Agriculture Agreement with respect to this aspect of the Act, the United States does not address the factual inaccuracies contained in the EC’s description in this section. The United States respectfully refers the Panel to the discussion in Section V.E, above, that explains the operation of the 50 per cent rule.

²⁰⁹ *FSC (AB)*, paras. 136-142, citing *Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products*, WT/DS103/AB/R, WT/DS113/AB/R, Report of the Appellate Body adopted 27 October 1999.

²¹⁰ The EC posits an alternative argument under the Agriculture Agreement that is conditioned on the United States making an argument that the Act confers export subsidies that are covered by Article 9.1 of the Agriculture Agreement. Because the United States does not make this argument, the EC’s alternative argument need not be addressed.

H. THE UNITED STATES COMPLIED WITH THE DSB'S RECOMMENDATIONS AND RULINGS

222. The EC contends that the United States has not complied with the DSB's recommendations and rulings because: (1) the Act contains transition rules that extend the FSC regime beyond 30 October 2000; and (2) because the Act was not signed into law until after 1 November 2000.²¹¹ As discussed below, the United States believes that it satisfactorily complied with the DSB's recommendations and rulings.

1. Based on All of the Circumstances Surrounding this Dispute, the Panel Should Find that the Act's Transition Rules Constitute a Reasonable Method of Complying with the DSB's Recommendations and Rulings

223. The Act repealed sections 921-927 of the IRC, the FSC tax provisions.²¹² The Act also provides that no FSCs may be created after 30 September 2000.²¹³ As a result, the measures contested by the EC in the *FSC* case and found by the DSB to give rise to prohibited export subsidies under the SCM Agreement no longer exist.

224. The Act, though, does provide limited transition relief to lessen the administrative burden and impact on taxpayers' business operations that might result due to the repeal of the FSC. The Act provides one tax year (*i.e.*, through December 2001) for FSCs in existence as of 30 September 2000 to continue in operation.²¹⁴ In addition, with respect to FSCs that entered into long-term, binding contracts with unrelated parties before 30 September 2000, the Act does not alter the tax treatment of those contracts.²¹⁵ As such, these rules are relatively narrow and apply only in highly particularized circumstances.

225. It is customary practice in the United States and other countries to promulgate transition rules when repealing significant tax legislation. This is done to avoid impairing pre-existing binding contracts and to otherwise minimize uncertainties that may ensue. Complex and harmful tax consequences could result where, for example, a profit or a loss is accounted for in one tax year while the transaction creating that profit or loss was entered into in a previous year.²¹⁶ If tax laws affecting that transaction are amended, questions would arise as to which law governs and whether the transactions need to be unwound or substantially revamped.

226. Transition rules, therefore, provide domestic and foreign businesses with an opportunity to adjust, and they "protect people who might have altered their conduct in reliance upon" the tax treatment provided under the earlier law.²¹⁷ As one scholar has explained, "those who reasonably relied upon an existing law should not be subjected to the costs associated with unexpected changes in that law."²¹⁸

227. The Appellate Body has recognized that WTO rules must be construed flexibly. Thus, the Appellate Body has stated that "WTO rules are not so rigid or so inflexible as not to leave room for reasoned judgments in confronting the endless and ever-changing ebb and flow of real facts in real cases in the real world. They will serve the multilateral trading system best if they are interpreted

²¹¹ *EC First 21.5 Submission*, paras. 234-241.

²¹² The Act § 2.

²¹³ The Act § 5(b)(1).

²¹⁴ The Act § 5(c)(1)(A).

²¹⁵ The Act § 5(c)(1)(B).

²¹⁶ Kirk J. Stark, *The Elusive Transition to a Tax Transition Policy*, 13 *Amer. J. Tax Pol'y* 145, 149 (1996) (Exhibit US-8).

²¹⁷ *Id.*, page 150.

²¹⁸ *Id.*, pages 149-150.

with that in mind.”²¹⁹ In several recent cases, WTO panels have excused procedural violations in the absence of prejudice to the complaining party, essentially taking into account equitable considerations in issuing their decisions.²²⁰

228. A limited transition period allowing taxpayers to adjust to a new tax regime appears all the more reasonable in light of the circumstances surrounding this case. Specifically, notwithstanding the EC’s assertions that it never agreed that the FSC was GATT- or WTO-consistent, it waited until thirteen years after the FSC was enacted before challenging it. During that time, US taxpayers came to rely on the FSC provisions in structuring their foreign transactions. Furthermore, the United States promulgated and maintained the FSC tax provisions in reliance on the 1981 Understanding adopted by the GATT Council. Notwithstanding the status ultimately accorded to the 1981 Understanding in this case, such reliance was not unjustified.

229. Despite the many obstacles posed by the fact that 2000 was a presidential election year in the United States, and acting under the strict time restraints set by the DSB, the United States did repeal the FSC provisions. The United States attempted to work in good faith with the EC to find a legislative solution that would be mutually acceptable. When that did not occur, the United States repealed the FSC provisions with effect from 1 October 2000, with the exception of the transition rules described above. Considering these factors, under the particular circumstances of this dispute, the United States believes that the Panel should find that the limited transition rules provided for in the Act constitute a reasonable implementation of the DSB’s recommendations.

2. The United States Complied with the Time Period Specified by the DSB

230. The EC also argues that the United States failed to comply with the DSB’s recommendations in the *FSC* case because the Act was not signed until 15 November 2000.²²¹ The EC’s argument fails for several reasons.

231. First, the Act’s provisions apply retroactively and repeal the FSC provisions before 1 November 2000. The DSB recommended that the United States withdraw the FSC subsidies with effect from 1 October 2000, which the DSB then extended to 1 November 2000. The DSB did not indicate when the legislation had to be enacted, although the United States obviously sought to eliminate any controversy on this point by attempting to enact the legislation by 1 October (and, thereafter, by 1 November). The Act provides that the “amendments made by this Act shall apply to transactions after 30 September 2000.”²²² Thus, the United States repealed the FSC with effect from 1 October 2000, thereby complying with the DSB’s recommendation.

232. Second, the WTO generally does not examine claims regarding measures that are no longer in effect and that were not in effect at the time a panel’s terms of reference were established. This comports with the fact that the WTO does not provide relief retroactively for alleged past wrongs.²²³

233. The same principle applies here. The “measure” in question constitutes an omission in the form of an alleged failure to act by 1 November 2000. However, the measure (*i.e.*, the omission) ceased to exist as of 15 November 2000 when the Act was signed into law. In other words, by the

²¹⁹ *Japan - Taxes on Alcoholic Beverages*, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, Report of the Appellate Body adopted 1 November 1996, page 34.

²²⁰ *See, e.g., United States - Safeguard Measures on Imports of Fresh, Chilled or Frozen Lamb Meat from New Zealand and Australia*, WT/DS177/R, WT/DS178/R, Report of the Panel circulated 21 December 2000 (on appeal), paras. 5.48-5.53, or on the basis of estoppel (*see, e.g., FSC (Panel)*), para. 7.10.

²²¹ *EC First 21.5 Submission*, paras. 244-246.

²²² The Act § 5(a).

²²³ This principle is reflected in Article 19.1 of the DSU, which provides that when a panel concludes that a measure is inconsistent with a covered agreement, the panel “shall recommend that the Member concerned bring the measure into conformity with that agreement.” (footnote omitted).

time the EC made its panel request to commence this Article 21.5 proceeding, the measure it ostensibly was challenging no longer existed. Panels typically refrain from examining measures that cease to be in existence or in effect before a panel's terms of reference are set.²²⁴

I. THE PANEL SHOULD REJECT THE EC'S PRELIMINARY OBJECTION REGARDING THIRD PARTY RIGHTS

234. The EC has made a preliminary objection to paragraph 9 of the Panel's Working Procedures, which require the parties to serve their first written submissions on third parties. The EC essentially asks the Panel to require the parties to also serve their written rebuttals on third parties.²²⁵ According to the EC, paragraph 9 is inconsistent with Article 10.3 of the DSU.

235. The EC has made similar arguments in other Article 21.5 proceedings in which a panel has held only a single meeting with the parties and third parties, and in each such proceeding, the panel has rejected the EC argument. The first in this line of cases is *Australia Leather*, in which the panel made the following ruling:

In its 11 November 1999 response to the EC, the Panel indicated that it had decided not to change the existing working procedures which provide for third parties to receive the first written submissions of the parties, but not the rebuttals. The Panel stated that if it had decided to hold two meetings with the parties, as is the normal situation envisioned in Appendix 3 of the DSU, third parties would have received only the written submissions made prior to the first meeting, but not rebuttals or other submissions made subsequently. Thus, in the more usual case, third parties would be in the same position as they were in this case with respect to their ability to present views to the panel. In the view of the Panel, the procedure it had established conformed more closely with the usual practice than would be the case if third parties received the rebuttals, and was in keeping with Article 10.3 of the DSU in a case where the Panel holds only one meeting.²²⁶

236. More recently, the panel in *Korea DRAMS* also rejected the EC's position. Because the parties were able to reach a mutually acceptable solution in that case, the panel never issued a report. However, prior to the termination of the proceeding, the panel issued a decision in which it rejected the EC request. The pertinent portions of the decision read as follows:

The Panel took note of the possible merit of the EC's argument when looking only at the words of Article 10.3. However, pursuant to the Vienna Convention rules on treaty interpretation one cannot isolate the words of a treaty from their context. The reference in Article 10.3 to "submissions . . . to the first meeting of the panel" is made in the context of standard panel procedures. There, a panel holds two meetings and documentation is submitted before each of these meetings. Third parties normally do not have a right to hear the oral statements of the main parties at panel meetings (including the first meeting). A special third party oral session is reserved for them only once, subsequent to the first meeting with the main parties. In that context, the effect of Article 10.3 is to limit third party rights to receive only the parties' first written submissions (submitted to the first meeting); not the parties' written rebuttals (presented to the second meeting).

²²⁴ See, e.g., *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*, WT/DS56/R, Report of the Panel, as modified by the Appellate Body, adopted 22 April 1998, paras. 6.13-15.

²²⁵ *EC First 215. Submission*, paras. 247-258.

²²⁶ *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather - Recourse to Article 21.5 of the DSU by the United States*, WT/DS126/RW, Report of the Panel adopted 11 February 2000, para. 3.9. This decision was followed in *Australia - Measures Affecting Importation of Salmon - Recourse to Article 21.5 by Canada*, WT/DS18/RW, Report of the Panel adopted 20 March 2000, paras. 7.5-7.6.

A panel under Article 21.5 has to follow DSU panel procedures. But it is obliged to do so in a different context, namely in the context of a much stricter timeframe. As a result, this Panel decided to hold only one meeting; not two as is usually the case. The practice of obtaining from the parties two sets of documentation in the form of first written submissions and written rebuttals (both, however, before the single meeting of the Panel) was maintained. In this context, the Panel is of the view that, in order to give effect to Article 10.3, Article 10.3 has to be interpreted as limiting third party rights to the first written submissions only; not including the written rebuttals. The drafters of the DSU restricted third party rights. It is not the task of this Panel to extend them in Article 21.5 procedures.²²⁷

237. In the view of the United States, the reasoning of these prior panels is sound, and should be followed by this Panel. Thus, the Panel should find that third parties do not have a right to the rebuttal submissions of the parties in this proceeding.²²⁸

238. Having said that, the United States notes that, with the exception of business confidential information, it routinely makes its submissions to WTO panels available to the public by placing its submissions on the Internet Web page of the Office of the US Trade Representative. Thus, as a practical matter, third parties (along with the rest of the world) will have access to the US rebuttal submission. Nothing prevents the EC from providing its rebuttal submission to the third parties in this proceeding (or for that matter, to the citizens of EC member states).

VI. CONCLUSION

239. For the forgoing reasons, the United States requests that the Panel find as follows:

- (a) The Act's exclusion of extraterritorial income from US taxation does not constitute a prohibited subsidy contingent upon export performance within the meaning of Article 3.1(a) of the SCM Agreement.
- (b) The Act's exclusion of extraterritorial income from US taxation does not constitute a prohibited subsidy contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the SCM Agreement.
- (c) The Act does not result in less favourable treatment being provided to imported goods in comparison to the treatment afforded to like domestic goods within the meaning of Article III:4 of GATT 1994.
- (d) The Act's exclusion of extraterritorial income from US taxation is not inconsistent with US obligations under Articles 10.1 and 8, or Article 3.3 and 8, of the Agreement on Agriculture.
- (e) The United States complied with the DSB's recommendations and rulings in the *FSC* dispute.
- (f) The third parties in this proceeding do not have a right to the parties' rebuttal submissions.

²²⁷ *United States - Anti-Dumping Duty on Dynamic Random Access Memory Semiconductors (DRAMs) of One Megabit or Above from Korea - Recourse by Korea to Article 21.5 of the DSU*, WT/DS99, Decision of the Panel Concerning the EC Request for Access to the Parties' Rebuttal Submissions, 27 June 2000 (footnotes omitted).

²²⁸ The United States notes further that none of the third parties that have expressed an interest in this proceeding have requested expanded third party rights.

EXHIBIT LIST

FSC Repeal and Extraterritorial Income Exclusion Act of 2000	US-1
U.S. Senate Report on the FSC Repeal and Extraterritorial Income Exclusion Act	US-2
U.S. House of Representatives Report on the FSC Repeal and Extraterritorial Income Exclusion Act.....	US-3
United States Internal Revenue Code.....	US-4
EC Second Written Submission to the FSC Panel	US-5
James E. Maule, <i>Gross Income: Overview and Conceptual Aspects, 501-2d Tax Management (BNA), pages A-1 through A-4</i>	US-6
OECD Model Tax Convention on Income and Capital.....	US-7
Kirk J. Stark, <i>The Elusive Transition to a Tax Transition Policy</i> , 13 Amer. J. Tax Policy 145 (1996), pages 145 - 149	US-8