ANNEX C

Second Submissions by the Parties

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ANNEX C-1

SECOND WRITTEN SUBMISSION OF THE EUROPEAN COMMUNITIES

(27 February 2001)

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1. Introduction

1. The EC respectfully submits to the Panel its second written submission in this case in rebuttal to the first written submission of the US.

2. The EC finds that the US submission does not respond to a number of the arguments contained in the first written submission of the EC. The EC will therefore commence this submission (Section 2 below) by recalling the arguments to which the US has not responded, as this may assist the Panel in identifying what is not contested.

3. Another feature of the first written submission of the US is that it provides little in the way of concrete information in response to that furnished by the EC but instead contains a number of misleading statements. The EC will comment on the US presentation of the facts in Section 3 below in order to clarify these issues for the Panel.

4. The legal arguments of the US are rebutted in Section 4 below. This section commences with a discussion of the questions of the burden and standard of proof to be applied in Article 21.5 *DSU* proceedings and its consequences for the present proceedings. It will continue with a discussion of the legal issues in the following order:

- ➢ Arguments relating to the existence of a subsidy;
- ➢ Arguments relating to export contingency;
- ➢ Arguments relating to the requirement to use US over foreign articles;
- ➢ The double taxation defence;
- ➢ Arguments relating to Article III:4 *GATT 1994;*
- ➢ Arguments concerning the transitional period;
- ➢ Arguments concerning the failure of the US to implement the rulings and recommendations of the DSB by 1 November 2000.

5. Finally, the EC will summarise its conclusions (Section 5).

6. The EC notes that the third parties who have submitted comments agree with the EC position. The EC will comment on these submissions as required during the discussion of the arguments.

2. The EC Arguments that remain unaddressed

7. The US has failed to address a number of claims and arguments made by the EC in its first written submission. The EC wishes to draw the attention of the Panel to the following unanswered claims and arguments.

2.1. The EC's basic argument concerning export contingency and illustrations

8. In paragraphs 77 to 79 of the EC's first written submission, the EC explained that one basic error of the US was to consider that extending a tax exemption (or exclusion) to other categories of income than that earned by selling US goods could prevent it being contingent upon export in those situation where export is a necessary condition for obtaining the tax exemption. More generally, 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 may not require export.

9. In other words, it should not be possible for the US to hide, what is essentially the same subsidy as that before the Panel in the original proceeding, within a slightly wider subsidy by adding to the basic FSC Replacement subsidy what the EC has called the extended FSC Replacement subsidy.[1]

10. The simple fact that tax-free income – or even income that is given the name "extraterritorial" or "excluded" – can be earned without exporting in some situations cannot suffice to prevent an export subsidy from being present if such income can be earned in other situations only by exporting. Otherwise, it would have been sufficient for the US to include in the FSC scheme any other category of income which is already exempted, or which it is thought desirable to exempt from tax to bring itself into 'compliance'.

11. The EC does not consider that the US has replied to these arguments.[2]

12. The EC developed its position by arguing that in order to assess whether a subsidy is contingent upon export or specifically related to export it is necessary to compare like with like – or, as the EC put it, there must be a comparison with some relevant benchmark.

13. The EC illustrated its point as follows:[3] 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.

14. 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 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.

15. The EC also pointed out that the situation of the FSC Replacement Act is in this respect similar to the export subsidy found by the panel and Appellate Body in *Canada – Aircraft*.[4] 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."[5] 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.

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[1] For an identification and explanation of the two subsidies see first written submission of the EC, paragraphs 62 to 66.

[2] The EC replies to the arguments that the US has made in Section 4.3 below.

[3] First written submission of the EC, paragraphs 123 to 127.

[4] Panel Report, *Canada – Measures Affecting the Export of Civilian Aircraft ("Canada – Aircraft")*, WT/DS70/R, adopted 20 August 1999, as upheld by the Appellate Body Report, WT/DS70/AB/R.

[5] See, e.g., Panel Report, *Canada – Aircraft,* paragraph 6.174.

16. Again, the EC finds no answer to these arguments in the first written submission of the US.

2.2. The EC argument that the *extended* FSC Replacement Subsidy is also contingent upon export performance and specifically related to exports

17. The US also fails to comment at all on the EC's further argument that adding the extended FSC Replacement subsidy to the basic FSC Replacement subsidy cannot, in any event, prevent the basic FSC Replacement subsidy frombeing export contingent because the extended FSC Replacement subsidy is itself also export contingent or specifically related to exports due to the existence of the foreign content limitation, which is equivalent in many cases to a US content requirement.[6]

18. It may be that the US considers that it has responded to this argument with its arguments relating to Article 3.1(b) of the *SCM Agreement* (that it does not consider that there is any requirement to use goods exported from the US).[7] In no way however does it respond to the argument that the extended FSC Replacement subsidy is *specifically related to exports* within the meaning of Item (e) of the Illustrative List.

2.3. The EC claim that the FSC Replacement scheme also provides subsidies under the *Agreement on Agriculture* and that these are contrary to Articles 10.1 and 8 of the *Agreement on Agriculture*

19. The US defence of the FSC Replacement scheme under the *Agreement on Agriculture* is limited to a reference back to its arguments under the *SCM Agreement* that the scheme does not give rise to export contingent subsidies.[8]

20. The US does not contest that if the FSC Replacement subsidies are contingent upon export performance for the purposes of the *SCM Agreement* for any reason, the FSC Replacement scheme will be inconsistent with Articles 10.1 and 8 of the *Agreement on Agriculture*. In particular, the US expressly confirms[9] that it does not argue that the FSC Replacement subsidies fall under any of the categories listed in Article 9.1 of the *Agreement on Agriculture*. In the light of the Report of the Appellate Body, the question of whether the FSC Replacement subsidies do fall under any of the categories listed in Article 9.1 of the *Agreement on Agriculture* may therefore be considered academic.

3. Comments on the Factual Background

21. As mentioned above, there are a large number of incorrect and misleading statements in the US first written submission. The EC will comment on and correct the statements that it considers most relevant and important for a proper understanding of the case.

3.1. The relationship between the FSC and FSC Replacement schemes

22. The US challenges[10] the EC's comment that the FSC Replacement scheme provides "essentially the same subsidy" as the FSC scheme. The EC made this comment when considering the subsidy from the point of view of US exporters and maintains that it is accurate. The attempt of the US to present the schemes as different deserves a number of comments here.

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[6] First written submission of the EC, paragraphs 104 to 120, 220-221 (and paragraphs 147 to 158 in connection with the term "specifically related to exports").

[7] First written submission of the US, footnote 102.

[8] First written submission of the US, paragraph 221.

[9] First written submission of the US, footnote 210.

[10] First written submission of the US, paragraph 47 *et seq.*

23. First, as the EC explained, in particular in paragraphs 35 to 37 of its first written submission, the FSC Replacement scheme provides arithmetically identical tax benefits to what was (and still is) available under the FSC scheme, but the availability had been facilitated and somewhat widened.

24. The US does not contest these facts. The EC notes that Canada also agrees with its arithmetic.[11]

25. Second, it is also clear from the transitional rules that the FSC Replacement scheme replaces the FSC.[12] The FSC Replacement Act does not apply to FSCs until 31 December 2001 and in some case may not ever apply to them. In fact, one scheme is phased in while the other is phased out. Also exporters can opt into the FSC Replacement scheme for individual transactions instead of using the FSC scheme.[13]

26. Third, the US statement in footnote 181 to its first written submission is wrong (or at least contradicts the stated intent of the US Congress) when it states, with reference to the foreign content limitation, that:

> This comparison, and any reference to the FSC rules, is irrelevant to the issues before this Panel.

The US Congress Joint Committee on Taxation made a statement to the contrary (taken up in the House and Senate Reports) in the following terms:

> Gap period before administrative guidance is issued
>
> The Committee recognizes that there may be a gap in time between the enactment of the bill and the issuance of detailed administrative guidance. It is intended that during this gap period before administrative guidance is issued, taxpayers and the Internal Revenue Service may apply the principles of present-law regulations and other administrative guidance under sections 921 through 927 to analogous concepts under the bill. Some examples of the application of the principles of present-law regulations to the bill are described below. These limited examples are intended to be merely illustrative and are not intended to imply any limitation regarding the application of the principles of other analogous rules or concepts under present law.

3.2. The FSC Replacement Act as a "fundamental change" to the US tax system

27. Central to the US argument that the FSC Replacement scheme cannot give rise to any subsidies at all are the contentions that the FSC Replacement Act is the result of congressional review of the US tax system[14] and represents a fundamental shift in the jurisdiction to tax.[15] The legislative history (even if considered relevant) does not, when examined, actually reflect any such intention and the EC challenges these statements as misleading and incorrect.

28. The US attempt to contrast the FSC Replacement Act with the "former US worldwide approach"[16] only serves to highlight the artificiality of its arguments. The US approach to the taxation of income is still fundamentally worldwide, even as regards so-called "extraterritorial income". As the EC has explained and the US has nowhere attempted to refute, the FSC Replacement Act excludes

[11] Written Observations of Canada, paragraph 32.

[12] The transitional rules are in section 5 of the FSC Replacement Act and are explained in paragraphs 234 to 241 of the first written submission of the EC.

[13] Section 5(c)(2) of the FSC Replacement Act.

[14] First written submission of the US, paragraph 25.

[15] First written submission of the US, paragraphs 52 to 54 (see also paragraphs 67 to 73).

[16] First written submission of the US, paragraph 52.

only a variable part of "extraterritorial income" from gross income and therefore tax, and does so subject to numerous conditions.[17]

29. The EC refers the Panel to an Article published in the US specialist publication Tax Notes International entitled "US Treasury Official Denies FSC Repeal Signals Move to Territoriality.[18] The Article is attached as Exhibit EC-10. The official concerned was the US Treasury's acting international tax counsel and was closely involved in the preparation and defence of the FSC Replacement Act, representing the US at the consultations held with the EC on 4 December 2000. She is reported as saying that the FSC Replacement Act "is a narrow exception from the traditional US tax model based on reaching the worldwide income of each tax payer, regardless of where such income is derived." The Article also makes clear that the US review of its subpart F legislation is yet to be completed.[19]

3.3. The US argument that 'extraterritorial income' is 'outside the taxing jurisdiction of the United States'

30. A related argument to that about 'fundamental change' to the US tax system is the often repeated US claim that 'extraterritorial income' is outside the taxing jurisdiction of the US. For example, in paragraph 20 of the first written submission of the US:

> 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.

and in paragraph 25:

> the Act creates a new general rule under which excluded extraterritorial income earned by US taxpayers is outside US taxing jurisdiction.

31. These statements are misleading. First, as the EC has explained in its first written submission, the US does tax 'extraterritorial income'. It is only a variable part thereof – qualifying foreign trade income that is excluded and then subject to numerous conditions, some of which were listed by the EC in paragraph 55 of its first written submission.

32. The extent of the exclusion of 'extraterritorial income' from US taxation is very much under US government control. There are many conditions in the FSC Replacement Act and further extensive executive powers to regulate the taxation of this 'extraterritorial income'. For example, new section 943(a)(4) allows the President to designate any property as in short supply and exclude income from its export from the FSC Replacement scheme. And new section 943(e)(4)(C) allows the Secretary to the Treasury to generally exclude 'one or more classes of corporations' from the making 'domestication elections' and thus from participating in the FSC Replacement scheme.

3.4. The US inaccurate and misleading description of the FSC Replacement scheme

33. The EC considers that the first written submission of the US is replete with other misleading and unjustified statements about the FSC Replacement scheme. For example, the US states that:

> Rather than providing unique or special treatment for export-related income, the Act treats all foreign sales and all taxpayers alike.[20]

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[17] First written submission of the EC, paragraphs 48 to 51.
[18] Tax Notes International, 18 December 2000, pp. 2749 to 2752.
[19] *Id.* page 2752.
[20] First written submission of the US, paragraph 23.

34. As the EC has pointed out the 'special tax treatment' under the FSC Replacement scheme is only available for 'foreign sales' on condition that they are not 'for ultimate use in the US'[21] and is also only available if certain conditions are met including a limitation on foreign content which restricts availability of the 'special tax treatment' in some cases to foreign goods incorporating US exports.[22]

35. Similarly, the US statement at another point of its first written submission:

> Thus, taxpayers receive the same US tax treatment with respect to income derived from foreign transactions regardless of whether exports are involved.[23]

is also, to say the least, misleading. It is clear that the vast majority of 'foreign transactions' are treated very differently by the US tax system.

36. A general feature of the first written submission of the US is the pervasive confusion that exists between 'foreign transactions', 'foreign sales', 'foreign goods', 'exports' and 'foreign-source income.' Different concepts are often assimilated when in truth they are distinct or only partially overlap. To take a few examples:

- In paragraph 126 of the first written submission, the US attempts to deny the comparability of goods sold domestically and those sold abroad by saying:

  > Products manufactured and sold in the US cannot be said to be foreign.

Obviously, products made in the US and then exported do not suddenly become foreign, even if the transaction is made with a foreign company.

- In quoting the House Report, the US says[24] that under the US and European systems

  > exporting is one way to earn foreign source income…

Of course, under the European systems, only the foreign activities relating to exporting earn such income, while under the Act all the domestic activities relating to exports earn such income.

37. The US also attempts to blur the distinction between "extraterritorial" income and "excluded" income. It erroneously states in paragraph 28 of its first written submission that the FSC Replacement Act gives a detailed definition of extraterritorial income which is contained primarily in sections 114, 941, 942 and 943 of the IRC. It refrains from referring to the straightforward definition contained in section 114(e) IRC but goes on in paragraph 29 to bring into the definition elements of *qualifying* foreign trade income which, as the EC explained, merely limit the extent to which "extraterritorial income" is subject to less tax than other income.

38. Thereafter, the US varies its terminology referring to "excluded income"[25] "excluded extraterritorial income"[26] and even "excludable extraterritorial income"[27].

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[21] Section 942(a)(2)(A)(i) of the IRC as explained, for example, in the first written submission of the EC, paragraphs 100-101.

[22] Section 943(a)(1)(C) of the IRC as explained, for example, in the first written submission of the EC, paragraph 107 *et seq.*

[23] First written submission of the US, paragraph 23.

[24] First written submission of the US, paragraph 193.

[25] E.g., First written submission of the US, paragraph 33.

[26] E.g., First written submission of the US, paragraph 31.

[27] First written submission of the US, paragraph 200.

39. The EC considers that the US attempt to confuse the basic facts concerning its law to be unhelpful. The EC considers that its own description of the FSC Replacement Act is more reliable and notes that the US has not demonstrated any instance in which the EC may have misunderstood any aspect of the FSC Replacement Act.

3.5. US descriptions of European Tax systems

40. The US is also inaccurate in its description of "European" tax systems.[28] The EC has no intention to defend the tax systems of its Member States, which it is convinced comply fully with their international obligations. It will only make the following brief comments:

- First, it is misleading to talk of a "European Model"[29] tax systems. Most EU tax systems are not territorial, as is shown in the description the EC produced in the original proceedings and the US has attached to its first written submission as exhibit US-5.

- Secondly and most importantly, the FSC Replacement Act is not comparable to any EC system. The description of the "European tax exemptions" is misleading. The US is simply wrong when its states, at the end of paragraph 40 of its first written submission, that:

> 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.

Contrary to the situation under the US FSC Replacement scheme, exemptions in the EC Member States do not depend on whether the product on which the income arises is exported or not. If a foreign distribution subsidiary of a Dutch producer, to take the example used by the US, of goods sells those goods in the Netherlands, the resulting profit will have exactly the same tax treatment as when the foreign subsidiary sells them outside the Netherlands.

Another important difference is that the exemption of foreign branch profits under the Dutch tax system (as well as under any other EC Member State's tax system which provide for the exemption of foreign branch profits) is limited to the profits attributable to the foreign branch in accordance with the arm's length principle. The applicability of this principle to the attribution profits between branch offices and head offices is well established in the international tax disciplines[30] and it is strictly adhered to by the Dutch tax law. Under the FSC Replacement scheme the amount of excluded income is simply calculated according to three alternative formulas. In practice none of these formulas is likely to give a result that would correspond to the amount of profits attributable to business activities carried out outside the territorial limits of the US.

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[28] First written submission of the US, first in paragraph 25 and then in detail in paragraphs 39 to 46.

[29] First written submission of the US, paragraph 39 *et seq.*

[30] Among such internationally embraced disciplines, perhaps most relevant to the attribution of business profits to a permanent establishment (e.g. a branch office) is that of Article 7 of the OECD Model Tax Convention. This principle and its applicability to the attribution of business profits is clearly set out in paragraph 2 of Article 7 of the Convention: "Subject to the provisions of paragraph 3, where an enterprise carries on business in the other Contracting State through a permanent establishment situated therein, *there shall be in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.*" (emphasis added).

3.6. The FSC Replacement Act as a measure for the avoidance of double taxation

41. The EC will be refuting the double taxation defence in detail in Section 4.6 below. However, in the present context, it takes issue with the US statement that the avoidance of double taxation was a *purpose* of the FSC Replacement Act.[31] The US refers to the House Report in footnote 28, but this, on examination, does not bear out its contention. The passage referred to (page 18 of the House Report) makes no reference to the avoidance of double taxation. The only references to double taxation in the legislative history relate, in fact, to the need to limit the use of foreign tax credits in respect of excluded income, a matter to which the EC will return in its discussion of the legal merits of this defence below.

42. In truth, the avoidance of double taxation was not a motivation for the FSC Replacement Act, since the US had no problem of double taxation to resolve but rather a need to replace a prohibited export subsidy with a measure of equivalent effect.

4. Response to the Legal Arguments of the US

43. The EC will now proceed to refute in detail all the arguments that the US has made in its first written submission.

4.1. Comments on the factual burden of proof in DSU Article 21.5 proceedings

44. The EC did not address the burden of proof in its first written submission but the US has. More specifically, the US submits that the EC has 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."[32]

45. This assertion suggesting that the EC generally bears the burden of proof in these Article 21.5 proceedings is too simplistic and calls for some clarification. At the outset, it might be noted that the US has already accepted, e.g., the burden to establish its defence under footnote 59.[33]

46. The EC considers that the burden of proof should not give rise to any difficulty in the present case because the FSC Replacement Act is *de jure* inconsistent with the covered agreements. The EC believes that it has demonstrated this in its first written submission and will bring further arguments below to refute those of the US. The EC has also provided some factual evidence – going beyond the text and history of the FSC Replacement Act – in the Annex to its first written submission – which it has developed and appends anew to this submission – but this is for the purposes of illustration[34] rather than in response for a need to provide such evidence.

47. The EC does however wish to make two brief clarifications regarding the burden and standard of proof in these Article 21.5 proceedings for reasons of principle.

4.1.1. The burden of proof in DSU Article 21.5 Proceedings

48. The case law governing the burden of proof in Article 21.5 proceedings is very limited. In the Article 21.5 proceedings on *Brazil – Aircraft* and *Canada – Aircraft*, the Appellate Body has not specifically addressed the issue. However, some guidance can be gleaned from scattered sentences in

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[31] First written submission of the US, paragraph 26.
[32] First written submission of the US, paragraph 57 (footnote omitted).
[33] *Ibid.* , paragraph 166, where the US qualified its defence as being an "exception".
[34] First written submission of the EC, paragraph 116.

these rulings suggesting that a compliance panel should, in principle, apply the basic rule governing the burden of proof as established for original proceedings.[35]

49. Thus, following the decision of the Appellate Body in *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India ("United States – Shirts and Blouses")*,

> the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence.[36]

50. In other words:

> The initial burden lies on the complaining party, which must establish a *prima facie* case of inconsistency with a particular provision … When that *prima facie* case is made, the burden of proof moves to the defending party, which must in turn counter or refute the claimed inconsistency.[37]

51. In short, the claimant in the Article 21.5 proceedings has the onus of establishing a *prima facie* case of inconsistency of the implementing measure with the covered agreements. The EC considers that it has met its burden, so that the onus is on the US to disprove the claims.

4.1.2. The standard of proof in DSU Article 21.5 proceedings

52. The EC takes issue with the statement of the US that in "cases involving a generally applicable measure, there must be a heightened evidentiary burden for the complaining party".[38] In fact, the attempt, on the part of the US, to raise the standard of proof is tantamount to conceding that the EC has successfully reached the initial level of proof which is to make a "presumption" or a "*prima facie* case" of inconsistency with a particular provision.[39] The term *prima facie* denotes the minimum quantum of evidence "which unexplained or uncontradicted is sufficient to maintain the proposition affirmed."[40] The Appellate Body elaborated on the standard of proof in *United States – Shirts and Blouses* when holding:

> In the context of the GATT 1994 and the *WTO Agreement*, precisely how much and precisely what kind of evidence will be required to establish such a presumption will necessarily vary from measure to measure, provision to provision, and case to case.[41]

Thus, the precise requirement of how much and which kind of evidence is necessary to substantiate a claim needs to be tailored on a case-to-case basis.

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[35] Appellate Body Report, *Brazil – Export Financing Programme for Aircraft Recourse by Canada to Article 21.5 of the DSU*, ("*Brazil – Aircraft, 21.5*"), WT/DS46/AB/RW, adopted 4 August 2000, paragraph 66, which reads: "[T]he fact that the measure at issue was 'taken to comply' with the 'recommendations and rulings' of the DSB does not alter the allocation of the burden of proving Brazil's 'defence' under item (k)." See also, Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft Recourse by Brazil to Article 21.5 of the DSU* ("*Canada – Aircraft, 21.5*"), where the Appellate Body added, in paragraph 38, that "the examination of 'measures taken to comply' is based on the relevant facts proved, by the complainant, to the Article 21.5 panel, during the panel proceedings."

[36] Appellate Body Report, *United States – Shirts and Blouses*, WT/DS33/AB/R, adopted 23 May 1997, p. 14.

[37] Appellate Body Report, *European Communities – Measures Concerning Meat and Meat Products (Hormones) ("EC – Hormones")*, WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, paragraph 98.

[38] First written submission of the US, paragraph 218.

[39] Appellate Body Report, *United States – Shirts and Blouses*, p. 14. See also, Appellate Body Report, *EC– Hormones*, paragraph 98.

[40] *Kazazi,* Motjaba, "Burden of Proof and Related Issues, A Study of Evidence Before International Tribunals" (Hague, Boston: Kluwer Law International, 1996), at 328 with further references.

[41] Appellate Body Report, *United States – Shirts and Blouses*, p. 14

53. The case before the Panel involves a specific evidentiary situation. The measure at stake is "legislation as such" as opposed to individual measures. Moreover, the Panel is now faced with a measure purportedly implementing its recommendations in the original proceedings. The FSC Replacement scheme is still in the process of being defined by regulation and considered by taxpayers. Thus, no factual evidence exists, e.g., on the question whether the non-US producers will, in practice, ever benefit from the FSC Replacement subsidy. When considering the standard of proof to be applied in this case, the EC submits that the Panel should take account of the following principles and considerations.

54. First, where the evidence regarding the effects of a piece of legislation is limited, panels may be forced to adjudicate the dispute on the basis of the general make-up and design of the measure. Thus, for example, in *Argentina – Textiles and Apparel*, the Appellate Body agreed with the Panel that "the structure and design" of the measure resulted in a violation of Article II of the GATT.[42] More importantly, the Appellate Body did not find it necessary that the application of the measure "result in a breach of Article II for *each and every* import transaction".[43]

55. A further illustration of how a *prima facie* case may be made on the basis of the law is the recent ruling in *Korea – Beef*. In that case, the Appellate Body declined Korea's argument that the Panel's finding on Article III:4 of the GATT 1994 was "seriously flawed, relying largely on speculation rather than on factual analysis" and affirmed that the dual retail system infringed Article III:4 of the GATT 1994 on the basis of an analysis of "the fundamental thrust and effect of the measure itself".[44]

56. Second, the Panel might also recall that, in the *Canada – Aircraft* case, Brazil did not possess much evidence about one of the subsidy schemes alleged in that case. To offset this lack of information on the part of the complainant, the Appellate Body clarified that each party has the duty to produce the evidence in its possession as requested by the panel under Article 13.1 of the DSU.[45] A failure to furnish the information sought permits the panel to draw adverse inferences from it.[46] While the Panel, in that case, refused to draw adverse inferences from Canada's failure to provide the information requested under Article 13.1 of the DSU arguing that Brazil had failed to make a *prima facie* case[47], the Appellate Body emphasised that adverse inferences may be drawn independently of whether a *prima facie* has been made. Thus:

> A *prima facie* case, it is well to remember, is a case which, in the absence of effective refutation by the defending party (that is, in the present appeal, the Member requested to provide the information), requires a panel, as a matter of law, to rule in favour of the complaining party presenting the *prima facie* case. […] [A] panel is vested with ample and extensive discretionary authority to determine *when* it needs information to resolve a dispute and *what* information it needs. A panel may need such information before or after a complaining or a responding Member has established its complaint or defence on a *prima facie* basis. A panel may, in fact, need the information sought in order to evaluate evidence already before it in the

[42] Appellate Body Report, *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items ("Argentina – Textiles and Apparel")*, WT/DS56/AB/R, adopted 22 April 1998, paragraph 62.

[43] *Ibid.*(emphasis added).

[44] Appellate Body Report, *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef* ("*Korea – Beef*"), WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001, paragraph 142.

[45] Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft ("Canada – Aircraft")*, WT/DS70/AB/R, adopted 20 August 1999, paragraphs 186-196.

[46] *Ibid*., paragraphs 197-205.

[47] Panel Report, *Canada – Aircraft*, as upheld by the Appellate Body Report, paragraph 9.181.

> course of determining whether the claiming or the responding Member, as the case may be, has established a *prima facie* case or defence.[48]

57. Finally, the specific situation of these Article 21.5 proceedings also bears upon the application of the standard of proof. The main piece of evidence available to the Panel is the FSC Replacement Act. In contrast to the original proceedings, there is only one Panel meeting at which the parties can request and discuss factual evidence in addition to the implementation measure itself.

58. In applying the standard of proof, the Panel should consider the DSU objective of prompt settlement of trade disputes and, in particular, the accelerated implementation provisions enshrined in Article 4 of the *SCM Agreement*. Article 21.5 of the DSU and Article 4 of the *SCM Agreement* envisage that an implementing measure be examined as soon as it is adopted. There is no time for its application in practice to be assessed. Thus, the EC believes that the principles governing the assessment and weighing of evidence in Article 21.5 cases involving prohibited export subsidies must ensure that the obligation to "withdraw the subsidy" in Article 4.7 *DSU* does not simply mean, in practice, maintaining the subsidy and disguising the export contingency in a manner that cannot be established until long after the expiry of the period of time fixed for withdrawal.

4.2. The FSC Replacement scheme continues to provide subsidies

4.2.1. The meaning of "revenue foregone" and "otherwise due"

59. The US is correct in considering that the words "revenue foregone" and "otherwise due" in Article 1.1(a)(1)(ii) of the *SCM Agreement* are the key to determining whether the FSC Replacement scheme gives rise to a financial contribution and therefore a subsidy.

60. The EC is pleased to note that the US recognises in particular that

> 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).[49]

61. However, the US proceeds to fundamentally misunderstand or misrepresent the interpretation that the Appellate Body gave to these terms in the original proceedings. It quotes frequently from paragraph 90 of the Appellate Body Report[50] but conspicuously fails to refer to the fact that the Appellate Body considered "otherwise due" to refer to revenue that would be due '*in a different situation*' or '*in some other situation*' under the tax system of the member concerned. The US omits these key words and instead contrives to conclude that the test is simply whether the taxes would have been collected 'but for' the measure in question.[51]

62. The US is wrong to say that the Appellate Body agreed that the 'but for' test was appropriate to the FSC case.[52] It stated that it *worked* in the FSC case but that

> 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

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[48] Appellate Body Report, *Canada – Aircraft*, paragraph 192.

[49] First written submission of the US, paragraph 63.

[50] First written submission of the US, paragraphs 63 and 64. The EC quoted paragraph 90 of the Appellate Body Report correctly and in full in paragraph 30 of its first written submission.

[51] First written submission of the US, paragraph 65.

[52] First written submission of the US, paragraph 65.

> revenues in question, absent the contested measures. We observe, therefore, that, although the Panel's "but for" test works in this case, it may not work in other cases.[53]

63. The FSC Replacement scheme is a tax regime that endeavours to 'circumvent' in precisely the way the Appellate Body had feared the 'but for' test would permit. The EC notes that Canada shares its opinion.[54]

64. The 'normative benchmark' referred to by the Appellate Body is therefore the tax that would be due under the tax system of the Member in question *in some other situation,* not the legal rule that would apply if the rule under consideration did not exist.

4.2.2. The US 'prevailing legal standard'

65. The second step in the US false reasoning, after having attempted to dispense with the requirement to consider the revenue that would be due in some other situation (i.e. domestic sale), is to manipulate the phrase 'prevailing legal standard'.

66. The US asserts that

> Under US law, the taxing authority of the United States government is defined by the statutory definition of "gross income."[55]
>
> and
>
> The definition of "gross income" is thus the "prevailing domestic standard" for US taxation.[56]

67. The EC contests this approach. First, of course, the correct approach is, as explained above, to compare the revenue due in one situation to that due in another under the tax system of the US. But secondly, the US is confusing the income actually subject to taxation under US law with the taxing authority of the US. It arrives at a ridiculous conclusion that would allow Members to provide any subsidy they like through the tax system using the simple device of excluding the income concerned from the definition of 'gross income'. In this way, the exclusion from tax of 'income derived from the sale of textile products' or 'income earned from export' from 'gross income' would also not be a subsidy!

68. In reality, the US 'prevailing domestic standard' applying to the type of income under consideration, that is corporate income from a commercial activity, is that income may be taxed if it is earned by a US corporation or is 'effectively connected' with a US trade or business. The so-called 'exclusion' of 'extraterritorial income' from US taxation is a derogation from this prevailing domestic standard. The fact that there are 'exceptions' to the exclusion does not change this.

69. In any event the US contention that

> the general authority to tax extraterritorial income has now been eliminated from the prevailing US standard[57]

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[53] Appellate Body Report, paragraph 91.
[54] Third Party statement of Canada, paragraph 28.
[55] First written submission of the US, paragraph 69.
[56] First written submission of the US, paragraph 71.
[57] First written submission of the US, paragraph 82 *in fine*.

is simply wrong. The US does tax 'extraterritorial income.' It is only 'qualifying foreign trade income' that is excluded and then under certain conditions, as the EC has explained in Section 3.2 above.

4.2.3. Inter-temporal comparisons

70. In paragraphs 74 to 76 of its first written submission, the US replies to an argument that the EC has never made, reasoning that Members must have the right to change their tax systems and that by doing so they are not forgoing revenue that would otherwise be due.

71. The misunderstanding by the US of the EC position is even clearer in paragraph 100 of its first written submission, where it states that:

> 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.

72. The EC trusts that it is clear to the Panel that it is not making such an argument. The misunderstanding by the US of the EC position would not have arisen if the US had properly described the standard established by the Appellate Body – that is that the comparison must be between the revenue due under the special regime and the revenue that would be due "in some other situation" under the *prevailing* domestic standard of the Member in question. For the EC it is clear that the comparison must be conducted between situations prevailing at the same time, not between the present and the past (or the present and the future).

73. Indeed, this further demonstrates that it is not appropriate to apply a simple 'but for the measure' approach to establishing whether revenue that would otherwise be due is forgone.

4.2.4. The US response to the EC's arguments

74. The EC will now reply in detail to the US response to the arguments on these issues contained in the EC's first written submission.

75. First, on the issue of whether the FSC Replacement scheme is an exclusion or an exemption, the EC notes that the US is in substance agreeing with its position. To be clear, the EC agrees that

> … 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.[58]

76. The important point is that made by the US in paragraph 88 of its first written submission where it states that

> … the semantic distinction between an exclusion and an exemption would not, in any event, be determinative. Rather, the test under subparagraph (ii) is whether tax on the income now excluded would be otherwise legally owed to the government.

77. The EC agrees and said as much in paragraph 53 of its first written submission, where it stated that:

[58] First written submission of the US, paragraph 87.

> 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.*

78. On this point at least the parties are in agreement.

79. The US next responds to what it calls "a variety of arguments to the effect that the Act confers a subsidy because the exclusion should be larger" although it does also recognise that the EC's arguments related not to the size of the subsidy but the conditions under which it is granted.[59] The US argument is that if it can do more, it must be entitled to do less. In this way the US concludes

> That an exclusion is qualified or moderated, however, does not convert it into a subsidy under Article 1.[60]

80. Again, the US seems to be proclaiming a subsidiser's charter. The very essence of a subsidy is that a government gives to some but not to others. The principle "he who can do more can do less" may apply to the *amount* of an exemption but it does not apply to the *scope* of exemptions (just as it cannot justify discrimination).

81. In defence of its view that it is entitled to exclude from tax whatever arbitrarily defined 'category' of income it wishes on whatever condition it wishes without there being a subsidy the US argues that

> 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.[61]

82. Here the US is of course departing from the words of the *SCM Agreement* and looking to the intent of the Uruguay Round negotiators. The EC would make two comments.

83. First, the extent to which revenue is forgone that is otherwise due, depends principally on the meaning given to the word 'otherwise'. The Appellate Body has said that there must be a comparison with a 'normative benchmark', that is with the revenue that would be due in some other situation under the tax system of the Member concerned. The EC shares this view and considers in addition that this 'other situation' must be a comparable situation. Thus, the EC believes, for example, that lottery winnings cannot be compared with earned income. The fact that these classes of income may be taxed differently does not mean that revenue is being forgone.

84. That is why the EC has argued[62] that different categories of income may be taxed differently if the categories are defined generally, objectively and neutrally. It may be that the word 'category' is insufficiently precise for this purpose because it can be defined arbitrarily (the US is arguing that 'extraterritorial income' or rather 'qualifying foreign trade income' is a 'category'). It is perhaps more accurate to speak of 'classes' or 'types' of income. The important point is, as the EC has stated above, that like be compared with like. Income from the sale of goods is a type or class of income. Exporting and selling domestically are simply *different situations* in which it may arise or be earned.

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[59] First written submission of the US, paragraph 89.
[60] Paragraph 91.
[61] First written submission of the US, paragraph 94.
[62] First written submission of the EC, paragraphs 57 to 61.

85. In the case with the FSC Replacement scheme, income from the sale of goods by commercial enterprises is taxed in one way if the goods are for final consumption outside the US and in another if they are for final consumption in the US. These are not in the EC's views properly considered different categories (in the sense of class or type) of income. In addition, as the EC pointed out in its first written submission, the FSC Replacement scheme excludes from tax part of the income from a single taxable event but only if this taxable event satisfies certain strict conditions.[63]

86. Second, the definition of subsidy in Article 1.1 of the *SCM Agreement* is clearly very broad. Apart from the provision on revenue forgone, which concerns us in this case, the definition is also drafted in very wide terms in other respects, covering, for example any actual and potential transfer of funds and even the purchase of goods by government where a benefit is conferred. The limitation on the scope of the disciplines is laid down in Article 1.2, which provides that these disciplines only apply to subsidies that are specific, within the meaning of Article 2. Of course Article 2.2 provides that subsidies falling under Article 3 are *deemed* to be specific. Thus, the intent of the Uruguay Round negotiators not to make all the exemptions and special conditions in tax laws (and indeed the provisions of many other measures) subject to the disciplines of the *SCM Agreement* is expressed in Article 1.2 rather than Article 1.1.

87. Accordingly, the EC maintains that for all the reasons that it set out in paragraphs 46 to 61 of its first written submission, that the FSC Replacement scheme results in revenue being forgone that would in other circumstance be collected.

4.2.5. The US' factual allegations

88. There is one final argument of the US. In paragraphs 100 to 106 the US seems to be arguing that the EC has not demonstrated any revenue loss and even suggests that

> 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.[64]

89. The US dismisses the EC's reliance on the Congressional Budget Office study in exhibit EC-8 on the grounds that it compares the revenue consequences of the FSC Replacement scheme with those of the FSC scheme under the "former US worldwide taxation system".[65]

90. The EC will first note that the US is not contesting the figures that the EC drew from the Congressional Budget Office study. If it wanted to do so, or wanted to contest the conclusions that the study appears to warrant, it should have produced the evidence that only it has of the budgetary consequences of the FSC Replacement scheme. If the US does not, the Panel must assume that these figures mean what they appear to mean.

91. The EC has already explained that the US still has a worldwide taxation system and that the US argument that revenue is not forgone because the "jurisdictional boundary" of the US tax system has changed is unfounded.[66] It therefore appears that the US argument that the EC has not demonstrated a revenue loss shares the same fate as its argument that there is no revenue forgone.

92. In case the US is arguing that that the Congressional Budget Office Study is insufficient because it compares the situation with that prevailing under the FSC scheme, the EC also attaches as exhibit EC-11 an extract from the US Treasury Budget estimates for Financial Year 2001 entitled

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[63] First written submission of the EC, paragraph 57.
[64] First written submission of the US, paragraph 102.
[65] First written submission of the US, paragraph 106.
[66] Section 3.2 above.

Total Revenue Loss Estimates in the Income Tax and providing FSC revenue loss figures for financial years 1999 to 2005. Since the Congressional Budget Office Study revenue loss figures which the EC referred to in its first written submission are based on a comparison with the situation prevailing under the FSC scheme, the total amount of revenue forgone by the FSC Replacement scheme is obtained by adding to them the amounts shown in the table in exhibit EC 11.

93. In the absence of evidence from the US to the contrary, it must be presumed that the Congressional Budget Office Study revenue figures took account of any possible increase of revenue due to corporations paying US tax that they would not otherwise have paid. In any event, any such effect can only represent a small part of the revenue forgone.

94. One reason for this is that the controlled foreign corporation ("CFC") rules of the US IRC are aimed exactly at preventing this type of jurisdiction-shopping. A sales subsidiary that was incorporated in Country X, bought products from the US parent, and then had sales operations in Country Y would have "foreign base company sales income" as defined in section 954(d) of the IRC. In general, the CFC rules would require the US parent to include this amount in the US parent's taxable income whether actually distributed to the US parent or not.

95. In any event, if the study did not take this into account, it would be for the US to produce the contrary evidence, which only it has. To the extent that it has not done so, the Panel must presume that the figures mean what they appear to mean. Also, for the purposes of these Article 21.5 *DSU* proceedings, it is only relevant that there will be revenue forgone; the precise amount does not need to be established.

4.3. The FSC Replacement subsidy is contingent upon export performance

96. The EC has already remarked on the incomplete manner in which the US has responded to the arguments in the EC's first written submission.[67] The EC has also already commented[68] on a number of misleading and wrong statements of the US concerning the FSC Replacement scheme. Many more are made when the US attempts to defend the FSC Replacement scheme as not contingent upon export performance or not specifically related to export, for example that the FSC Replacement scheme is "unrelated to exporting"[69] or that exporting is "merely incidental"[70] to it.

97. The EC does not comment further on such statements but in this section, will reply to the US analysis of its legislation under Article 3.1(a) of the *SCM Agreement* and the comments that the US does make on the EC's analysis.

4.3.1. The fundamental difference between the EC and the US

98. The US is correct when it says that there is a difference in "analytical framework"[71] between the EC and the US. However, it is the US analytical framework that does not correspond to the *SCM Agreement*, not that of the EC.

99. The US argument is that there are various alternative ways ("a broad range of foreign transactions") in which a company may earn excluded income and therefore this is not export contingent. According to the US, these include:[72]

- the sale, exchange, or other disposition of qualifying foreign trade property;

[67] Sections 2.1 and 2.2 above.
[68] Section 3 above.
[69] First written submission of the US, paragraph 120.
[70] First written submission of the US, paragraph 116.
[71] First written submission of the US, paragraph 130.
[72] First written submission of the US, paragraph 118.

- 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.

100. The US concludes that this allows a 'broad range of taxpayers' to earn 'extraterritorial income'.[73]

101. A first comment of the EC on this argument is that most of this impressive list relates to services. As the EC argued in its first written submission (and as stated above,[74] the US has ignored), an export-contingent subsidy for goods cannot cease to be so just because it is made available in other, different, circumstances - for the supply of services abroad.[75]

102. The EC argument is that one has to compare like with like. For owners of US produced goods, export is a condition for obtaining the benefits under the scheme for those goods.

103. In the real world (and this is the perspective from which the *SCM Agreement* is drafted and from which contingency must be assessed) companies do not start with a desire to earn excluded income and then consider the various options available for this purpose. They then compare the attractiveness of selling domestically and exporting goods they have produced or plan to produce. If the goods and the place they are produced is taken as given, then the companies have no other option than exporting if they want the benefit of the scheme.

104. Under the "analytical framework" of the US, on the other hand, companies are supposed to compare the option of earning excluded income by exporting the goods they have produced in the US with that of earning it by selling foreign-made goods abroad. Because the objective of companies is to make a profit from selling the goods they produce rather than simply earning "excluded income", this is not the choice that is really before them. This is also clear from the fact that the US analytical framework leaves open the question of what is to happen to the US produced goods if excluded income is earned by selling foreign goods abroad. Assuming that the US produced goods are not to be destroyed, the producer still has the choice of exporting them or selling them domestically. If it does the former it will earn (more) excluded income, if it does the latter, it cannot. The US analytical framework does not correspond to the true choice which is to be made.

105. To show that it is the EC approach that is required by the *SCM Agreement*, the EC set out in its first written submission a number of contextual reasons why the comparison should be with the sale of the same goods domestically (not different goods abroad).[76] The US has set out no reasons why its analytical framework should be used. It merely criticises some (but by no means all) of the

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[73] First written submission of the US, paragraph 119.
[74] Section 2.1.
[75] First written submission of the EC, paragraph 102.
[76] First written submission of the EC, paragraphs 85 to 98.

EC's contextual arguments. The argument that the US chooses to respond to is the EC's reference to items (d), (f), (g), (h) and (l) of the Illustrative List as examples of where the benchmark is the domestic sale of goods. The US claims[77] that the comparison made in these items of the Illustrative List is made for the purpose of determining the financial contribution.

106. The US is wrong. For instance, under item (f) there is clear comparison between the domestic and export tax base in order to determine whether there is export contingency. The financial contribution already derives from the requirement that there be "special deductions".

107. The US argument is in any event strange since financial contribution is defined in Article 1.1 of the *SCM Agreement* and the Illustrative List in Annex I merely illustrates export contingency. As the Appellate Body observed in *US - FSC*, the Illustrative List is relevant for determining what are prohibited export subsidies, not for determining what is a subsidy (and therefore what is a financial contribution). Rather, the fact that the comparisons relate in many cases also to the question of financial contribution, simply illustrates that the benchmark for establishing export contingency should be the same as that for establishing the financial contribution.

108. Just as in the case of the examples in the Illustrative List, the relevant benchmark for assessing the existence of a financial contribution in this case is the same as for establishing the export contingency – it is the "some other situation" referred to by the Appellate Body.

109. In the case of the export of US goods the "other situation" for assessing whether there is a financial contribution includes a situation where the goods are not exported, that is they are sold domestically. The same comparison is to be made for assessing export contingency.

110. The error of the US is also reflected in the fact that it repeatedly considers exports to be a subcategory of "foreign transactions"[78] and income from exports as a subcategory of "foreign income".[79] They are not. In reality, exports are a subcategory of the total sales of a company and income from exports a subcategory of total sales income.

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[77] First written submission of the US, paragraph 131.

[78] E.g. first written submission of the US, paragraph 114, where it is stated that:

> Thus, unlike the FSC, the Act provides an exclusion from taxation for income derived from all qualifying foreign transactions, not simply exports

Another interesting example is in paragraph 126, where it is stated that

> Transactions involving property used or consumed in the United States are not covered by the Act because they are not foreign transactions.

> Exports are covered by the FSC Replacement Act, whether or not they are foreign transactions.

[79] E.g. first written submission of the US, paragraph 25, where it is stated that

> By excluding extraterritorial income from the definition of "gross income", the Act fundamentally changes the way the United States taxes foreign income.

4.3.2. Whether there are 'alternative' conditions for obtaining the benefit of the FSC Replacement scheme

111. The US has misunderstood the EC's argument when it claims that the EC's position is that the word "other" in the phrase "contingent, … *whether solely or as one of several other conditions*, upon export performance" means "alternative" rather than "additional" in Article 3.1(a).[80]

112. The EC takes no position on the meaning of the world "other" in the above phrase. It would only state that it is not necessary to the EC argument for the word "other" to mean "alternative". The EC argument is simply that a subsidy that is export contingent in some circumstances does not cease to be so if it can also be obtained in other situations which do not require export.[81] The EC proceeded to give two illustrations of this principle[82] which the US has studiously ignored, as already observed above.[83]

113. An owner of US goods does not have an alternative means of obtaining the FSC Replacement Act subsidy on the sale of his goods. Export is a *necessary* condition for obtaining the benefit of the FSC Replacement scheme in these circumstances and this is therefore export-contingent. This derives directly from the ordinary meaning of 'contingent' and does not depend on the words "one of several other conditions," which were really only relevant to the EC's observation that the US appeared to consider export contingency to exist where export was truly an alternative condition in the US Department of Commerce's countervailing duty regulations.[84]

4.3.3. The US comments on the EC's de facto export contingency arguments

114. In Section V.C.4 (paragraphs 137 to 150) of its first written submission, the US responds to the EC's subsidiary arguments (Section 3.3.5, paragraphs 131 to 145 of the EC's first written submission) that, even if the EC's other arguments are not successful, the FSC Replacement scheme must be considered *de facto* export contingent because it cannot be expected that the extended FSC Replacement scheme will be much used in practice.

115. The EC gave a whole series of reasons why this would be so. The US only replies partially to this argument, as the EC will now explain.

116.The US has made three comments on this *de facto* export contingency argument, to which the EC will now reply: that a 'domestication election' is not always necessary; that foreign corporations may make 'domestication elections' without increasing their tax liability; and that the 'domestication election' was intended to provide tax equity.

4.3.3.1. The US argument that a 'domestication election' is not always necessary

117. The EC agrees with the US[85] that a 'domestication election', that is for a foreign corporation to opt to be treated as a domestic US corporation for US tax purposes, is not necessary if the foreign manufacture is performed by a branch of a US corporation. In such cases the US corporation is already subject to US tax as a domestic corporation. It is already 'domesticated'. The EC never made any assumption to the contrary.

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[80] First written submission of the US, paragraphs 134 and 135.
[81] First written submission of the EC, paragraph 123.
[82] First written submission of the EC, paragraphs 124 to 126.
[83] Section 2.1 above.
[84] The EC is pleased to note from footnote 117 of the US submission that the US does not consider that its Department of Commerce's countervailing duty regulations cannot change the interpretation of the *SCM Agreement* but does still wonder if it considers them to be compatible with the *SCM Agreement*.
[85] First written submission of the US, paragraphs 138 to 141.

118. It is, however, crucial to note that situations whereby the foreign manufacture is performed by a branch of a US corporation are in relative terms bound to be far less common than those where the US corporation decides to establish a subsidiary in the foreign jurisdiction to undertake such activities. Undoubtedly, the choice of the legal form for the foreign manufacturing operations depends on the particular circumstances present in each individual case but in general there are a number of both tax and commercial reasons for the general preference for the legal form of a subsidiary.

119. First, and perhaps most importantly, from a US corporation's point of view, it is essential to take account of the fact that the mainstream profits of a foreign branch are subject to current taxation in the hands of the corporation in the US. A foreign subsidiary is only liable to tax on such profits in its country of residence and the taxation in the US is deferred until the repatriation of the profits (in the form of dividends) to the US shareholder. The FSC Replacement scheme has not introduced any fundamental change in this respect as the exclusion is merely partial and concerns only 'qualified foreign trading income'. The potential benefit of the deferral of taxation until the time when a foreign subsidiary distributes dividends is, however, still available to US corporations who decide to structure such foreign manufacturing operations in the legal form of a subsidiary.

120. Second, it is often a critical factor affecting the decision between a branch office and a subsidiary that as a branch is not a separate legal entity and thus it has no separate limited liability protection, i.e. distinct from that of the corporation of which it is an inherent part. Also, a local subsidiary may have a marketing advantage as compared to a branch as it is more closely identified within the local market.

121. Third, the legal form of a separate legal entity incorporated in the foreign jurisdiction may often be an absolute precondition for being entitled to fully engage in all transactions necessary for the carrying out of the manufacturing operations. For example, it is not uncommon that the legal provisions of the host jurisdiction prevent a foreign entity from acquiring immovable property such as land on which a manufacturing plant is to be built.

122. Fourth, it is also not uncommon that the legal provisions or the standard practice in the host jurisdiction (where a branch is located) require disclosure of the annual financial statements for the whole enterprise. This, in its turn may entail additional administrative burden and lead to tedious disputes over the correct attribution of profits to the branch.

123. Fifth, when operating in the form of a branch there are many potential areas where disputes concerning the proper attribution of profits to the branch may arise. A typical example is the allocation and deductibility of the expenses incurred at the head office level but nevertheless partly for the purposes of the branch (e.g. marketing, advertising, executive and general administrative expenses). Moreover, there may be differences between the ways as to how the two tax jurisdictions in question treat different classes of income, for example, currency conversion differences for tax purposes. The resolution of such disputes between the tax jurisdictions may well be difficult to achieve under (or it is fair to say, despite) the mutual agreement provisions. A non-incorporated entity as a branch is under the double tax treaties not normally considered as a resident of the State in which it constitutes a permanent establishment and therefore generally not entitled to the treaty benefits unless there are specific rules to that effect.[86]

124. Sixth, there may be local tax incentives which are only applicable to local incorporated companies (i.e. only to subsidiaries and not to branches), that may equally affect the choice of the legal form for the foreign manufacturing operations.

[86] Such as the non-discrimination rule contained in paragraph 3 of Article 24 of the OECD Model Tax Convention.

125. The EC therefore considers that the possibility for foreign branches of US corporations to benefit from the extended FSC Replacement subsidy is of little practical significance.

4.3.3.2. The US argument that foreign corporations may make 'domestication elections' without increasing their tax liability

126. The EC can also agree that there may be circumstances in which foreign corporation can make a 'domestication election' without increasing its tax liability. The US is wrong to say that the EC has assumed the opposite.[87]

127. The EC's point is, simply, that since

(a) The US does not normally tax foreign corporations more heavily than its domestic corporations;

(b) Foreign countries cannot be expected to tax their companies less simply because they make a 'domestication election' in the US;

Then making a 'domestication election' will only rarely reduce the tax burden and be advantageous.

128. The US is correct when it says that foreign corporations that make a 'domestication election' in the US will be entitled to foreign tax credits for foreign taxes in the same way as US corporations. This will mean that when the foreign tax rate is *higher or just as high* as in the US, such corporations may get full credit for foreign taxes paid in the US. (The reason the EC uses the word 'may' is that in reality, matters are likely to be complicated by differing methods of calculating tax – e.g. rules on deductions, tax deductible capital allowances, whether different classes of income are in fact subject to tax and many other rules.)

129. Even when it is possible for a company to conclude that making a 'domestication election' in the US is unlikely to give rise to an *increase* in overall taxation, this simply means that there will be no immediate *penalty* for such a company. It will clearly not in itself persuade a company to make such an election. A tax *advantage* from making a 'domestication election' is only likely to arise in special circumstances, notably because the availability of the FSC Replacement scheme, will in the first place involve a loss of the possibility of *deferring* US taxation of foreign income.

130. The EC's main point is ignored by the US, however. It is that the minor benefit that a company may sometimes have in making a 'domestication election' in the US cannot be expected to overcome the following disadvantages:

- The additional reporting requirements and administrative burden involved in being fully subject to an additional tax jurisdiction;
- The requirement to waive *all* benefits granted by the US under *any* treaty; [88]
- The fact that upon domestication election, the retained earnings of the foreign corporation (the non-distributed profits of a foreign subsidiary of a US corporation) will immediately become subject to US tax; [89]

[87] First written submission of the US, paragraph 137.
[88] First written submission of the EC, paragraph 135.
[89] First written submission of the EC, paragraph 138.

- The fact that reversing the 'domestication election' will give rise to additional and unpredictable tax liability arising out of deemed transfers of assets under sections 367 and 354 of the IRC; [90]

- The conflicts that complying with US taxation requirements may create for foreign corporation in their own jurisdictions and the application of double taxation treaties;[91]

- The fact that foreign states may object to their companies being made subject to US jurisdiction in this way and prevent their companies from making 'domestication elections;[92]

- The need to ensure that the 50 per cent foreign content limitation is complied with.[93]

131. For all these reasons the EC maintains that the obligation of 'domestication' is bound to make the use of the extended FSC Replacement subsidy rare and the FSC Replacement scheme is at least *de facto* contingent upon export performance.

4.3.3.3. The US argument that the 'domestication election' was intended to provide tax equity

132. In paragraphs 147 to 150 of its first written submission, the US claims that the purpose of the FSC Replacement Act was to "equalize the treatment of US taxpayers abroad, regardless of whether they operate in branch or corporate form." It also claims that the restrictions placed on the use of the scheme by foreign corporations arise because:

> In drafting the Act, the US Congress sought to prevent taxpayers from inappropriately invoking the Act's exclusion with respect to tax-deferred income.[94]

And that

> 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.[95]

133. The EC does not wish to speculate as to the intent of the US Congress but would simply point out some objective facts:

- The legal and factual situations of foreign branches and subsidiaries are complex and diverse. The EC has pointed to a series of factors affecting the choice of using one or other vehicle. Equalising the tax treatment of the two vehicles will only partially affect the overall balance. In any event, the FSC Replacement Act does not do this. To give just one example, only foreign corporations making a domestication election are required to waive all benefits granted by the US under any treaty;

- Whether deliberate or not, the obstacles in the way of foreign manufacturers benefiting from the extended FSC Replacement subsidy are, as explained above, considerable;

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[90] First written submission of the EC, paragraph 136 to 138.
[91] First written submission of the EC, paragraph 139 to 141.
[92] First written submission of the EC, paragraphs 142 to 143.
[93] First written submission of the EC, paragraph 144.
[94] First written submission of the US, paragraph 148.
[95] Paragraph 150.

- The FSC scheme is of much greater significance for US exporters who see the WTO-inconsistent FSC scheme replaced by an arithmetically identical scheme.

134. The EC submits that objectively the overwhelming purpose of the FSC Replacement scheme can only be considered to be the preservation of the FSC scheme benefits for US exporters.

4.3.3.4. Evidence

135. The title to Section V.C.5 of the US first written submission,[96] alleges that the EC has not provided *evidence* that the FSC Replacement subsidies are export contingent. It is not entirely clear what argument the US is making but the EC would make two points.

136. First, the EC believes that it has established with the arguments in its first written submission, and developed above, that FSC Replacement subsidies are export contingent.

137. These arguments are based on the text and structure of the FSC Replacement Act and other laws. The US has a responsibility to produce rebuttal arguments and, if necessary evidence. The EC has set out its views on the standard and burden of proof in Section 4.1 above. The EC cannot be expected to produce evidence that is within the control of the US.

138. Second, if the US is suggesting that *factual* proof is called for of specific companies actually be required to export, the EC rejects this contention because it is attacking the FSC Replacement Act *as such.*

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

139. In Section 3.4 (paragraphs 147 to 158) of its first written submission, the EC argued that its conclusion that the FSC Replacement subsidies were prohibited export subsidies was confirmed by Item (e) of the Illustrative List, which 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)

140. The US responds to this argument indirectly in an introduction to its double taxation defence. It expresses the view[97] that the Illustrative List does not expand the prohibition in Article 3.1(a) and concludes that

> In order for paragraph (e) to apply, the tax benefits at issue must be export-contingent within the meaning of Article 3.1(a).[98]

141. The US position is therefore that the Illustrative List can only *reduce* the scope of the prohibition in Article 3.1(a) through the operation of footnote 5 to the *SCM Agreement*,[99] not expand it.

142. The EC rejects this contention of the US. The word ‘including’ in Article 3.1(a) of the *SCM Agreement* does not have to be taken to mean that the Illustrative List cannot expand the ordinary

[96] Preceding paragraph 151.
[97] First written submission of the US, paragraphs 158 to 161.
[98] First written submission of the US, paragraph 161 *in fine*.
[99] First written submission of the US, paragraph 156.

meaning of the first part of Article 3.1(a). It can also mean that the export subsidies defined in Annex I are *deemed* to be included in the prohibition of export subsidies.

143. The US is quoting the dictionary partially when it says that

> The term "include" is defined as "contain as a part of a whole" or "place in a class or category".[100]

144. The word "include" can also mean, according to the same dictionary:

> contain by implication, involve[101]

and, even more pertinently, the preposition "including" is defined as meaning

> If one takes into account, inclusive.[102]

Therefore the word "including" can also mean that 'taking into account', 'containing by implication' and therefore 'incorporating'. Indeed the same dictionary also gives 'include' as one of the meanings of 'incorporate'

145. This latter meaning of the word 'including' (that is 'incorporating' or 'taking into account') is confirmed by, indeed, required by, the *context*. Footnote 5 expressly excludes from the scope of the prohibition the measures referred to in Annex I as not constituting export subsidies. If the Illustrative List could only *reduce* and not *expand* the prohibition, it would not have been necessary to include the words 'including those illustrated in Annex I' in Article 3.1(a) which would then become redundant, a result that the Appellate Body has many times made clear is not acceptable.[103]

146. The meaning of the word 'including' is also required by the *object and purpose* of the *SCM Agreement*.

147. One of objectives of the Uruguay Round negotiations, and one to which the US was particularly attached, was to introduce more effective disciplines on certain subsidies which are considered particularly pernicious – export subsidies and import substitution subsidies. This can be seen from the fact that these subsidies are, unlike all other subsidies, *prohibited* and that action can be taken against them without there being any need to prove adverse effects.[104] It is also evident from the tighter deadlines[105] and more expeditious procedures[106] and remedies[107] contained in Article 4 of the *SCM Agreement*.

148. The intent of the parties in incorporating Annex I was not to ensure that everything that was previously not prohibited would now be exempted (which would mean *no progress*). It was to ensure that what was previously prohibited would remain prohibited (which means *no backtracking*). They added footnote 5 to ensure that only what was *referred to* (that is *identified*) in the Illustrative List as not being an export subsidy, would be exempted. If the Illustrative List exempted measures that are simply not identified as export subsidies, the general words of Article 3.1(a) would fail in their basic task of introducing stricter disciplines.

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[100] First written submission of the US, paragraph 160.
[101] New Oxford Shorter English Dictionary (1997 - CD-ROM version)
[102] *Id.*
[103] See e.g. Appellate Body Report, *United States - Import Prohibition of Certain Shrimp and Shrimp Products* WT/DS58/AB/R, adopted 6 November 1998, paragraph 131 and the other sources quoted there.
[104] Cp. Article 5 of the *SCM Agreement*.
[105] Deadlines are generally half those applicable in other disputes.
[106] For example, a Panel may be established on the first request – Article 4.4 of the *SCM Agreement*.
[107] Article 4.7 *SCM Agreement* requires an offending Member "withdraw the subsidy without delay".

149. Therefore, the EC maintains that either

- Item (e) is relevant as a separate source of prohibition of export subsidies; or
- It requires the term 'subsidies … contingent upon export performance' in Article 3.1(a) to be read as including, at least as regards direct taxation measures, subsides that are specifically related to exports.

150. In either case the arguments presented by the EC in this connection in its first written submission, remain valid and item (e) of the Illustrative List confirms that the FSC Replacement scheme gives rise to prohibited export subsidies.

4.5. 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

4.5.1. Footnote 5 of the SCM Agreement

151. The US first refers to footnote 5 of the *SCM Agreement*.[108] According to this footnote,

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

This reference is not entirely clear. The US does not specify which item of Annex I to the *SCM Agreement* would provide that the FSC replacement subsidies are not "prohibited".

152. To the extent that it hints to item (e) of Annex I, and in particular to the "double taxation" reference in footnote 59, which is the EC's assumption, it is addressed in Section 4.6 below.

4.5.2. The meaning of "contingent" and of the "local content" requirement

153. Next, the US also points out that the word "contingent" has the same meaning both in Article 3.1(a) and in Article 3.1(b) of the *SCM Agreement*, and specifically that it means " conditional" or "dependent for its existence on something else".[109]

154. From this the US draws the consequence that the basic FSC Replacement subsidy is not "contingent" within the meaning of Article 3.1(b) because, in the US view, they do not affirmatively require the use of any US manufactured articles or preclude using more than a fixed amount of imported articles.

155. It will already be clear to the Panel that the EC agrees that "contingent" means the same both in Article 3.1(a) and 3.1(b), and notably means "dependent for its existence".[110] In the Annex to its first written submission, the EC has precisely shown cases in which the "foreign content limitation " in the FSC Replacement Act will render the use of US articles necessary. It has done so with respect to certain production sectors in its first written submission. It further exemplifies those data with company related information in this submission.

[108] First written submission of the US, paragraph 196.
[109] First written submission of the US, paragraph 198.
[110] First written submission of the EC, paragraphs 166, 83.

156. The EC notes that in an attempt to rebut the EC's claim, the US makes a very generic allegation that under the foreign content limitation "a good can meet this requirement even if 100 per cent of its content is foreign".[111]

157. It is rather ironic that later in its submission the US contends that in order to establish its case under Article 3.1(b) the EC has the burden of proving how the foreign content limitation works at individual company level, while crafting for itself this very light standard of proof. At any rate, the EC claim does not relate to a hypothetical and unspecified "good". The EC has not argued that for each and every product that can possibly be produced by the beneficiaries of the FSC replacement scheme the foreign content limitation will require use of US over imported goods. Article 3.1(b) however prohibits local-content contingency with respect to each and every product that can be produced by a beneficiary of a subsidy scheme. Therefore, a WTO Member adopting a measure of general application cannot excuse the WTO-inconsistencies of such measure in respect of some products by referring to the possible WTO-conformity of the same measure in respect of other products.

158. The US further tries to disguise the real scope of the foreign content limitation by suggesting that its rules of origin anyway turn non-US inputs into US origin components, thus diluting the real impact of the foreign content limitation.

159. A number of WTO Members have rules of origin turning foreign inputs into a domestic product upon a certain "transformation" or "processing", but this has never affected the application of WTO rules and notably those prohibiting local content requirements. The US rules of origin may increase the scope for some companies to arrange their affairs so as to comply with the requirement but do not remove the requirement.

160. The distinction between components entirely made of US inputs and components made up of a mix of US and foreign inputs nowhere is drawn in the FSC Replacement Act. More importantly, it is completely irrelevant under applicable WTO rules, and rightly so. If Article 3.1(b), in prohibiting subsidies contingent upon "use of domestic over imported goods" made a distinction between "pure" and "mixed" components, a WTO Member could simply dilute the local content contingency to the necessary extent and then escape Article 3.1(b) prohibition.[112] Instead, Article 3.1(b) prohibits local-content contingency to <u>any</u> degree, even a slight bias in favour of domestic goods. There is no *de minimis* rule for prohibited subsidies in the *SCM Agreement*.

161. The foregoing considerations are confirmed by practice under Article III:4 of GATT 1994. If the origin of the inputs of the domestic goods favoured by "local content" requirements were to be relevant, probably hardly any case could have been successfully brought under Article III:4 of GATT. Any country has rules of origin turning foreign inputs into a domestic product upon a certain "transformation" or "processing" but assessing the underlying input composition of a domestic good is not a type of enquiry which is required under WTO rules at issue in this dispute.

162. If moreover, it was true that the foreign content limitation is so limited in its impact, the US has failed to explain why it has been so attached to it over the last fifteen years and continues to be so, to the point of reproducing in identical terms the relevant wording of the FSC Act in the FSC Replacement Act.[113]

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[111] First written submission of the US, paragraph 200.

[112] Suppose, for example that, in order to meet a foreign content limitation, a domestic good is used which is in turn made up of foreign inputs for 85 per cent. According to the country's rules of origin, these foreign inputs are turned into a good of domestic origin by adding 10 per cent domestic inputs and 5 per cent domestic value added. If this new good was not caught by Article 3.1(b), there would be a 10 per cent *de minimis* rules.

[113] See the comparison in the first written submission of the EC, Section 3.5.

4.5.3. Proof of the "contingency" in Article 3.1(b)

163. The US contends that the EC has failed to bring any evidence supporting its claims against the foreign content limitation.[114]

164. The US response to the EC's claims under Article 3.1(b) of the *SCM Agreement* and Article III:4 of GATT 1994 mainly relates to the burden and the standard of proof, and is an adaptation of that provided in connection with Article 3.1(a). The same considerations already developed by the EC on these issues in Section 4.1 above are the first reason why the US arguments do not refute the EC's demonstration.

165. The only way to back up this proposition is to put forward, as the US does in paragraphs 204 and 207 of its first written submission, a standard of proof for the present case that nowhere has been set out or applied to *per se* claims against legislative measures under Article 3.1(b). In essence, the US argues that the EC would have to prove how the foreign content limitation would actually operate at the level of individual beneficiaries of the FSC replacement scheme. As demonstrated below, this contention rests on a misrepresentation of the *Canada - Automobiles* Appellate Body Report and should be rejected.

4.5.3.1. The *Canada – Automobiles* case

166. The US seeks support for its contention in the Appellate Body's interpretations of Article 3.1(b) of the *SCM Agreement* in the *Canada – Automobiles* case.[115]

167. The EC is aware of such interpretations, but does not consider that they affect its case and draws the attention of the Panel to the following.

168. The measures before the Appellate Body in the *Canada - Automobiles* case were fundamentally different in nature and content from that at issue in these proceedings. The measures challenged in that case were a series of specific measures, each one contingent upon a different local content requirement, each one addressed to one particular beneficiary. While the possibility of becoming eligible for the duty free benefit (subject to the local content requirement set for each beneficiary) had existed for any company for some time, as of 31 July 1989 this possibility disappeared and the list of beneficiaries was frozen into a small closed class.[116]

169. The claim under Article 3.1(b) of the *SCM Agreement* concerned a "value added requirement" ("Canadian value added", or "CVA" requirement), imposed on car manufacturers as a condition for obtaining a benefit (in the form of a right to import cars duty-free, which amounted to revenue forgone by the Canadian tax authorities).[117]

170. The benefit was conferred upon a closed list of beneficiaries based on different individual measures laying down a different levels of CVA. The measures were of two types:

(i) The "Auto Pact" of 1965, later replaced by the Motor Vehicles Tariff Order (MVTO) of 1998

The MVTO was an administrative measure (Order-in-Council) addressed to a closed class of beneficiaries (certain companies, four overall, which were manufacturing cars in Canada in a previous

[114] First written submission of the US, paragraphs 207, 210, 216-217.
[115] First written submission of the US, paragraphs 204 ff.
[116] Panel Report, *Canada – Certain Measures Affecting the Automotive Industry* ("*Canada – Automobiles*"), WT/DS139/R, WT/DS142/R, adopted 11 February 2000, paragraph 2.10.
[117] Id., paragraph 10.202.

"base-year", that is 1963-64).[118] For each of the beneficiaries, a different CVA was set in the "letters of undertaking" that each of them had submitted to the Canadian authorities, as well as in the Order-in-Council.

(ii) Special Remission Orders (SROs)

The SROs were also individual measures of administrative nature (Orders-in-Council). Some car-making companies, which could not qualify under the Auto Pact of 1965 because not producing in the "base year", had later been granted the same benefit through these measures. These additional beneficiaries also constituted a closed class[119] as a result of the 1989 "freezing". The SROs which were reviewed in the *Canada – Automobiles* case were thus individual measures, each one setting its own CVA requirement.[120]

171. Thus, the measures that the Appellate Body had before it in *Canada – Automobiles* were individual measures, each one applying a specific local content requirement to individual companies. The requirement of bringing evidence as to how the individual and different local content requirements were operating was set out by the Appellate Body in this context.

172. By requiring information at the level of individual company, the Appellate Body was seeking to assess how each different CVA requirement, and thus each of the challenged company-specific measures, would operate.

173. On the contrary, the measure at issue in this dispute is a legislative measure applying to an undetermined and unlimited series of instances and beneficiaries and setting out a single local content requirement. It does not therefore correspond to the hypothesis reviewed by the Appellate Body in the *Canada – Automobiles* case.

174. Moreover, the EC is contesting the consistency of the FSC Replacement Act with Article 3.1(b) *as such* – it is not making any claim in respect of its application in a particular sector or to a particular product.

175. Accordingly, the EC merely has to establish, based on the wording of the FSC Replacement Act, that the Act *in the abstract,* or *in some cases*, will give rise to the use of US over imported goods.

176. It may be that in certain sectors the foreign content limitation will not require the use of US products. This circumstance does not however make the foreign content limitation consistent with Article 3.1(b) for all the cases where that requirement necessitates use of domestic goods over imported goods in order to obtain the tax benefit. Therefore the US cannot maintain a general, horizontal measure with such a foreign content limitation. Article 3.1(b) must be respected in each and every case, and the fact that the FSC Replacement Act may not in all cases give rise to use of domestic over imported goods cannot compensate for the cases where it will give rise to such use.

177. At any rate, the EC provided information in the Annex to its first written submission in order to *illustrate* its legal points. The EC notes that the US, while arguing that the EC should provide information at company level, has not even tried to challenge the information supplied by the EC relative to certain sectors.

178. Furthermore, although the EC does not believe that it is required to provide company specific information, for the case the Panel considered it necessary that the EC respond to the US contention, it has developed the Annex to its first written submission by providing additional explanation for the

[118] Id., paragraphs 2.4, 2.21-22.
[119] Id., paragraph 2. 31.
[120] Id., paragraph 2.32.

figures indicated therein. This additional explanation is in the form of examples of companies operating in the sectors considered in the Annex, for which the foreign content limitation gives rise to an obligation to use US over foreign goods. For ease of understanding, this information is added to the text of the Annex itself, which is hereby resubmitted. Should the Panel wish to review these data, the EC will ensure that the confidential documents establishing the accuracy of the figures used in the Annex are available at the meeting with the Panel.

179. For the foregoing reasons, the US has not refuted the EC's claim that the foreign content limitation makes the grant of the FSC Replacement subsidy contingent upon the use of domestic over imported products, contrary to Article 3.1(b) of the *SCM Agreement*. Accordingly, the EC requests the Panel to uphold its claim and find that the FSC Replacement Act is contrary to Article 3.1(b) and that the US has not withdrawn its subsidy, thus contravening the DSB recommendations and rulings.

4.6. The Double Taxation Defence

4.6.1. Introduction – The status of footnote 59

180. The US develops in some detail the position that both the first and last sentences of footnote 59 refer to measures that are not export subsidies within the meaning of footnote 5 to the *SCM Agreement*. The EC notes that the US is invoking the last sentence of footnote 59 as a defence.

181. The EC sees no reason to contest that the last sentence of footnote 59 may be an exception to Article 3.1(a). However, for the reasons that it will explain below, the FSC Replacement scheme is not a measure to avoid the double taxation of foreign source income.

182. The first sentence of footnote 59 on the other hand is more in the nature of a reminder that there is only a subsidy if revenue is forgone, rather than a statement concerning export subsidies, and in any event uses the words 'need not'. However, since the first sentence of footnote 59 does not appear relevant to the issues before the Panel, the EC will not comment further.

183. The EC notes that the terms "double taxation" and "foreign-source income" are terms of art with special meanings. It therefore considers that an analysis of the particular meanings these *terms* have acquired in the field of taxation is a more useful starting point than the dictionary definitions of the individual words of which they are composed.

184. The EC will proceed to respond the double taxation defence by making the following points:

- Commenting on the meaning of 'measures to avoid double taxation';
- Explaining that the income excluded by the FSC Replacement scheme is not 'foreign source';
- Explaining why the FSC Replacement Act is not necessary for the avoidance of double taxation and may create double taxation or the 'over-compensation' of double taxation;
- Arguing that even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) because it gives exporters a choice that is not available to other operators.

185. Finally, the EC will comment on the view expressed by Canada that the income exempted under the extended FSC Replacement subsidy may be foreign-source income.

4.6.2. The meaning of 'measures to avoid double taxation'

186. The relief of double taxation forms one of the cornerstones of international tax policy. Eliminating the burden which unrelieved double taxation places on international trade and investment is one of the principal tasks of international tax rules. In this context, the international tax disciplines have been created in different levels, but the most widely recognised international standards for relieving double taxation are those recorded in the OECD Model Tax Convention on Income and Capital (hereinafter "the OECD Convention").[121] The US uses in its own treaty practice as a variation of the OECD Convention.[122] The OECD Convention forms the basis of the vast majority of double taxation treaties concluded between countries exercising their taxing rights and the two basic methods developed in the Convention to deal with the issue of double taxation, the credit method and the exemption method, are also commonly used as means of providing unilateral relief under the national legislation of practically all industrialised countries.

187. The US refers to the OECD Convention for guidance on the meaning of 'measures to avoid the double taxation of income'. The EC would first of all point at a fundamental principle reflected in the double taxation provisions of the OECD Convention.

188. The first paragraphs of Article 23A and Article 23 B of the OECD Convention state:

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.

and

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.

189. A common feature of both of these paragraphs is the presence of the words:

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[121] The US provides extracts from the OECD Convention in its Exhibit US-7. The EC provides the full text in Exhibit EC-12.

[122] The US Model Tax Convention is Exhibit EC-13.

which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State

190. Measures for the avoidance of double taxation relate to measures that may legitimately (hence "in accordance with the provisions of this Convention") be taxed in another State.[123] If a country provides a reduction of the tax burden for income that may not legitimately be taxed by another country, that is *single taxation relief*, not double taxation relief. Such a relief is clearly not required by any policy based on the relief from double taxation since double taxation by definition does not exist.

191. This point demonstrates a fundamental flaw in the US defence. That the FSC Replacement scheme income excludes from tax income that *cannot* be taxed by any other country. It is indeed an internationally embraced principle, that no country can tax the business profits of an enterprise resident in another country unless the enterprise resident in the other country carries on its business in the first mentioned country through a permanent establishment situated therein.

192. Indeed, Article 7 of the OECD Convention[124] reflects this principle when it states:

Article 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

193. The taxing right over the business profits of an enterprise resident in any other country is thereby made dependent on the existence of a permanent establishment[125], which in the OECD Convention is defined in its Article 5;[126]

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[123] The EC notes that in paragraph 182 of its first written submission, the US omits referring to the critical principle when it quotes selectively from the OECD Convention stating:

… 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]."

[124] Full text in Exhibit EC-12.

[125] In the Commentary to Article 7 of the OECD Convention it is further explained that "This Article is in many respects a continuation of, and corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular type of income shall or shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules of reference to which the profits made by the permanent establishment, or by an enterprise trading with a foreign member of the same group of enterprises, are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9." (paragraph 1).

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop, and

a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

194. Under the FSC Replacement scheme the excluded income is derived from: [127]

- 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.

195. All these transactions can well be performed physically from within the territorial limits of the US and in so far as such activities are not carried out through a permanent establishment situated in another country, that other country will not have a legitimate right to tax the income that is excluded under the rules of the FSC Replacement scheme. The FSC Replacement scheme is therefore single taxation relief, not double taxation relief.

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[126] In the Commentary to Article 5 of the OECD Convention it is further explained that “the main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Under Article 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein.” (paragraph 1).

[127] As enumerated in paragraph 118 of the first written submission by the US.

196. It is in principle possible, subject to a number of preconditions, for an US enterprise to benefit from the exclusion provided for in the FSC Replacement scheme by carrying out manufacturing outside the US through a branch situated in a foreign country, but as explained before such situations are in practice rare.[128]

197. Similarly, it is in principle possible that the above enumerated activities are carried out through a permanent establishment situated in a country other than the US, but here again it should be recalled that doing so would only entail an additional administrative burden and could indeed result in adverse tax consequences for the US taxpayer in question, which is why it is much more likely that such operations are carried out from within the territorial limits of the US.

198. In addition, it is important to note that the FSC Replacement scheme in no way requires as a precondition of the exclusion such foreign economic processes that would under the internationally accepted standards, constitute a permanent establishment for an US enterprise wishing to earn such excluded income.

4.6.3. The income excluded by the FSC Replacement scheme is not 'foreign source'

199. The last sentence of footnote 59 is expressly limited to the avoidance of double taxation of *foreign-source income.*

200. As a taxation term, the EC submits that the meaning to be attributed to the term 'foreign-source income' is that which it has in the field of taxation.

201. In tax treaties the source of income is usually referred to in an indirect manner. The term is not expressly defined in the OECD Convention, but its meaning can be deduced from the provisions of that Convention.

202. For example, Article 10 (Dividends) of the OECD Convention applies to 'dividends paid by a company which is a resident of a Contracting State'. The implication is that the company's residence determines the source of the dividend. Paragraph 5 of the same Article of the OECD Convention forbids imposition of tax on dividend in a Contracting State on the sole ground that the company's profits are derived from that state.

203. When it comes to business profits the source of income is commonly understood to mean the place in which the activities giving rise to these profits have taken place. Article 7 (Business Profits) quoted above makes this clear when read in conjunction with Article 5 also quoted above.

204. Thus, and as explained in more detail before, the taxing rights over business profits depend on the fact of whether and to what extent the activities have been carried out (are attributable to the activities) within the geographical limits of which Contracting States.

205. The US attempts to derive a definition of foreign-source income from its reading of the dictionary as follows:

> 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.[129]

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[128] See Section 4.3.3.2 above.

[129] First written submission of the US, paragraph 167

206. By substituting the words 'money' and 'assets' for 'income', the US introduces a confusion that, when revealed, well illustrates the unfoundedness of its defence. The tax that is concerned by the FSC Replacement Act is tax on income in the sense of profit. While it is true that the *money* to pay for exports comes from (has its source) outside the US, the same is not true of the *profit*. The profit on an export sale derives from the *economic activity*, which is conducted in the exporting country. Thus when the word 'income' in the term 'foreign-source income' is correctly understood as referring to *profit*, rather than *price*, it is clear that although the FSC Replacement Act undoubtedly only applies to foreign sales, the income it is excluding from tax is not foreign-source income.

207. There are many other instances of confusion between profit and price in the US first written submission leading ultimately to the manifestly wrong statement in paragraph 192 that:

> "extraterritorial income" under the Act is income derived from non-domestic sources. As such, it comes within the ordinary meaning of "foreign-source."

208. The EC would also point out that 'extraterritorial income' and 'qualifying foreign trade income' are also not foreign source income as this term is used in US legislation. This is made perfectly clear by section 943(c) of the IRC concerning source rules. This provision sets a <u>limit</u> to the amount of income from the sales of qualifying foreign trade property that may be considered as "from sources without the United States", that is, foreign source.

4.6.4. FSC Replacement scheme was not intended to and is not necessary for the avoidance of double taxation in the US and may create double taxation and in some cases over-compensates for 'double taxation'

209. The EC has noted in its factual comments above[130] that the US Congress did not understand the FSC Replacement Act as a measure to avoid the double taxation of foreign-source income but only referred to this notion in connection with the exclusion of foreign tax credits.

210. In this section the EC would simply refer to a number of more objective reasons that further confirms that the FSC Replacement Act is not a measure to avoid the double taxation of foreign-source income.

211. First, the US has no need of the FSC Replacement Act to avoid double taxation. Its system of foreign tax credits is a comprehensive means of avoiding double taxation. Indeed, the FSC Replacement Act, by providing a partial exemption from tax for 'extraterritorial income' and then only under certain conditions cannot solve problems of double taxation. The amount of "excluded income" under the FSC Replacement scheme being limited companies may still need to claim foreign tax credits to relieve double taxation in some cases.

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

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[130] Section 3.6 above.

213. Indeed the FSC Replacement Act, fits uneasily with the US arrangements for avoiding double taxation. Apart from failing to relieve double taxation completely, in some circumstances, it can lead to over-compensation of 'double taxation' in other circumstances. This arises as follows:

214. The provision of the FSC Replacement Act that is presented as preventing the cumulation of the foreign tax credits and excluded income under the FSC Replacement Act two is the new section 114(d) of the IRC which generally disallows credit for foreign tax paid with respect to extraterritorial income that is excluded from gross income. However the new section 943(d) of the IRC states that, for purposes of section 114(d), any "withholding tax" shall not be treated as paid or accrued with respect to excluded income.

215. As a result, a US taxpayer will be able to claim credit against its US taxes for a foreign tax imposed on its excluded income provided that the tax is a "withholding tax."

216. The new section 943(d) of the IRC defines a "withholding tax" as "any tax which is imposed on a basis other than residence and for which credit is allowable under section 901 or 903."

217. If a US corporation is engaged in selling goods in a foreign country, one would generally expect the foreign country to subject those sales to its net income tax, not to a gross-basis withholding tax, and do so only in the case where that US corporation carried out its business through a permanent establishment situated in that foreign country. At the same time, the US corporation, while engaged in business in the foreign country, will not typically be considered a "resident" of that country and in fact normally for the purposes of double taxation treaties would not be accorded such resident status. In such a case, the foreign tax would appear to come within the definition of "withholding tax" now in new section 943(d). Thus, the US corporation would be entitled to credit for such withholding tax even though a portion of its sales income is excluded from gross income under new section 114(a).

218. 'Double' relief from 'double taxation' cannot in any circumstances be considered a means of avoiding double taxation and further demonstrates that the purpose of the FSC Replacement Act is the granting of tax benefits to US exporters.

219. Second, the FSC Replacement Act, rather than avoiding double taxation actually creates it since it requires foreign corporations that are subject to the tax jurisdiction of other countries but wish to benefit from the FSC Replacement Act to make a 'domestication election' to become subject to US tax jurisdiction as if they were US corporations and to waive all rights under treaties and in particular under bilateral tax treaties.

220. Another indication of the fact that 'avoiding of double taxation' of foreign-source income cannot be the real objective of the FSC Replacement Act is that it applies formulaic rules to calculate the excluded part of the income. In doing so the amounts excluded do not correspond to the arm's length apportionment of the profits that would be considered to relate to the part of profit which another country would seek to tax in case that there was such possibility for the other country to do so. The foreign economic processes preconditions for the applicability of the exclusion are variable and require different levels of inputs to be made outside the US, but the rules for calculating the amount of excluded income remain the same irrespective of the nature of the foreign economic processes. Anyway, none of the required foreign economic processes would imply that the country of destination of the exported goods would have the right to tax the income derived from the export transactions. They would not establish effective connection with trade and business and thereby a permanent establishment in that country.

4.6.5. Even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) because it gives exporters a choice that is not available to other operators

221. Even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) of the *SCM Agreement* because it gives exporters a *choice* that is not available to other operators. Allowing exporters the choice between two alternative methods of double taxation relief gives such companies an export-contingent advantage which is not available to other companies. This additional advantage would also be a subsidy, but would not be an "exemption, remission or deferral of tax," which is the only kind of measure that item (e) covers.[131]

222. An additional complaint that can be made against the FSC Replacement Act is that it can give rise to 'double' double taxation relief as explained in the previous section. This unwarranted *overcompensation* is also a subsidy that is contingent upon export performance and specifically related to exports.

4.6.6. Comment on the view expressed by Canada that the income exempted under the extended FSC Replacement subsidy may be foreign-source income

223. As mentioned above, the EC has one final comment to make on the double taxation defence. Canada expressed the view in its third party submission that

> the "foreign income" component of "extraterritorial income" is the type of income typically subject to a measure designed to avoid double taxation.[132]

224. It immediately went on to say that

> However, in Canada's view, the United States has added this new category of income to the measure in question in an attempt to confuse the domestic tax situation that would otherwise apply to the "domestic export income" component of "extraterritorial income".

225. Canada is clearly of the view that the income covered by the extension of the scheme to the foreign sales of foreign goods is of a different nature than that earned by the sale of US goods. The EC agrees and that is in fact why is considers that there are two subsidies arising under the FSC Replacement Act.

226. But the EC does not agree with Canada's apparent view that the income covered by the extended FSC Replacement subsidy will be foreign source and potentially benefit from the last sentence of footnote 59.

227. The reason for this is that, as the US points out in a different context, US companies can earn 'extraterritorial income' by selling goods made abroad by a foreign producer (provided they satisfy the conditions of the FSC Replacement Act, notably by making a domestication election and respecting the foreign content limitation). The income earned by a US company by distributing foreign goods may in large part be earned within the US. Indeed as observed above[133], the Section 943(e)(4)(C) of the IRC *limits* the extent to which this income may be foreign-source income for US tax purposes.

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[131] As the US rightly observes, footnote 59 is attached to item (e), not to any other provision of the *SCM Agreement* and would not therefore be able to save the FSC subsidies. See e.g. paragraphs 103 and 110 of the US Appellant's Submission.

[132] Third party submission of Canada, paragraph 33.

[133] At the end of Section 4.6.3.

228. Accordingly, not even the extended FSC Replacement subsidy can in any event be considered to come within the last sentence of footnote 59 to the *SCM Agreement*.

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

229. The US response to the EC claim under Article III:4 of GATT 1994 is limited to two points. The first is again the argument that the FSC Replacement Act does not contain an affirmative requirement to use US goods. The second relates to the burden and standard of proof.

4.7.1. The "affirmative requirement" argument

230. As the Panel will know by now, the US has repeated throughout its submission that the FSC Replacement Act does not require use of US-origin goods but provides that no more than 50 per cent of the value of goods may be attributable to foreign content (articles and direct labour).

231. As explained in its first written submission[134], the EC submits that in all cases, the requirement will act as an incentive to source inputs domestically because this will enhance the chances of a US producer intending to export its goods to qualify for the tax benefit. This is sufficient to violate Article III:4 of GATT 1994, which guarantees equality of competitive opportunities and foreign markets undistorted by discriminatory internal regulations. In addition, in some cases (like the ones in the Annex to the first written submission of the EC), depending on the cost structure of a given product type, the foreign content limitation will *necessitate* use of domestic goods.[135] It will thus be even more than an *incentive* for the use of US goods, which is the standard under Article III:4.

232. In the *Canada – Automobiles* case the panel was confronted with a similar argument. Canada argued that the Canadian value added ("CVA") requirements did not provide less favourable treatment within the meaning of Article III:4 since "these requirements [did] not affect the "internal sale,… or use" of imported products because they [did] not in law or in fact require the use of domestic products and therefore play[ed] no role in the parts sourcing decisions of manufacturers."[136] However, the panel noted the broad interpretation given by the Appellate Body to the term "affecting" [137] and concluded that

> a measure which provides that an advantage can be obtained by using domestic products but not by using imported products 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. Consequently, the CVA requirements, which confer an advantage upon the use of domestic products and deny that advantage in case of the use of imported products, must be regarded as measures which "affect" the "internal sale,… or use" of imported products, *notwithstanding the fact that the CVA requirements do not in law require* the use of domestic products. [138]

The panel report was not appealed on this point.

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[134] First written submission of the EC, Section 3.7.
[135] First written submission of the EC, Section 3.5; rebuttal submission of the EC, *supra*, Section 4.6.
[136] Panel Report, *Canada - Automobiles*, paragraph 10.79.
[137] Id., paragraph 10.80.
[138] Id., paragraph 10.82 (emphasis added).

4.7.2. The EC has made a prima facie case which stands unchallenged

233. More fundamentally, the US response fails to undermine the EC case because it is premised on an incorrect view of the standard of proof in cases brought under Article III:4 of GATT 1994.

234. The US seems to assume[139] that in order to establish its case the EC should supply evidence that a particular class of imported goods will be accorded less favourable treatment than a class of domestic "like products".

235. All the US seems to do for the rest is to point to a "heightened burden" that it alleges to exist for cases where a measure of general application is challenged.[140]

236. The foregoing is unsupported by WTO rules, and does not correspond to panel or Appellate Body pronouncements in cases reviewing Article III:4 claims, including against legislation *per se* as in the present proceedings.

237. All the EC has to prove is, based on the terms of the law, that the FSC Replacement Act provides that an advantage can be obtained by using domestic products but not by using imported products, even if the measure allows for other means to obtain the advantage.[141]

238. On the contrary, the EC does not have to show the "effects" of the FSC Act. The very fact that it is easier to meet the foreign content limitation and therefore obtain the benefit if domestic products are used than if imported products are used is sufficient to find that this requirement affects internal sale.[142]

239. Whether or not Article III:4 cases were mostly brought against product specific or horizontal measures is irrelevant. What is relevant is that where a horizontal measure was challenged, the standard applied did not differ from that applied for product specific measures.

240. The *EEC - Parts and Components* case, already referred to by the EC, is in point.[143] The dispute concerned a horizontal measure of general application, Article 13.10 of the EEC's basic anti-dumping regulation in force at that time.

241. The panel reviewed the words of that provision as such.[144] It noted that they made the grant of an advantage (the suspension of certain anti-dumping proceedings against finished products) conditional on limiting the use of foreign (Japanese) components, without imposing similar limitations on the use of like EEC products, thereby according "treatment to imported products less favourable than that accorded to like products of [EEC] origin". After this analysis of the terms of the law as such, it also concluded that the individual measures taken on the basis of Article 13.10 of the basic anti-dumping regulation violated Article III:4 of GATT 1994. The Panel conducted the whole analysis without the need to compare a certain class of domestic products with the same class of imported products.[145]

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[139] First written submission of the US, paragraph 216.

[140] First written submission of the US, paragraph 218.

[141] Panel Report, *Canada - Automobiles*, paragraph 10.82.

[142] Id., paragraph 10.83. Evidence is in any event already before the Panel because it is already included in the Annex to the first written submission of the EC. The EC notes that the US has not made any attempt to refute this evidence, nor has it brought evidence to the contrary.

[143] Panel Report, *EEC – Regulation on Imports of Parts and Components*, BISD 37S/132, adopted 16 May 1990 ("*EEC – Parts and Components*").

[144] Id., paras. 5.20-5.21.

[145] In this connection the EC would also like to comment on the sentence taken from its first written submission which the US cites completely out of its context (first written submission of the US, paragraph 217). That sentence has of course to be read in its context. The EC was arguing that absence of a violation in respect

242. For the above reasons, the US has not refuted the EC's claim that the foreign content limitation provides less favourable treatment to imported parts and materials than to domestic goods with respect to their internal use in the production of goods, contrary to Article III:4 of GATT 1994. Accordingly, the EC requests the Panel to uphold its claim and find that the FSC Replacement Act violates Article III:4 of GATT 1994.

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

243. The EC explained in its first written submission that the FSC Replacement Act allows US exporters to continue to benefit from the WTO-incompatible FSC scheme until 31 December 2001 using FSCs existing on 30 September 2000 and, in certain circumstances, allows them do so for an *indefinite period* and therefore 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.[146]

244. The US does not deny these basic facts but tries to argue that its failure to respect its obligations under Article 4.7 of the *SCM Agreement* and Article 21 of the *DSU* is 'reasonable' for a series of reasons on which the EC will now comment.

245. The first of these reasons is that it is necessary to "lessen the administrative burden and impact on taxpayers' business operations that might result due to the repeal of the FSC" and that this is customary in the US.[147]

246. The EC does not contest the policy arguments in favour of transition rules but that is precisely why it, and it assumes the Panel, agreed in the original proceedings to allow the US to have a relatively long period of time to abolish the FSC scheme. This *was* the transitional period. The Panel specified "that FSC subsidies must be withdrawn at the latest with effect from 1 October 2000."[148]

247. The Panel's findings were first known to the US on 23 July 1999 (in the Interim Panel Report) and to the whole world on 8 October 1999 (with the publication of the final Panel Report). The Panel Report was not adopted until 20 March 2000 due to the appeal, but the date of 1 October with effect from which the Panel specified that the FSC subsidies must be withdrawn (at the latest), was not the subject of appeal. That date was chosen, as the Panel will recall, because it was argued that it would be unduly disruptive to change tax rules in the middle of a tax year.

248. The usual period of time for abolishing a prohibited export subsidy is just 90 days.[149] The US had more than twice this period, following the adoption of the Panel Report by the DSB and an extra 8 months to prepare itself from the date of the Interim Panel Report.

249. The deadline of 1 October 2000 therefore took into account the need for a transitional period and the US did not object to the length of this period. Even if the US had raised in the original

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of certain products cannot "compensate" or excuse cases where domestic products will or can be preferred. Article III:4 protects potential competition, not solely actual competition. This however has nothing to do with what the EC has to prove, since, as demonstrated in the text, there is no requirement to show the effects of a measure challenged under Article III:4.

[146] First written submission of the EC, paragraphs 234 to 241.

[147] First written submission of the US, paragraphs 224 to 227.

[148] Panel Report, paragraph 8.8.

[149] Panel Report, *Australia – Automotive Leather*, WT/DS126/R, adopted 16 June 1999, para. 10.7; Panel Report, *Canada – Aircraft*, WT/DS70/R, adopted 20 August 1999, para. 10.4; Panel Report, *Brazil – Aircraft*, WT/DS46/R, adopted 20 August 1999, paragraph 8.5.

proceeding in a more explicit way the arguments that it is now making about the need to avoid disrupting 'business operations' this would not have justified any longer period.

250. First, it is well known that tax rules are subject to revision at least every year and companies are well aware that they cannot assume that tax breaks will be available indefinitely. They therefore arrange their affairs so as to minimise the disruption that changes may cause. In the present case they had almost a full tax year in which to adjust.

251. Second, disruption to private contracts has already been rejected by the Appellate Body as well as panels as a reason for not applying WTO rules. In the Article 21.5 proceeding concerning *Brazil – Aircraft*, the Appellate Body rejected an argument that private contractual obligations could be relevant to the question of fulfilling an obligation to withdraw a prohibited export subsidy.[150] In the Article 21.5 proceedings concerning *Australia – Automotive* leather the panel ruled more generally that:

> Many situations can be envisioned, and not only in the subsidies area, in which a Member's actions to implement a ruling of the DSB might result in some interference with private rights, and result in domestic legal claims. This possibility does not, in our view, limit our interpretation of the text of the SCM Agreement.[151]

252. Finally, on this point, the EC would note that the US is perfectly capable of adopting tax legislation that interferes with private rights. As the US later states itself[152], the FSC Replacement Act was adopted on 15 November 2000 and prevented the creation of new FSCs retroactively to the 1 October 2000. There were no howls of protest, because taxpayers knew that the rules were likely to change and took their precautions.

253. The second reason given by the US why the Panel should excuse its failure to withdraw the FSC subsidies with effect from 1 October 2000 is that WTO rules should, according to it, be 'construed flexibly'.[153] It cites the Appellate Body Report in *Japan – Alcoholic Beverages*, as authority for this proposition. The US is not of course asking for rules to be 'construed flexibly' but to be *enforced leniently*. The Appellate Body was considering in that case the flexible notions of 'like product' and 'directly competitive or substitutable product' which clearly have scope to be construed flexibly. In the present case, however, the rules are perfectly clear.

254. The final arguments that the US throws into the pot are that the EC waited a long time before challenging the FSC scheme and that the year 2000 was a presidential election year.[154] The first point was already made before the Panel and the Panel knows the EC's and its won response to it. The second point is true, but was also known at the time of the original proceeding. If elections can be relevant at all, the EC would have thought that the fact that the incumbent president was leaving office and not seeking re-election would have made overcoming vested business interests and complying with WTO obligations easier rather than more difficult.

255. Accordingly, the EC maintains that the US has failed to implement the relevant DSB recommendations and rulings.

[150] Article 21.5 Appellate Body Report, *Brazil – Aircraft*, WT/DS46/AB/RW, adopted 4 August 2000, para. 46.
[151] Article 21.5 Panel Report, *Australia – Automotive Leather* WT/DS126/RW, adopted 11 February 2000, para. 6.23.
[152] First written submission of the US, paragraph 231.
[153] First written submission of the US, paragraph 227.
[154] First written submission of the US, paragraphs 228 and 229.

4.9. The US failed to implement the rulings and recommendations of the DSB by 1 November 2000

256. The US response to the EC's claim 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* is based on a fundamental error. The US claims in paragraph 231 of its first written submission that:

> 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.

257. The first part of the quoted sentence is correct because the DSB adopted the Panel's ruling that the FSC subsidies must be withdrawn at the latest with effect from 1 October 2000. The second part of the sentence is not correct. The powers of the DSB under Articles 16.4 and 17.14 of the *DSU* and 4.9 of the *SCM Agreement* are only to adopt or not adopt (that is reject) panel and Appellate Body reports. It cannot modify them.

258. What the DSB did on 12 October 2000 was to modify the time period for implementing measures to be adopted, *not* the date from which they were to take effect, which was specified in the Panel Report.

259. Accordingly, the retroactive repeal of the FSC scheme with effect from the 1 October 2000 would (if it had really repealed the FSC scheme, withdrawn the FSC subsidies and not introduced measures inconsistent with the covered agreements) have implemented the Panel's ruling in paragraph 8.8 of the Panel Report but not the requirement in Article 21 of the *DSU* to do so within a reasonable period of time, which the DSB had specified would end on 1 November 2000.[155]

260. The US also argues that

> Panels typically refrain from examining measures that cease to be in existence or in effect before a panel's terms of reference are set.[156]

261. The EC would simply point out that it is not asking the Panel to examine a measure that is no longer in effect. It is asking it to find that there was a *failure* to act by a certain deadline. A finding on such an issue is necessary to ensure that in future all WTO deadlines are not *de facto* extended by the length of time necessary to have a panel established and its terms of reference set.

5. Conclusion

262. For the above reasons, the EC maintains the conclusions set out in its first written submission.

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[155] Australia states (in paragraph 10 of its Third Party Submission) that the EC agreed to the extension to 1 November 2000. This is not correct. The EC simply supported the consensus in the DSB to grant the extension.

[156] First written submission of the US, paragraphs 232 to 233.

ANNEX

The cost of materials as 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 submissions 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 are 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.

For some products (heavy steel plate, stainless steel fasteners, aluminium household foil and PET bottle chip) more precise cost figures for individual firms are given. The firms involved are not identified and the currency is not specified. If the Panel wishes to see the source information, this could be made available at the meeting with the Panel.

In the calculations for individual firms, the selling price is based on a profit margin of 10 per cent. This is a generous figure, since it is in excess of target profit for each of the products concerned, and well above the actual profit margin for the products. It is also above the 8 per cent figure used in the US Tariff Act of 1930. The 10 per cent profit margin normally results in a more conservative percentage of raw materials for the individual firms than is found in the section on the general cost assumptions for the product.

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 around 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 around 61 per cent.

A cost breakdown in a specific example of a producer of heavy steel plate is as follows:

Cost of production - Heavy steel plate	
1999	
A. Blast furnace*	51.017.593
Raw materials	55.324.999
Total Iron	106.342.592
B. BOF plant*	57.743.638
Input coefficient (t)	0,8223
Liquid steel	164.086.230
C. Continuous casting*	36.078.324
Input coefficient (t)	1,0386
Slabs	200.164.554
D. Quarto mill	
Rolling mill*	30.427.365
Input coefficient (t)	1,0132
Finishing*	43.509.319
Input coefficient (t)	1,1302
E. Total cost of manufacturing	274.101.238
F. SG+A**	20.776.874
G. **Total cost of production**	294.878.112
H. Quantity produced to which	57.204
these costs are related	
I. Unit cost per tonne	5.155

* Including direct labour, energy, maintenance and repair

** Including selling expenses, general + administration, financing cost, depreciation, etc

Thus, the cost of raw materials to the firm concerned is 200 million. Assuming a recovery rate of 5 per cent for steel scrap, this makes the net total cost of materials 190 million. The total cost of production is 295 million. Assuming a 10 per cent profit, the selling price is equivalent to 325 million. This means that, in the case of this firm, raw materials account for 58 per cent of the final selling price.

(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.

A cost breakdown in a specific example of certain producers of Stainless Steel Fasteners is as follows:

All companies	1996	1997	1998	1999	Average
Full cost all products	81.619	94.133	102.566	99.691	94.502
Cost of raw material purchases	47.134	64.119	64.843	58.456	58.638
Cost of salaries	8.585	9.696	10.721	10.584	
Cost of social benefits	4.058	4.655	4.787	4.748	
Depreciation of tangible fixed assets	3.409	3.304	3.663	3.716	
Cost of raw material purchases as a % of full cost	57.7%	68.1%	63.2%	58.6%	
Cost of salaries as a % of full cost	10.5%	10.3%	10.5%	10.6%	
Cost of social benefits as a % of full cost	5.0%	4.9%	4.7%	4.8%	
Depreciation of fixed assets as a % of full cost	4.2%	3.5%	3.6%	3.7%	
Total	77.4%	86.9%	81.9%	77.7%	

Thus, the average cost of raw materials to a number of firms over a four-year period is 58.638. The total cost of production is 94.502. Assuming a 10% profit, the selling price is equivalent to 103.952. This means that, in the case of these firms, raw materials account for 56 per cent of the final selling price.

2. Other metal products

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.

A cost breakdown in a specific example of a producer of Aluminium Household Foil is as follows:

ALUMINIUM HOUSEHOLD FOIL 1999

	CONVERTER
SALES TONNES	3.797
GROSS SALES	7.555
DEDUCTIONS	357
NET SALES	7.198
COST 0 Materials	**4.900**
COST 0 TONNE	1.290
CONT 0	2.298
CONT 0 TONNE	605
COST 1 Variables	1.713
COST 1 TONNE	451
CONT 1	586
CONT 1 TONNE	154
COST 2A Fixed Mftg	303
COST 2B Depreciation	447
COST 3A Selling	61
COST 3B R&D	3
COST 3C Admin	114
CONT 3 (Before Man Fee)	(343)
MANAGEMENT FEE	55
CONT 3	(397)
Other	
Profit (Loss)	**(397)**

Thus, the cost of raw materials to the firm concerned is 4900. The total cost of production (the sum of items 1,2&3) is 7596. Assuming a 10 per cent profit, the selling price is equivalent to 8356. This means that, in the case of this firm, raw materials account for 59 per cent of the final selling price.

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

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 can account for up to 70 per cent of the fair market value (normal selling price) of the final product.

A cost breakdown in a specific example involving a producer of PET Bottle Chip is as follows:

Cost of production of product concerned PET Bottle Chip

FINANCIAL YEARS	**IP 01/10/98-30/09/99**
Raw materials :	
Terephtalic Acid PTA	59 236 670
Ethylene Glycol	19 844 039
Other	3 862 167
Total raw materials	**82 942 876**
Power and electricity	5 025 906
Direct labour	2 378 949
Total direct costs (a)	90 347 731
Manufacturing overheads	
Indirect labour	9 488 430
Maintenance	1 437 219
Depreciation	7 508 704
Other	154 976
Total overheads (b)	18 589 329
Total manufacturing (a+b)	108 937 061
SG&A expenses	
Transport	3 789 123
Other selling expenses	2 282 316
General and administration	2 484 857
Financial costs	1 551 716
Total SG&A (c)	10 108 013
Research & development (d)	1 435 111
Full cost (a+b+c+d)	**120 480 185**
Quantity produced	25596
Unit cost per tonne	4706.992703

Thus, the cost of raw materials to the firm concerned is 82.9 million and the full cost of production (including SGA, finance costs and R&D) is 120.5 million. With a profit margin of 10 per cent, the selling price of PET is equivalent to 132.6 million. This means that, in the case of this firm, raw materials account for 63 per cent of the selling price of this product.

5. Aircraft

Even without looking at the aluminium and alloys used for the production of airframes, the engines of an aircraft can account for 30 per cent of the final price of the finished product. Similarly, the avionics and other equipment on a modern aircraft can also cost 30 per cent of the final value.

Engines, avionics and other equipment 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, avionics and other equipment 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-10 Article: *US Treasury Official Denies FSC Repeal Signals Move to Territoriality* Tax Notes International, 18 December 2000, pp 2749 to 2752.

EC-11 Extract from the US Treasury Budget estimates for Financial Year 2001 entitled Total Revenue Loss Estimates in the Income Tax (providing FSC revenue loss figures for financial years 1999 to 2005).

EC-12 OECD Model Tax Convention on Income and Capital.

EC-13 The US Model Tax Convention.

ANNEX C-2

SECOND WRITTEN SUBMISSION OF THE UNITED STATES

(27 February 2001)

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I. INTRODUCTION

1. In accordance with the scheduled established by the Panel, the United States submits this second submission in this proceeding arising from the recourse by the European Communities ("EC") to Article 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* ("DSU"). Because the rebuttal comments of the EC are due to be submitted simultaneously with these comments, the United States will present its response to the EC's rebuttal at the Panel meeting. Thus, these comments are limited to developments that have occurred in this proceeding since the filing of the first written submission of the United States in this proceeding ("*First US 21.5 Submission*"). Specifically, these comments address arguments contained in the third-party submissions.

2. A number of the arguments and positions expressed in the third-party submissions are the same or similar to those presented by the EC, arguments to which the United States previously has responded. To the extent the third parties raise arguments not presented by the EC, such arguments cannot serve to meet the EC's burden in this proceeding. With this overriding consideration in mind, the United States addresses below certain arguments and issues raised in the third-party submissions.

II. ARTICLE 3.1(A) OF THE SCM AGREEMENT

3. In providing their views on Article 3.1(a) of the SCM Agreement, Australia and Canada first discuss whether the Act's exclusion constitutes a subsidy under Article 1 of the SCM Agreement, and then give their views on whether the exclusion is export contingent within the meaning of Article 3.1(a). Accordingly, the United States first takes up the subsidy issue and then proceeds to examine export contingency.

A. AUSTRALIA AND CANADA ERR IN THEIR SUBSIDY ANALYSIS

1. Australia's Argument

4. Australia argues that the Act's exclusion constitutes a subsidy under Article 1 because, in its opinion, *all* tax exclusions constitute subsidies. Australia states that "'foreign trading gross receipts' [are] excluded from gross income on which tax liability is calculated. The effect of the exclusion is to reduce the tax liability of the beneficiary corporation."[1] Australia reaches this conclusion based on the premise that the reduction in tax liability flowing from the exclusion of extraterritorial income "represents a departure from the rules of taxation that would otherwise apply to such gross income."[2]

5. Australia's analysis is flawed in several respects. First, Australia fails to recognize that the Act's exclusion of extraterritorial income is an integral part of the definition of "gross income", a concept which forms the outer boundary of US taxing jurisdiction. The exclusion is, in the words of the Appellate Body, the "prevailing domestic standard" or "normative benchmark" under US law against which any particular measures must be evaluated.[3] Accordingly, Australia's assertion that the Act's exclusion "represents a departure from the rules of taxation that otherwise apply" is simply incorrect.

6. Second, Australia's erroneous characterization of the effects of the Act seem to result from its misunderstanding of how the US tax system operates. Australia states in its submission that, "[a]s a general rule, the United States asserts the right to tax all income earned worldwide by its citizens and

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[1] *Australia Third-Party Submission*, para. 14.
[2] *Id.*
[3] *United States - Tax Treatment for "Foreign Sales Corporations"* ("*FSC (AB)*"), WT/DS108/AB/R, Report of the Appellate Body adopted 20 March 2000, para. 90.

residents."[4] This statement fails to recognize that the Act fundamentally altered the manner in which the United States treats foreign income. It is incorrect to argue that "the effect of the exclusion is to reduce . . . tax liability" because no such liability exists in the first place under the US tax system with respect to excluded extraterritorial income.

7. Third, Australia's test for subsidization apparently would condemn any tax reform that results in a contraction of a Member's tax base. According to Australia, any measure that reduces tax with respect to a category of income confers a subsidy. Taken to its logical conclusion, this argument would transform a mere reduction in tax rates into a subsidy because the revenue foregone by the rate reduction was "otherwise due" before the reduction went into effect. Such reasoning conflicts with the Appellate Body's holding in *FSC* 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.[5]

2. Canada's Argument

(a) Canada Offers No Principled Basis for Applying Article 1

8. Canada begins its analysis of whether the Act's exclusion confers a subsidy within the meaning of Article 1 by acknowledging that the Act passes the *FSC* Panel's "but for" test.[6] Canada then argues that the "but for" test "is not determinative of whether the [US] government has foregone revenue otherwise due" and that "a more complete analysis of domestic tax rules must be conducted in order to determine what situation would apply to the revenues in question absent the contested measure."[7]

9. Canada, however, does not provide any framework or principles for conducting such an analysis, nor does it explain what factors would lead to a determination that revenue "otherwise due" is foregone. Instead, Canada appears to merely point to aspects of the Act that it does not like, or that seem unusual to Canada, and from this concludes that the Act's exclusion comes within the scope of Article 1.

10. Such *ad hoc* reasoning cannot be a basis for interpreting and applying provisions of WTO agreements. The *FSC* Panel and Appellate Body made clear that the appropriate inquiry is whether income that is not taxed under a challenged measure would "otherwise" be "due" under other provisions of the tax laws of the country in question.[8] In order to determine whether taxes would be "otherwise due," it is necessary to compare the challenged measure with a "normative benchmark."[9] Canada's *ad hoc* approach is especially inappropriate in the present context given the Appellate Body's statement that "the word 'foregone' suggests that the government has given up an entitlement

[4] *Australia Third-Party Submission*, para. 4.

[5] *FSC (AB)*, para. 90. In this regard, Australia seems to assume that in the absence of the Act's exclusion, excluded income necessarily would be taxed. However, as demonstrated in the *First US 21.5 Submission*, paras. 100-106, this assumption is not warranted.

[6] *Canada Third-Party Submission*, paras. 27-28.

[7] *Id.,* para. 29.

[8] The *FSC* Panel explained that "there is in the WTO Agreement no theoretical 'correct' benchmark for taxes that would represent the norm for taxes and duties 'otherwise due.'" *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. 7.42.

[9] *FSC (AB)*, para. 90 (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"); *see also FSC (Panel),* para. 7.43 ("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 ... .").

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."[10] Thus, the Act must be assessed against an articulated and clear standard, and not on the basis of conclusory reasoning.

(b) No Negative Inference Can Be Drawn from the Fact that the Act Passes the "But For" Test

11. Canada does not attempt to make the comparison contemplated by the *FSC* decisions. Instead, Canada effectively complains that by revising its laws, the United States was too successful in satisfying the "but for" test.[11] Although Canada does not appear to dispute the fact that by excluding extraterritorial income from "gross income" the United States redefined the outer boundary of its tax system, Canada alleges that this redefinition somehow constitutes a "circumvention" of the "but for" test. Canada argues that, because the United States does not have "a rule formally taxing the revenues in question," the Panel should examine the size and nature of the exclusion.[12]

12. Canada is wrong on all counts. First, it was entirely appropriate for the United States to craft the Act so as to avoid creating a situation where, "but for" the existence of the Act, foregone revenue would be due. As the United States explained in its first submission, complying with the *FSC* Panel and Appellate Body decisions was one of the underlying purposes of the Act.[13] Had the United States not done so, it would have ignored the Panel's central statement regarding the definition of a subsidy. WTO Members implementing WTO decisions must be permitted to structure new measures specifically to comply with those decisions.[14]

13. Second, it also was entirely appropriate for the United States to modify its tax system by redefining its jurisdictional boundaries. As the Appellate Body has explained, WTO obligations do not dictate what type of tax system a Member must have. 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 revenue []".[15] By excluding extraterritorial income from US taxation, the United States simply exercised this sovereign right.

14. Third, despite Canada's suggestion to the contrary, the absence of "a rule formally *taxing* the revenues in question" indicates that the Act does not confer a subsidy. Stated differently, what matters in the present context is whether the challenged measure foregoes revenue when compared against a "normative benchmark" under US law. Canada has identified no such benchmark and, like Australia, has failed to explain what provision of US law necessarily would capture income that is excluded because of the Act.

(c) Canada's Analysis of the Act is Flawed

15. Canada raises several aspects of the Act that are not relevant to determining whether the Act confers subsidies under Article 1.

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[10] *FSC (AB)*, para. 90 (emphasis in original).

[11] *Canada Third-Party Submission*, para. 27.

[12] Canada argues that US foreign tax credits were a preexisting benchmark and that the United States cannot create a "new" benchmark. *Id.,* note 19. However, US foreign tax credits are inapplicable to excluded extraterritorial income, and therefore cannot be a relevant benchmark in this context. The United States explains in this section why there is no restriction against a WTO Member modifying its system of taxation and thereby establishing a "new" benchmark.

[13] *First US 21.5 Submission*, paras. 22-23.

[14] If this were not so, then it would be contrary to the role of the dispute settlement system as a central element in providing security and predictability to the multilateral trading system.

[15] *FSC (AB)*, para. 90 (emphasis in original).

(i) It is Irrelevant that Only Certain Categories of Extraterritorial Income are Excluded from Tax

16. Canada maintains it is inappropriate that "only certain categories of 'extraterritorial income' are excluded from tax."[16] However, nothing in the language of Article 1 suggests that the size or comprehensiveness of a tax exclusion is relevant to whether a subsidy has been provided. Many exemption systems, for example, impose complicated conditions on the non-taxation of foreign income. Canada does not explain how the scope of the exclusion is relevant to whether taxes on extraterritorial income are "otherwise due".

17. In addition to being irrelevant, Canada's assertion that the Act's exclusion is insufficiently comprehensive is false. The exclusion of extraterritorial income applies broadly to individuals, partnerships, and corporations, irrespective of whether they are located in the United States or abroad. The exclusion applies to a broad range of foreign transactions – *i.e.*, foreign sales, foreign leases, and foreign rentals.

(ii) For Purposes of Article 1, it is Irrelevant Whether the Act Excludes Export-Related Income or is a Measure to Avoid Double Taxation

18. Canada next contends that the Act confers subsidies under Article 1 because its exclusion applies to export-related income and that the exclusion of such income does not constitute, in Canada's opinion, a measure to avoid double taxation.[17] These considerations are wholly irrelevant to a determination of whether a measure confers subsidies within the meaning of Article 1. The Appellate Body has made clear that the definition of a subsidy is free standing – that is, it applies throughout the SCM Agreement and does not turn on whether the measure at issue involves exports.[18] Moreover, Article 3.1(a), the provision of the SCM Agreement specifically focused on exportation, applies only to subsidies "within the meaning of Article 1". Article 3.1(a)'s export-contingency is only relevant to measures that first confer subsidies under Article 1.

19. As for Canada's assertion that the Act's exclusion is not a measure to avoid double taxation, that issue also has no bearing on whether the exclusion constitutes a subsidy. The United States previously made a similar argument in the *FSC* dispute, contending that footnote 59, including the fifth sentence (which deals with measures to avoid double taxation), forms part of the context for interpreting the "otherwise due" language of Article 1. The Appellate Body, however, rejected that argument, finding footnote 59 to be relevant to Article 3.1(a) and not Article 1.[19] Therefore, whether or not the Act constitutes a measure to avoid double taxation is not relevant to determining whether or not it can be deemed a subsidy.[20]

(iii) It is Irrelevant Whether the Act Relies on the FSC's "Arithmetic"

20. Finally, Canada contends that the Act constitutes a subsidy because it "corresponds arithmetically to the exempt foreign source income of the FSC scheme."[21] To the extent Canada is suggesting that the FSC provisions were not repealed, Canada is wrong, because the Act repealed the

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[16] *Canada Third-Party Submission*, para. 30.
[17] *Canada Third-Party Submission*, paras. 31-35.
[18] *FSC (AB)*, para. 89.
[19] *Id.,* paras. 93-94. The United States responds to Canada's contention that the Act is not a measure to avoid double taxation in section II.C.2, below.
[20] Should the Panel find the double taxation argument relevant to the issue of whether the Act confers a subsidy, the United States renews its argument that the Act does not confer a subsidy under Article 1.1(a) because it constitutes a measure for the avoidance of double taxation.
[21] *Canada Third-Party Submission*, para. 32, quoting *EC First 21.5 Submission*, para. 35.

FSC provisions. To the extent Canada really is arguing that the Act uses the same percentages as the FSC provisions, Canada is dwelling upon an irrelevant point. Neither the Panel nor the Appellate Body in *FSC* found objectionable the percentages used by the FSC provisions. Moreover, such a comparison between the provisions of the FSC and the Act is neither accurate nor meaningful. As a general matter, challenged measures can be modified to remedy WTO deficiencies. In this case, the FSC provisions have been repealed, and the Act is significantly different.[22]

B. THE ACT'S EXCLUSION IS NOT EXPORT-CONTINGENT WITHIN THE MEANING OF ARTICLE 3.1(A)

21. Canada and Australia argue that the Act's exclusion is contingent upon export performance and therefore violates Article 3.1(a) of the SCM Agreement. Together, Canada and Australia present four main arguments regarding Article 3.1(a). First, both argue that the foreign-use requirement in the Act, in and of itself, renders the Act and its exclusion of extraterritorial income an export-contingent subsidy. Second, Canada argues that the application of the exclusion to non-export transactions is not enough to save the Act from the prohibition of Article 3.1(a). Third, Canada and Australia claim that the inapplicability of the exclusion to income earned in domestic transactions demonstrates the export-contingency of the Act. Fourth, Australia claims that the Act's 50-percent rule on certain foreign value makes the exclusion of income of foreign entities export-contingent. None of these arguments, however, find support in the language of Article 3.1(a), as interpreted by the Appellate Body.

1. The Foreign-Use Requirement Does Not Render the Exclusion of Extraterritorial Income Export Contingent

22. Australia and Canada claim that the Act's foreign-use requirement – *i.e.*, that property involved in a transaction giving rise to excluded extraterritorial income must be "held for use, consumption, or disposition outside the United States" – renders the exclusion of extraterritorial income export contingent.[23] Contrary to these arguments, the foreign-use requirement does not make the exclusion export contingent.

23. The Act provides in general for the exclusion of income arising in foreign transactions. As noted in the *First US 21.5 Submission*, the foreign-use requirement is but one characteristic of a "foreign" transaction, and the exclusion applies regardless of whether the products involved are manufactured or produced in the United States. While foreign transactions giving rise to excluded extraterritorial income include export transactions, they also include transactions that take place entirely within another country, or that involve multiple countries other than the United States. The applicability of the exclusion to income earned in a wide range of foreign transactions reflects the export-neutral principle underlying the exclusion. Exporting is merely one way of conforming to that principle.

24. Thus, the foreign-use requirement in the Act does not render the exclusion of extraterritorial income export contingent. If that were not so, then the Panel would in effect be holding that a tax exemption for foreign sales income is necessarily an export subsidy. Such a result would come as a quite a surprise to countries employing territorial tax systems or tax systems providing territorial exemptions.

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[22] See *US First Art. 21.5 Submission*, paras. 47-55 for a discussion of the differences between the Act and the FSC.

[23] *Canada's Third Party Submission*, para. 40; *Australia's Third Party Submission*, para. 16.

2. The Availability of the Exclusion of Extraterritorial Income Earned by Foreign Entities is Relevant under Article 3.1(a)

25. As discussed above, Canada focuses on export transactions in the context of the foreign-use requirement, arguing that the availability of the exclusion for income earned in foreign, non-export transactions is irrelevant.[24] However, bifurcating the Act in this way is not consistent with the way the Act operates and results in a distorted analysis under Article 3.1(a).

26. With respect to foreign sales transactions, the Act does not distinguish between export transactions and non-export transactions or between exporters and non-exporters. With one exception, there is no distinction in reporting by taxpayers, whether they be branches or subsidiaries of US corporations or foreign corporations. The only distinction in the identity of taxpayers is that foreign taxpayers must be subject to US tax on their manufacturing income in order to earn excluded income. As explained in the *First US 21.5 Submission*, this distinction merely equalizes the US tax treatment of foreign branches and corporate subsidiaries. The Act applies neutrally and broadly to income derived from foreign transactions – that is, where the goods subject to the transactions are purchased and used outside the United States.

27. Contrary to Canada's argument, the Appellate Body in *Canada-Aircraft* did not determine that subsidies provided to non-exporters are irrelevant for purposes of evaluating a measure under Article 3.1(a).[25] *Canada Aircraft* was a *de facto* export-contingency case. As the panel noted in that case, Brazil did "not claim that the TPC programme is *de jure* export contingent. Rather, Brazil asserts that TPC contributions in the regional aircraft sector are 'contingent . . . in fact . . .upon exportation', within the meaning of Article 3.1(a) of the SCM Agreement."[26] As support for its claim of *de facto* export contingency, Brazil provided extensive factual information relating to particular TPC contributions and established that these contributions would not have been provided to the Canadian regional aircraft sector but for the sector's export orientation. Thus, when the Appellate Body reviewed the panel's decision in *Canada Aircraft*, the Appellate Body confirmed that, in a *de facto* export contingency case, only those subsidies claimed to be export-contingent are relevant for the panel's consideration.

28. *Canada Aircraft* is distinguishable from this case. The EC has not made a *de facto* export contingency claim or presented any evidence that would support such a claim. The only evidence presented by the EC is the Act itself. Ignoring the export-neutral aspect of the definition of extraterritorial income would be to ignore one of the most important issues in this case. In contrast to the Appellate Body's finding in *Canada Aircraft* that the TPC program would not have contributed to the regional aircraft sector "but for" that sector's export orientation, the Act is indifferent as to how *any* taxpayer earns extraterritorial income. The Act does not create any sub-categories of taxpayers whose eligibility to earn extraterritorial income is "tied" to actual or anticipated exportation or export earnings. Thus, the Panel should consider the Act as whole in evaluating whether the exclusion of extraterritorial income is export contingent.

3. The Inapplicability of the Act's Exclusion to Income Derived from Domestic Transactions is Irrelevant under Article 3.1(a)

29. Canada and Australia contend that the inapplicability of the exclusion to income earned in purely domestic transactions renders the exclusion export-contingent.[27] As Canada stated in its

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[24] *Canada's Third Party Submission*, para. 41; *see also id.*, para. 44.

[25] *Canada's Third Party Submission*, paras. 45-47.

[26] *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, para. 9.330.

[27] *Canada's Third Party Submission*, paras. 43-44; *Australia's Third Party Submission*, para. 16.

submission, "the proper basis for comparison must necessarily be with the tax treatment of domestic sales of domestic goods."[28]

30. This argument is not grounded in the language of Article 3.1(a) as interpreted by the Appellate Body. Whether a domestic transaction is eligible for a tax exclusion has no bearing on whether that exclusion is "contingent on", "conditioned upon", or "dependent for its existence on" export performance. In providing a framework for evaluating a measure under Article 3.1(a), the Appellate Body has never indicated that any comparison is required, let alone a comparison between the tax treatment of export transactions and the tax treatment of domestic transactions. If the drafters of Article 3.1(a) had wished to adopt a test for export contingency that compared the treatment of foreign sales with the treatment of domestic sales, they would have done so in the text of the agreement. However, they did not.

4. The 50-per cent Rule Does Not Render the Act's Exclusion Export-Contingent

31. While Canada appears to take the view that the Act's exclusion is not export-contingent with respect to sales of foreign-produced property, Australia argues that the Act's 50-percent rule "requires the export of United States product" with respect to such transactions. Australia's argument is based entirely on the false premise that "at least 50 per cent of [the property's] fair market value must be attributable to United States content and United States direct labour costs."[29]

32. The 50-percent rule in the Act does not require *any* US content. Qualifying foreign trade property may include property with 100 percent foreign content. Furthermore, the 50-percent rule does not require that any portion of a final product's fair market value be attributable to US-produced inputs and US direct labour costs. Instead, the Act provides a cap on the amount of the fair market value of a product that is attributable to *foreign* inputs and labour. Thus, Australia's argument is based upon a basic misunderstanding of the operation of the Act. As reflected by the attached statement from a US taxpayer ("X") intending to rely upon the Act, the 50-percent rule does not require that US content be included in products subject to the Act. This taxpayer explains that it will not need to include US content in products whose sale will generate extraterritorial income:

> The [merchandise] sold by the foreign branches of this [X] Swiss subsidiary is considered "qualifying foreign trade property" under the Act. [This merchandise does] not contain any US-produced inputs and [is] not manufactured with any US direct labour. The 50-percent rule in the Act is satisfied by the significant amount of the fair market value of the [] product that is attributable to US intellectual property rights, notably [X's] process patents that are licensed to foreign manufacturers. In no case is [X's] ability to exclude extraterritorial income dependent or conditioned upon the use of US goods exported outside the United States.[30]

Accordingly, the 50-percent rule does not require the exportation of US goods and the Act cannot be said, for that reason, to be contingent upon export performance.

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[28] *Canada's Third Party Submission*, para. 44.

[29] *Australia's Third Party Submission*, para. 18.

[30] Exhibit US-9, para. 8. Pursuant to paragraph 3 of the *Working Procedures of the Panel*, the United States designates US-9 as confidential. In the quotation from US-9 in the text, the United States has deleted material – identified in brackets – in order to summarize the information in a manner that can be disclosed to the public.

C. THE ACT'S EXCLUSION CONSTITUTES A MEASURE TO AVOID DOUBLE TAXATION WITHIN THE MEANING OF FOOTNOTE 59

33. Australia and Canada both argue that the Act does not constitute a measure to avoid double taxation pursuant to the fifth sentence of footnote 59 of the SCM Agreement.[31] In reaching this conclusion, however, they propose conditions and limitations on what constitutes a measure to avoid double taxation that are not supported by the text of footnote 59 and that are not consistent with methods used to avoid double taxation around the world.

1. Australia's Argument

34. Australia bases its argument on two points. First, it asserts that the Act's exclusion cannot be a measure to avoid double taxation under footnote 59 because "United States tax rules already provide income tax credits to minimize double taxation" and because "[t]he United States has also entered into agreements with other countries to avoid double taxation of income."[32] Second, Australia claims that the Act is not a measure to avoid double taxation because its exclusion is "not calculated on, or limited to, the amount of foreign taxes paid on 'extraterritorial income'."[33]

(a) WTO Members May Rely on Alternative Methods for Avoiding Double Taxation of Foreign-Source Income

35. In the context of international commerce, relief from double taxation generally is provided through an exemption of foreign income, through a credit for foreign taxes paid, or through an income tax convention pursuant to which each jurisdiction cedes taxing rights over particular categories of income. As the EC has recognized, most if not all Members employ all three of these mechanisms, in varying proportions, for the relief of double taxation.

36. According to its legislative history, the Act establishes an alternative measure for the relief of double taxation for a particular category of income defined by the Act. According to that legislative history, "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."[34] In other words, the Act implements certain aspects of the exemption systems employed by other countries, including EC member states. Reflective of its nature as an alternative mechanism for the relief of double taxation, the Act disallows foreign tax credits and deductions otherwise allocable to excluded extraterritorial income.[35]

37. Nothing in the SCM Agreement prohibits Members from using this type of alternative mechanism for the relief of double taxation. To the contrary, the OECD and the UN endorse the use of this mechanism.[36] Footnote 59 leaves the choice of mechanism to WTO Members, stating that the ban against export-specific direct tax exemptions, remissions, or deferrals set forth in paragraph (e) of the Illustrative List of Export Subsidies "is *not intended to limit* Members from taking *measures* to avoid . . . double taxation … . " (Emphasis added). This language is particularly flexible, imposing

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[31] Neither Australia nor Canada appears to dispute the legal consequences that would flow from finding the Act's exclusion to fall under footnote 59; *i.e.*, that by virtue of footnote 5 of the SCM Agreement, the exclusion would not be prohibited by any provision of the Agreement.

[32] *Australia Third-Party Art. 21.5 Submission*, para. 21.

[33] *Id.*, para. 22.

[34] *Senate Report* (US-2), page 5.

[35] The Act § 3, amending IRC § 114(c)-(d).

[36] *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).

no *limit* on WTO Members in fashioning double tax relief *measures.*[37] Moreover, the Appellate Body in *FSC* did not condition the sovereign right of Members to exempt a category of income on some requirement that they only do so through a unitary measure. Therefore, the United States may adopt alternative mechanisms for the avoidance of double taxation.[38]

38. The same is true with respect to US bilateral tax treaties. These treaties provide relief from double taxation in conjunction with or parallel to US domestic legal provisions, but these agreements are confined by their terms to circumstances where the two signatory governments can claim the right to tax the same income. As a general rule, bilateral tax treaties are entered into to supplement domestic legal measures designed to avoid double taxation. Almost every country entering into such a treaty has its own mechanism for avoiding double taxation, and these domestic mechanisms often differ in some way – *i.e.*, in terms of methodology or scope of application – from that of the treaty. Thus, a treaty might provide relief to taxpayers where the laws of a given treaty party otherwise would not. However, a treaty does not preclude the need for a domestic measure to avoid double taxation.

(b) A Measure to Avoid Double Taxation Does Not Have to Be Limited to the Amount of Foreign Taxes Paid

39. Australia next argues that the Act is not a measure to avoid double taxation because the exclusion is not limited to the amount of foreign taxes paid. This argument also is meritless.

(i) The Exemption Method is Tied to the Tax Rates of the Countries Involved

40. The premise underlying the exemption method is that the same income of a taxpayer should not be subjected to the tax systems of two sovereign nations. This stands in contrast to the tax credit method, which presumes that taxpayers will be taxed twice on the same income but which offsets any foreign taxes paid after the fact.

41. As the United States explained in its first submission, a natural consequence of the exemption method is that the overall effect on the tax liability of a given taxpayer is determined by the tax rate applied by the country of source for exempted foreign-source income. To the extent that the tax rate applied by the country of source 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 country of source applies a *lower* rate, then the taxpayer *will pay less* than if the income were earned in the country of residence.

(ii) An Example

42. The Commentary to the OECD Model Convention demonstrates that an overall savings in taxes is natural byproduct of the exemption method, but nonetheless is permissible. The Commentary

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[37] It is instructive that the drafters of the SCM Agreement used the word "measures" in footnote 59 and did not attempt to identify particular methods of avoiding double taxation. The term "measure" has been found to be a rather broad term in other contexts. As the *Japan Film* Panel explained, "GATT panels dealing with the related issue of what may constitute 'all laws, regulations and requirements' . . . under GATT Article III:4 ... . Panels have taken a broad view of when a governmental action is a law, regulation or requirement ... . Given that the scope of the term *requirement* would seem to be narrower than that of measure, the broad reading given to the word *requirement* . . . supports an even broader reading of the word measure in Article XXIII:1(b)." *Japan - Measures Affecting Consumer Photographic Film and Paper*, WT/DS44/R, Report of the Panel adopted 22 April 1998, para. 10.51.

[38] In this regard, the EC previously has acknowledged that both the credit and the exemption method are proper methods of avoiding double taxation, and that it is internationally accepted that both methods may be used in combination. Annex EC-2, page 2 (US-5).

does so through an example in which a taxpayer obtains a tax savings because the taxpayer's country of residence imposes a higher tax rate than the other country involved. The example assumes that (1) the total income of a taxpayer is $100,000, (2) the first $80,000 of the $100,000 is taxable only in the country of residence, (3) the other $20,000 is subject to tax in both countries, (4) the tax rate in the country of residence is 35% at $100,000 and 30% at $80,000, and (5) the foreign country's rate of taxation is 20%. Absent a measure to avoid double taxation, the taxpayer would be subjected to taxes of $35,000 on his worldwide income of $100,000 by the country of residence, plus a tax of $4,000 levied by the country of source on the $20,000 earned there – resulting in a total tax of $39,000.[39]

43. The OECD Commentary then explains that under the exemption method[40], the $20,000 in foreign-source income would not be considered for tax purposes by the country of residence. This would result in the country of residence taxing the remaining $80,000 at a 30 percent rate, yielding a tax of $24,000, while the other country would levy its tax of $4,000 on the $20,000 earned within its territory. The exemption method would thus yield a total tax of $28,000, relieving the taxpayer of $11,000 in taxes (the double tax of $39,000 minus the revised amount of $28,000).

44. The Commentary shows this example graphically as follows:

Tax in County of Residence (30% of $80,000)	$24,000
Plus Tax in Foreign Country	$4,000
Total Taxes	$28,000
Relief Given by Country of Residence	$11,000

45. To summarize these results, under the exemption method, the taxpayer would owe only $28,000 in combined taxes and $24,000 in country-of-residence taxes. This amounts to a savings of overall and country-of residence taxes of $11,000.

46. Despite the overall savings in taxes, the OECD approves of the exemption method. The EC appears to agree, having informed the *FSC* Panel that, "[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."[41]

(iii) The Credit Method Does Not Offer Perfect Results

47. It is important to note that, while the credit method may in theory be better suited to calibrating the impact of double taxation and can more easily prevent a tax savings from occurring[42], tax credits in practice are not a perfect method for avoiding double taxation. Tax credits are often complicated in their application, raising substantial questions about their effect in situations where companies suffer foreign losses, roll credits over to subsequent tax years, or pay taxes in a foreign jurisdiction that are not subject to crediting (*e.g.,* payment of excise or value-added taxes instead of income taxes). Like exemption, credits may not result in an exact dollar-for dollar offset of foreign taxes paid. However, unlike exemption, credits may result in taxpayers continuing to be subject to double taxation on the same income by two nations.

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[39] US-7, pages C(23)-5 to C(23)-7.

[40] This example relies on what the OECD refers to as the "full exemption" method. An alternative method, "exemption with progression", would yield different but similar results.

[41] Annex EC-2 (US-5), page 2. The EC went on to note that some countries apply a partial exemption system in order to limit the advantages a taxpayer may reap. These countries exempt income only if it is "derived from countries that are committed to imposing taxes at rates and under conditions that are roughly comparable to [their] own rates and conditions." *Id.*

[42] This is because tax credits are applied *ex ante* and thus can theoretically be calculated with precision to offset taxes actually paid in the country of source.

48. In view of the complexities involved with each method, it is not surprising that countries have adopted one or the other, or both, and that the major model treaties have approved both. The model treaties in this regard follow the long and widespread acceptance of both methods by nations around the world, including many EC member states as well as many other WTO Members.

2. Canada's Argument

49. Canada begins its analysis of whether the Act constitutes a measure to avoid double taxation for purposes of footnote 59 by distinguishing between the treatment of what it refers to as "foreign income" and "domestic export income". Canada states that it "agrees that the 'foreign income' component of 'extraterritorial income' is the type of income typically subject to a measure to avoid double taxation."[43] Canada, however, posits that "the United States has added this new category of income to the measure in question in an attempt to confuse the domestic tax situation that would otherwise apply to the 'domestic export income' component of 'extraterritorial income'."[44] Canada goes on to say that "income earned from export transactions is income that would generally be taxable only in the United States. The fact that the proceeds of sales are from foreign sources does not transform the export income into 'foreign income' for tax purposes."[45] Finally, Canada argues that "[e]xporting goods in a foreign country does not create a sufficient nexus to trigger taxation in the importing country, even when one takes into consideration the 'foreign economic processes' required under the [Act]."[46]

50. These unsubstantiated assertions lack a foundation in the text of the SCM Agreement and reflect a misunderstanding of how measures to avoid double taxation are used throughout the world.

(a) Canada Draws a False Distinction Between "Foreign" and "Domestic Export" Income

51. At base, Canada is arguing that the mere application of the Act's exclusion to income from export sales renders it export-contingent, regardless of the fact that the exclusion applies to a much broader category of income. As the United States has explained, a broad range of foreign transactions may give rise to excluded extraterritorial income. To the extent that exporting may give rise to extraterritorial income, that is merely the result of the fact that export sales are one form of foreign transaction. The Act in no way treats exports differently or more generously than other types of foreign sales. A statement from a US taxpayer ("X") illustrates this point:

> None of the extraterritorial income earned by [X's] Swiss subsidiary is generated through exports from the United States. The amount of income that [X] will exclude under the Act bears no relationship to whether and to what extent [X] engages in export transactions. Indeed, the Company's decision to elect to become a US taxpayer is completely unrelated to whether and to what extent [X] engages in export transactions.[47]

Therefore, Canada's distinction between "foreign" and "domestic export" income is illusory at best.

[43] *Canada Third-Party Submission*, para. 33.
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] US-9, para. 7.

(b) The United States Did Not Include Wholly Foreign Transactions to "Confuse the Situation"

52. Canada admits "that the 'foreign income' component of 'extraterritorial income' is the type of income typically subject to a measure to avoid double taxation." Canada nevertheless objects to the application of the Act's exclusion to foreign income derived from export transactions. Among other things, this statement fails to recognize how US taxpayers can rely on the Act's exclusion for non-export transactions.

53. The United States explained in its first submission and above that the Act applies to a wide array of foreign transactions.[48] All of these transactions can be performed without any goods or services originating in the United States; *i.e.*, these transactions need not involve exportation from the United States at all. As one company has explained, extraterritorial income can be earned by foreign companies and can be "earned exclusively through non-US or foreign transactions".[49]

54. Thus, contrary to Canada's assertion to the contrary, the Act applies meaningful double taxation relief with respect to non-export transactions. It applies with full force to non-export transactions and will be used by US taxpayers earning income from sales occurring entirely outside the United States, including foreign companies.

(c) Canada Improperly Narrows the Fifth Sentence of Footnote 59

55. In its submission, Canada attempts to narrow the meaning of the fifth sentence of footnote 59 or add conditions that are not contained in its text. Canada first argues that foreign-source income for purposes of footnote 59 is *only* income attributable to economic processes occurring outside a taxpayer's country of residence. Canada also argues that double taxation relief may be provided only to taxpayers having "permanent establishments" in jurisdictions other than their country of residence. As the United States demonstrates below, neither proposition is correct.

(i) Canada's Definition of Foreign-Source Income is Erroneous

56. Canada appears to disagree with the definition of foreign-source income advanced by the United States – that is, an assessment based on all facts and circumstances that could lead to characterizing income as foreign. Canada appears to be arguing that income is "foreign source" only to the extent that it is attributable to economic processes occurring outside a taxpayer's country of residence. Canada even goes so far as to assert that the United States is arguing that extraterritorial income is "foreign source income" within the meaning of footnote 59 just from "[t]he fact that the proceeds of sales are from foreign sources."[50] Canada oversimplifies the US position, and offers no explanation for how its definition comports with the relevant text.

57. As the United States explained in its first submission, a foreign source of payment is but one of many factors that could make income "foreign source". The ordinary meaning of the term "foreign-source income" for purposes of footnote 59 is profits or proceeds originating outside the borders or territory of the WTO Member instituting a measure to avoid double taxation.[51] The United States further explained that the essential characteristics that would indicate whether profits or proceeds originate outside the borders or territory of a country might include: 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

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[48] The Act § 3, amending IRC § 941(a)(1), describes the types of transactions covered.
[49] Exhibit US-9, para. 6.
[50] *Canada's Third-Party Submission*, para. 34.
[51] See US First Art. 21.5 Submission, para. 166-67.

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. These attributes are factors that can render income subject to taxation in two jurisdictions. It is important to note that this definition includes income attributable to foreign economic processes, but the language of the fifth sentence of footnote 59 does not appear to make foreign economic processes the sole factor for determining what is, or is not, meant by "foreign source income".

58. "Extraterritorial income" under the Act involves all of these foreign attributes that can result in such income being subjected to double taxation.[52] The central premise of the Act is to provide a tax exclusion for income from foreign transactions. With regard to the types of transactions that may generate excluded income, the Act provides that the goods involved must be used, consumed, or disposed of outside the United States.[53] 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[54], and certain required levels of foreign economic activities must be performed with respect to the sales and distribution functions associated with qualifying transactions.[55]

59. To find that the Act's exclusion does not constitute a measure to avoid double taxation, there must be something more than a bald assertion that foreign economic processes are the sine quo non of "foreign source income". There would have to be a showing as to why extraterritorial income, which has a number of foreign characteristics, cannot be subjected to tax in two jurisdictions, cannot give rise to double taxation, and in turn cannot be protected from such double taxation through the Act.

(ii) There is no Requirement for a "Permanent Establishment"

60. Canada appears to argue that, even if extraterritorial income is sufficiently foreign in nature, it is not subject to double taxation because US taxpayers relying on the Act are not required to maintain a "permanent establishment" in a foreign taxing jurisdiction. Canada argues that, absent a "permanent establishment" requirement, the Act's mandated foreign economic processes "do not create a taxable presence abroad, and, therefore, would not be considered foreign business income subject to double taxation."[56]

61. Canada's argument glosses over the fact that, just as there is no international consensus on what constitutes foreign-source income, there are divergent views and practices among countries as to what brings a non-resident enterprise within a country's taxing authority. The United States, for example, does not, as a general matter, subscribe to the requirement that a non-resident enterprise must have a "permanent establishment" within the United States in order to be subjected to US taxation. Instead, the United States looks to see if there is a sufficient amount of business activity occurring within the United States with respect to a given transaction or series of transactions to find that a taxpayer has engaged in "a trade or business in the United States."[57] Income "effectively

[52] For example, one company has stated, "[t]he extraterritorial income earned by this [X] Swiss subsidiary is subject to tax in Switzerland. The election of the Swiss subsidiary to become a US taxpayer does not relieve the Swiss subsidiary from paying taxes to the government of Switzerland. However, because extraterritorial income is excluded from gross income under the ETI Exclusion Act, excluded income earned by this [X] Swiss subsidiary will not be subject to double taxation but, rather, subject only to Swiss tax." US-9, para. 10.

[53] The Act § 3, amending IRC § 943(a)(1)(B).

[54] The Act § 3, amending IRC § 943(a)(1)(A).

[55] The Act § 3, amending IRC § 942(b).

[56] Canada Third-Party Submission, para. 34.

[57] All that is required to establish a US trade or business is "considerable, continuous and regular" economic activity. For example, a US trade or business has been found to exist where a foreign individual's

connected" with that trade or business is subject to US taxation. In short, the United States does not require the existence of a fixed or enduring business operation.

62. The United States is not alone in relying on a standard more flexible than something amounting to a "permanent establishment". Section 253 of the Canadian Income Tax Act provides that soliciting orders or offering items for sale in Canada through an agent or servant (whether or not the contract or transaction is to be completed inside or outside of Canada) may be deemed to be carrying on business in Canada for tax purposes.[58] Similarly, to use one EC member state as an example, UK. tax laws take into account a number of factors, including where a contract is made, in determining whether "trading income" is taxable by the United Kingdom.[59]

63. The Act takes account of the varied approaches for determining tax jurisdiction throughout the world. It recognizes that other countries rely on different standards that can turn on subtle factual distinctions in determining whether income is subject to their tax regimes. The Act therefore requires that transactions giving rise to extraterritorial income must have a variety of foreign attributes that can result in a sufficient nexus to a foreign taxing regime as to render US taxpayers subject to foreign taxation.

64. It is true, as Canada asserts, that certain US bilateral tax treaties rely on the OECD standard that a non-resident is not to be subject to taxation in the absence of a "permanent establishment". However, as explained above, bilateral tax treaties serve as an additional layer of double tax avoidance in addition to domestic laws. A number of nations have broader jurisdiction under their domestic tax laws to reach income of non-residents than that prescribed by most tax treaties. In fact, one reason for a nation to enter into a bilateral tax treaty is to secure double tax relief from these more aggressive standards. That nations rely on bilateral tax treaties to prevent their businesses from being subjected to a foreign tax in the absence of a "permanent establishment" does not in any way mean that lower thresholds cannot be relied upon in domestic double tax avoidance measures (especially with regard to situations in which no such treaty exists).

(iii) The FSC Decisions Cast Doubt on Foreign Economic Processes as the Test of "Foreign Source Income"

65. One reason the United States adopted the foregoing approach – and chose not to rely exclusively on foreign economic processes as the test of "foreign source income" under footnote 59 – is that the FSC Panel and Appellate Body decisions cast doubt on whether such a narrow standard is appropriate.

66. As the Panel may recall, the United States predicated its arguments in the FSC dispute in large part on the 1981 Understanding of the GATT Council. The Understanding begins by stating:

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export business in the United States solicited orders, inspected merchandise, made purchases, completed sales, and maintained an office and a bank account. United States v. Balanovski, 236 F.2d 298 (2nd Cir. 1956), cert. denied, 352 U.S. 968 (1957) (Exhibit US-10). The mere ownership and active management of US real estate has been found to constitute a US trade or business. See De Amodio v. Commissioner, 34 T.C. 894 (1960), aff'd, 299 F.2d 623 (3rd Cir. 1962) (Exhibit US-11); Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), aff'd, 221 F.2d 227 (9th Cir. 1955) (Exhibit US-12). Moreover, the US taxing jurisdiction generally reaches a broader category of income with respect to a US trade or business ("effectively connected" income) than the category of taxable income attributable to a US permanent establishment. See Rev. Rul. 91-32, 1991-1 C.B. 107 (Exhibit US-13); Rev. Rul. 81-78, 1981-1 C.B. 604 (Exhibit US-14), amplified by Rev. Rul. 84-17, 1984-1 C.B. 308 (Exhibit US-15).

[58] See Exhibit US-16.

[59] Tax Management, Foreign Income Portfolios, Business Operations in the United Kingdom, 989-2nd (1999 Bureau of National Affairs), at A-80 to A-81 (Exhibit US-17).

> "The Council adopts these reports on the understanding that with respect to these cases, and in general, *economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities* in terms of Article XVI:4 of the General Agreement."[60]

The United States cited this language in support of the proposition that footnote 59 allowed WTO Members to refrain from taxing export-related income attributable to foreign economic processes and the failure to tax such income does not constitute an export subsidy.

67. The FSC Panel and Appellate Body, though, ruled that the Understanding has no relevance to the SCM Agreement in general or to footnote 59 in particular. As the Appellate Body stated, "[t]he 1981 Council action related to a different provision, Article XVI:4 of the GATT 1947, and not to the export subsidy disciplines established by Articles 1.1 and 3.1(a) of the SCM Agreement."[61]

68. As a result, the notion that "foreign source income" under footnote 59 can be directly equated to income derived from foreign economic processes, as Canada appears to contend, cannot be derived from the language of the 1981 Understanding. Such an interpretation must emanate from the language of footnote 59 itself. However, as the United States has explained in its first submission and above, the text of the fifth sentence of footnote 59 is not susceptible to such a narrow construction.

III. THE FIFTY-PER CENT RULE DOES NOT VIOLATE ARTICLE 3.1(B) OF THE SCM AGREEMENT

69. Australia argues that the Act makes the exclusion of extraterritorial income contingent on the use of domestic over imported goods and thus violates Article 3.1(b) of the SCM Agreement.[62] As discussed above, this argument is based on an erroneous description of the Act. Australia states:

> for property to constitute "qualifying foreign trade property" under the Act, at least 50 per cent of its fair market value must be attributable to articles manufactured, produced, grown or extracted *within the United States* ... . Given the tax exemption only arises on the meeting of a 50 per cent local content requirement, it is contingent upon the use of domestic over imported goods.[63]

70. However, contrary to Australia's argument, the Act does not require that any portion of the value of a final product be "attributable to articles manufactured . . . within the United States." In addition, the Act does not contain a "local content requirement."

71. The Act defines "qualifying foreign trade property" as "property not more than 50 percent of the fair market value of which is attributable to articles manufactured, produced, grown, or extracted outside the United States, and direct costs for labour . . . performed outside the United States."[64] Australia appears to be misreading this language to state that 50 percent of the fair market value of property be attributable to articles manufactured within the United States. Rather, the 50-percent rule takes into account only the value of foreign articles and foreign direct labour used in producing a finished product. The rule does not limit other foreign value. Thus, property can meet the fifty-percent rule even if 100 percent of its content is foreign.

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[60] Tax Legislation Cases, adopted December 7-8, 1981, BISD 28S/114 (1982) (emphasis added).
[61] FSC (AB), para. 119.
[62] Australia's Third Party Submission, para. 19.
[63] Id. (emphasis in original).
[64] The Act § 2, amending IRC § 943(a)(1)(C).

IV. THE UNITED STATES COMPLIED WITH THE DSB'S RECOMMENDATIONS AND RULINGS

72. Australia argues that the United States has not withdrawn the FSC subsidies by the 1 November 2000 deadline, as extended by the DSB. The United States explained in its first submission that the Act complies with the DSB's recommendations and rulings because the Act repeals the FSC provisions with effect from 30 September 2000, and provides that no FSCs may be created after that date.

73. The Act provides limited transition relief to lessen the administrative burden and impact on taxpayers' business operations that might result due to the repeal of the FSC provisions. As the United States explained in its first submission, providing limited transition rules to allow taxpayers to adjust to a new regime is customary practice in the United States and in other countries when repealing significant tax legislation. In addition, permitting limited transition rules is reasonable in this case in light of the reliance of taxpayers on the FSC rules – reliance caused, in part, by the EC's delay of thirteen years after the FSC was enacted before challenging it.

74. Australia completely ignores the arguments presented by the United States in its first submission with respect to the appropriateness of the Act's transition rules. Consequently, the United States respectfully refers the Panel to these arguments in its first submission.[65]

V. CONCLUSION

75. For the reasons set forth above and in the *First US 21.5 Submission*, the United States respectfully requests that the Panel reject the EC's claims and arguments, and make the findings requested in paragraph 239 of the *First US 21.5 Submission*.

[65] First US 21.5 Submission, paras. 37-38, 223-39.

US EXHIBIT LIST

Number	Document
9	Confidential Taxpayer Statement
10	*United States v. Balanovski*, 236 F.2d 298 (2nd Cir. 1956)
11	*De Amodio v. Commissioner*, 34 T.C. 894 (1960)
12	*Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953)
13	Rev. Rul. 91-32, 1991-1 C.B. 107
14	Rev. Rul. 81-78, 1981-1 C.B. 604
15	Rev. Rul. 84-17, 1984-1 C.B. 308
16	Section 253 of the Canadian Income Tax Act
17	*Tax Management, Foreign Income Portfolios, Business Operations in the United Kingdom*, 989-2nd (1999 Bureau of National Affairs), pages A-80 to A-81