ANNEX F

Answers to Questions and Comments on these Answers

ANNEX F-1

ANSWERS OF THE EUROPEAN COMMUNITIES TO THE QUESTIONS OF THE PANEL

(27 March 2001)

Q1 In section 3.2.5. of its first submission, the European Communities expresses the view that the FSC Replacement scheme gives rise to two distinguishable subsidies : the "basic FSC Replacement subsidy" and the "extended FSC Replacement subsidy".

- **Does this mean that the EC is requesting the Panel to make two separate rulings, one on each of the alleged subsidies?**

- **Does the EC consider that the application of a different portion of the FSC Replacement scheme may involve different types of subsidies under the SCM Agreement?**

- **Please identify the relevant portion of the FSC Repeal and Extraterritorial Income Exclusion Act ("the Act") framing these two "distinguishable" alleged subsidies.**

- **Does the EC believe that the status of a subsidy under the SCM Agreement is determined by the particular legal circumstances in which it is granted on a case-by-case basis?**

Reply

1. The EC does not consider that the Panel need necessarily make two separate rulings on each of the subsidies. It is not requesting two independent rulings in the way that it had asked for separate and independent rulings on the FSC subsidies resulting respectively from the tax exemptions and the special administrative pricing rules. But the EC does consider that the Panel's analysis and reasoning will have to consider the subsidies separately.

2. The first reason for this is that the two subsidies cover different situations. Furthermore, doing so allows a proper understanding of what the contingency laid down in the FSC Replacement Act means in respect of the different situations covered by the Act. Although the basic and the extended subsidy are both prohibited export subsidies, the reasons for this are different.

3. The basic FSC Replacement subsidy is prohibited because it is only applicable to profits arising from *export transactions*. The extended FSC Replacement subsidy is prohibited because it will often be necessary to use US articles (and therefore exports) in order to satisfy the *foreign content limitation*. Also, although the amount of both subsidies is the same, the conditions to be fulfilled to obtain it are different in each case (export of US goods in one case - export of US inputs and domestication in the second one).

4. Turning to the Panel's other precise questions:

- the subsidies arise from interconnected legal provisions.

- The EC is contesting a subsidy *scheme* (or *programme* to use the word employed in the *SCM Agreement*), rather than individual subsidy *payments*. It is therefore the conditions of the *law* that need to be considered, not the "legal circumstances in which it is granted on a *case-by-case* basis." However these conditions may differ from one category of cases to another (and do differ in the case of the FSC Replacement scheme between the basic FSC Replacement subsidy and the extended FSC Replacement scheme).

- As regards the legal condition under which subsidies are granted, the EC would add that the benchmark for the extended FSC Replacement subsidy would be the situation prevailing if the conditions (notably sale "not for use within the US" and the foreign content limitation) were not fulfilled. Generally applicable US tax rules would then require more tax to be paid.

5. With regard to the EC's Annex, the EC stresses that this was provided for the purposes of illustration. Although this relates to EC companies, the EC considers that, in view of the comparability and openness of the EC and US economies, the same cost structures can be presumed to also be illustrative of conditions in the US.

Q2 The European Communities claims that the FSC Replacement scheme is de facto export contingent and therefore contrary to Article 3.1(a) of the SCM Agreement.[1] Please explain how the legislation as such -- which, by its terms, at least in the case of FSCs in existence on 30 September 2000, does not apply to transactions occurring before 1 January 2002 -- can constitute a de facto violation of Article 3.1(a) of the SCM Agreement. Can the EC cite any GATT/WTO reports in which legislation as such was found to be a de facto violation of any obligations under the GATT/WTO Agreement?

6. The precise boundaries of *de facto* violations are not entirely defined. All the arguments of the EC can be considered to relate to *de jure* subsidies because, as the question puts it, the EC is attacking the law *as such.*

7. The EC would further note that the Appellate Body has considered that a *de jure* condition is one that arises from the words of the law or by *necessary implication* from those words.[2] That is the case here. The term *de facto* export contingent subsidy is probably best reserved for cases where the export contingency is not apparent at all from the text of the law or even a necessary implication but arises out of the exercise of some separate power – for example when a discretion to grant a subsidy is exercised in a way that means that the grant "is in fact tied to actual or anticipated exportation or export earnings" (see the terms of footnote 4 to the *SCM Agreement*).

8. The EC would also observe that the Appellate Body has held that the standard of contingency is the same, whether the subsidy arises *de facto* or *de jure*.[3]

.9. The EC would also refer the Panel to what it said on the requirements of proof regarding factual issues in cases such as this in its second written submission.[4]

10. A complaint against a mandatory law that is not yet fully applied can in any event only be judged on the basis of the text and evident facts.

11. The EC has argued in the alternative that there is a *de facto* violation for the case that the Panel should take a different view of the distinction.

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[1] EC first submission, para. 145.

[2] Appellate Body Report, *Canada – Certain Measures Affecting the Automotive Industry ("Canada – Automotive Industry")*, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, para. 99.

[3] Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft ("Canada – Aircraft")*, WT/DS70/AB/R, adopted 20 August 1999, para. 167.

[4] Second written submission of the EC, Section 4.1 (paras 41 to 58).

Q3. The European Communities states that it "… sees no reason to contest that the last sentence of footnote 59 may be an exception to Article 3.1(a)."[5] Does this mean that the EC is of the view that measures satisfying the requirements for the last sentence of footnote 59 constitute "[m]easures referred to in Annex I as not constituting export subsidies" under footnote 5 of the SCM Agreement?

Reply

12.. The EC was not stating that it considers that the last sentence of footnote 59 is an exception to Article 3.1(a). The precise requirements for a statement in Annex 1 to be considered as falling within the terms of footnote 5 have not yet been clarified by cases. The EC was merely stating that it does not consider it necessary for the Panel to address this question since the conditions of the last sentence of footnote 59 are in any event not fulfilled.

13. The EC would also emphasise that the last sentence of footnote 59 only applies to measures falling under the terms of item (e).

14. The EC considers that the last sentence of footnote 59 can be considered to be declaratory. The simple exemption of foreign source income is not in the view of the EC a subsidy at all, or at least not specific. This matter is discussed further in response to question 45 below.

Q4. Please provide further clarification of the point made in paragraph 161 of the EC second submission, if possible, with reference to actual cases addressing Article III:4 of the GATT.

Reply

15. The EC was making the point that an analysis of the origin of sub-components would have made the cases impossibly complicated.

16. The point, made in response to a paragraph of the US first submission (para. 203), is that, when a claim concerning a local content requirement is reviewed (under Article III:4 of the GATT as well as other WTO provisions), the domestic status of a given product depends on its origin as a "unitary" good. Whether this input, is in turn, made out of sub-components that were originally foreign is not relevant.

17. Likewise, when comparing the use of 'domestic' over 'imported' products in Article 3.1(b), one has to look at a product as a whole - if that is domestic, the previous (foreign) origin of some of its sub-components is irrelevant to assess whether there is preference for domestic products.

18. Regard must be paid to the current origin of the products (domestic and foreign) being compared. There are no longer individual sub-components distinguishable from the domestic products that are being compared to the 'imported' ones.

19. The sub-components would further not be "like" or "directly competitive to" the foreign products to which the "qualifying foreign trade property" would be preferred.

20. There are, to the EC's knowledge, no cases under Article III:4 of the GATT where, in comparing domestic and imported products, panels looked beyond the domestic origin of products to check (and give relevance) to the former foreign origin of the sub-components of domestic products.

[5] EC second submission, para. 181.

Q5. Please provide further clarification of the point made in paragraph 227 of the EC second submission.

Reply

21. The EC was simply pointing out that (contrary to what Canada appeared to believe) the income benefiting from the extended FSC Replacement subsidy need not be foreign-source. The example it gave was that of a US company distributing foreign-made goods. The reference to the FSC Replacement Act should be to Section 943(c), not Section 943(e)(4)(C).

Q6. The European Communities claims that the FSC Replacement scheme is a prohibited export subsidy contrary to Article 3.1(a) and item (e) of Annex 1 of the SCM Agreement. Are these alternative claims? In the EC's view, which claim must be addressed first by the Panel?

Reply

22. The claims are alternative.

23. The item (e) claim is also an Article 3.1(a) claim. It is Article 3.1(a) that brings the practices described in the Annex within the prohibition. The examples in the Annex are particular examples of prohibited subsidies.

24. It is a matter for the Panel whether it looks to the general terms of Article 3.1(a) or the Annex first. The EC has addressed the Article 3.1(a) claim first but does not consider that the Panel "must" do so.

Q13. Regarding the relationship between Article 3.1(a) of the SCM Agreement and item (e) of Annex I, would it be possible that a certain measure is not within the scope of the latter, but nonetheless within the scope of the former, and vice versa?

Reply

25. The EC believes it is possible that a measure could fall within the scope of Article 3.1(a) of the SCM Agreement but not item (e) of Annex I and also *vice versa*.

26. For example:

- Tax exemptions to export promotion or shipping companies (rather than the exporters themselves) may not fall under the general terms of Article 3.1(a) but would fall under item (e).

- A tax advantage that is not an exemption remission or deferral (e.g. a deduction) would not fall under item (e) but would fall under the general terms of Article 3.1(a) if contingent upon export performance.

Q14. The Panel is well aware that the WTO-conformity of income tax regimes of European countries is outside the scope of our terms of reference for this case. In paragraph 96 of the US first submission, the US introduces examples of a few European tax systems which "refrain from taxing foreign income in a qualified or conditional manner."[6] Among those systems, is there one which excludes foreign income from the scope of taxable income on the following conditions:

[6] US first submission, para. 97.

(i) the property for sale from which income arises must be held for ultimate use outside the country, (and not be sold for final consumption in that country); and

(ii) the same property must have foreign content of not more than a certain percentage of its fair market value.

Reply

27. The EC is confident that none of its Member States has such a tax system.

28. The US is apparently of the view that the term "foreign-source income" should be interpreted widely so as to signify export income. The EC would comment that if this had been intended, the last words of footnote 59 would have been “export income.”

Q15. Is the term “foreign-source income,” “foreign-source” or “source” used elsewhere in any provisions of other WTO Agreements than the SCM Agreement? What guidance, if any, may be drawn as to the meaning of these terms from the SCM Agreement or other WTO Agreements?

Reply

29. The term “foreign-source income” or “foreign-source” is only used in footnote 59. The word source is used elsewhere, notably in the trade defence agreements, including the SCM Agreement to refer to the origin of imports or of information.

30. As the EC has explained, the term “foreign-source income” is used as a taxation term of art in footnote 59.

31. At the hearing on the Panel also asked whether this expression was used in panel or Appellate Body reports.

32. The term foreign-source income was indeed used extensively by the US in the *DISC* and *Tax Legislation* cases to describe income arising outside the territory of the taxing country. For example, the US explained that:

> Prior to 1962 the United States did not tax the foreign source income of a foreign corporation organized outside the United States. Taxes on that income were deferred until the income was repatriated. When "sub-part F" was enacted in the Revenue Act of 1962, the United States began taxing currently to the United States shareholders of controlled foreign corporations the income from certain sales and services of these foreign subsidiaries.[7]

33. The US was using the term "foreign-source income" in the sense of "income from sources without the US" in Section 862 of the IRC. [8]

Q16. The European Communities claims that[9]:

> **"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**

[7] *United States - Income tax legislation (DISC)* (BISD 23S/98), para.8.
[8] Text in Exhibit EC-21.
[9] EC second submission, paras. 221-222.

> **is not available to other operators…. This additional advantage would also be a subsidy,…. This unwarranted overcompensation is also a subsidy….**
>
> **(For the EC): Please provide a textual analysis of how the alleged additional advantage and overcompensation constitute subsidies under Article 1 of the SCM Agreement.**
>
> **(For the US): How does the US respond to this allegation?**

Reply

34. The argument that there is an additional subsidy is really just another way of stating what was already said (in the previous section 4.6.4, paragraphs 213 to 218 and 220) that a measure that gives rise to 'double' double taxation relief cannot be said to be "to avoid double taxation".

35. The EC is further arguing in paragraph 222 of its second written submission that the 'double' double taxation relief to which the FSC Replacement scheme can give rise (as explained in the section 4.6.4, paragraphs 213 to 218 and 220) is also a subsidy in that revenue is forgone that would be due under the generally applicable system of double taxation relief (the foreign tax credit system) which gives rise to a corresponding benefit.

36. It appears to the EC that Section 943(d) must, if it has any meaning, provide a possibility for such double double taxation relief.

Q17. The EC seems to argue that a Article 3.1(b) violation may exist if a certain measure gives an "incentive" to domestic production for export.[10] In the same vein, the EC argues that "Article 3.1(b) prohibits local-content contingency to <u>any</u> degree,… [and] there is no de minimis rule for prohibited subsidies in the SCM Agreement.".[11]

> **(For the EC): How would this argument be supported by a textual analysis of Article 3.1(b) in accordance with Article 31 of the Vienna Convention? Can the European Communities cite any Appellate Body or panel reports in which the term "incentive" was explicitly used in the context of Article 3.1 of the SCM Agreement, or Article XVI:4 of the GATT Agreement?**
>
> **(For the US): Would a textual analysis of Article 3.1(b) lead to a conclusion that the EC's above argument is without merit? If so, why and how? Would the US take the view that there is de minimis rule for prohibited subsidies in the SCM Agreement? If so, what is the qualitative or quantitative threshold for that rule? Is the Appellate Body Report in Canada - Certain Measures Affecting the Automotive Industry[12] relevant to this question? Please give reasons for your responses.**

Reply

37. The two quotes are in a sense "in the same vein", even though they relate to separate points.

38. The first sentence concerns the main EC argument, that the foreign content rule is inconsistent with Article 3.1(b) because it gives rise to a requirement in <u>any</u> case, and is also related with a further question (no. 26).

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[10] *See* EC first submission, para. 165.
[11] EC second submission, para. 160.
[12] WT/DS130/AB/R, WT/DS142/AB/R.

39. The second sentence responded to the US argument about the origin of sub-components, and the response can be outlined as follows. The presence of sub-components in domestic articles is not relevant for the purposes of applying Article III:4 of GATT to a situation where more favourable treatment of foreign articles is alleged.

40. Furthermore, there is not a *de minimis* rule in the sense that there is not a minimum threshold of domestic sub-components for a US good to be caught by Article 3.1(b).

41. Article 3.1(b) applies to all US goods (and compares all of them to foreign products), no matter what they are made of. It is an unqualified prohibition.

42. By contrast, the first sentence quoted by the Panel (paragraph 165, EC's first written submission) does not address the meaning of the word "contingent", nor the meaning of the world "domestic", but rather the meaning of the clause "use of domestic over imported".

43. For the textual analysis of Article 3.1(b), the EC would refer to its Oral Statement. The EC has clarified the meaning of Article 3.1(b) in its entirety, whereas the US continues to provide a selective interpretation. In interpreting Article 3.1(b), the Panel is called to give meaning to all its words, including the clause "use of domestic over imported" products.

44. As to previous reports, we would point out that in *Canada – Automobiles* the Appellate Body, when comparing Article 3.1(b) and Article III:4 of GATT 1994, noted that the latter "also addresses measures that favour the use of domestic over imported good".[13]

Q18. Relating to Article III:4 GATT, EC has cited[14], inter alia, the Panel Report on Italian Discrimination against Imported Agricultural Machinery.[15] We note that two other documents -- GATT Doc. L/695 (1957) and GATT Doc. L/740 (1957) -- address similar issues. Are these relevant to the question of whether Article III:4 of the GATT in the first place covers exemptions to the tax on the "firm"? Please comment on whether and how these reports are relevant to our case.

Reply

45. The EC referred to *Italian Discrimination Against Imported Agricultural Machinery* in paragraph 198 and in footnote 69 to paragraph 192 of its first written submission.

46. The Panel seems to raise a preliminary question as to whether the EC considers that the relevant question is not whether Article III:4 of the GATT "covers exemptions to the tax on the firm".

47. The EC wishes to clarify that it is not claiming that the tax exemption as such is a "requirement affecting internal sale" within the meaning of Article III:4 of GATT 1994.

48. As clearly results from the EC's first written submission,[16] the EC's claim under Article III:4 of GATT 1994 is focusing on the foreign content limitation, which affects the sale or use of products on the US market and discriminates against foreign products.

49. This has been correctly understood by the US in its first written submission,[17] and there is thus no difference between the parties in this respect.

[13] *Canada – Automobiles*, Appellate Body Report, para. 140.
[14] EC first submission, para. 98.
[15] GATT Doc. L/833 (1958), adopted 23 October 1958, BISD 7S/60.
[16] See e.g. EC first submission, para. 188.

50. More specifically, the EC submits that the foreign content limitation is a "requirement" not because "an enterprise is legally bound to carry [it] out", but because "an enterprise voluntarily accepts [it] in order to obtain an advantage from the government". [18]

51. The above quotes from *EEC - Parts and components* show that for the analysis under Article III:4 of the GATT the 'advantage' ultimately sought from the government when voluntarily accepting a certain "requirement" is not relevant. In particular it is not relevant whether it is an advantage to the "firm".

52. The situation was similar in the *Italian Discrimination Against Imported Agricultural Machinery* case.[19] In that case, Italian farmers (the "firms") received an advantage (the special purchase credit terms) on condition that they met a certain requirement (the purchase of domestic products - agricultural machinery).

53. The two documents referred to by the Panel appear to confirm that requirements like the foreign content limitation are covered by Article III:4 of GATT 1994. Doc. L/693 in particular related to a benefit to purchasers of agricultural machinery (the "firms"), which benefit had become conditional on the purchase of domestic machinery since the entry into force of decree no. 57,904. The UK government precisely challenged the discrimination resulting from inducing French farmers to buy domestic products in order for them to be eligible for the benefit.[20]

Questions of 13 March

Q23. The EC argues that, "for owners of US produced goods, export is a condition for obtaining the benefits under the scheme for those goods"[21] and that there is accordingly an export subsidy. Assume the existence of an exclusion from taxation for all foreign-source income based upon application of a pure territorial system. Would export not be a condition for owners of domestically-produced goods to obtain the exclusion in that case as well? Does this mean that the application of a pure territorial system would also involve an export subsidy? Please explain.

<u>Reply</u>

54. In a pure territorial system, business profits from domestic sales and exports are taxed in exactly the same way. Income tax is paid on all income <u>generated</u> in the country concerned. If a firm located in a country with a territorial system sells to unrelated customers on the domestic and export market, and obtains the same level of profit on both sales, they will be taxed the same.

55. If the same firm sells to a foreign subsidiary taking responsibility for the distribution (and therefore resale) of the goods on the domestic market, the parent will pay tax on the profit earned by it in selling to the foreign subsidiary in the transaction but not on the profit of the foreign subsidiary. The situation is the same where the firm to the foreign subsidiary for subsequent distribution on

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[17] US first submission, para. 211, where the US notes "[t]he EC claims that the 50 per cent rule of the Act provides less favourable treatment to imported products than to like domestic products in violation of Article III:4 of GATT."

[18] *EEC - Parts and components*, Panel Report, para. 5.21; see also EC first submission, paras. 191-195; EC second submission, paras. 240 ff.

[19] Panel Report, *Italian Discrimination Against Imported Agricultural Machinery*, adopted on 23 October 1958, BISD 7S/60.

[20] *Guide to EC Law and Practice*, Analytical Index, Geneva, 1995, Vol. 1, p. 173.

[21] EC rebuttal submission, para. 102.

export markets; the parent will pay tax only on the profit earned by it in selling to the foreign subsidiary. Thus, in both cases, the profit earned by the foreign subsidiary in these transactions through its activities in the country where it is located is not subject to income tax on this profit in the country that has a pure territorial system. This is because countries with territorial systems tax only income earned from activities in their territory. The separation (attribution) of income is made on an objective basis – at arm's length (i.e. as if the transaction was concluded according to commercial and financial terms, which would apply between unrelated parties). Unlike the FSC Replacement Act, a pure territorial system does not exempt income generated by activities undertaken within the territory, be it export or any other activity. Therefore, there is no revenue forgone and no subsidy.

56. The US regularly states that the EC has accepted that territorial systems provide better treatment to export sales. The US has misunderstood the EC position. As explained above, a pure territorial system does not treat export sales more favourably. More favourable treatment of export sales through a foreign distribution compared with domestic sales through a domestic distribution subsidiary may arise out of the fact that the foreign country has a lower tax rate (but not when the foreign tax rate is higher). However, when like is compared with like, there is, as explained above, no more favourable treatment of such export sales compared with domestic sales.

57. The US has also stated that the 1981 tax legislation cases have made "factual findings" that territorial systems provide better treatment to export sales. The EC does not agree that this is so and does not consider these cases, which dealt with a different legal provision in a different agreement and under very different dispute settlement arrangements, to be pertinent to the present dispute.

Q24. Would a measure that exempted foreign-source income from taxation (i.e., a pure territorial system) be a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59?

Reply

58. The EC considers that because the prevailing benchmark in territorial tax system is the taxation of income generated on the territory in question, the exemption of foreign source income does not involve revenue forgone and is not a subsidy under Article 1 of the *SCM Agreement*. It is also not contingent upon export performance or specifically related to exports. It is however undeniably a measure to avoid the double taxation of foreign-source income.

Q25. The EC argues that "the fact that the extension of the FSC replacement scheme to foreign produced goods is subject to a foreign content requirement creates in many cases a requirement for exports to be made from the US. This renders the extended FSC Replacement subsidy also export contingent and thus prohibited."[22] Is it the EC's view that the measure is contingent de jure on export performance? Or de facto? Is it export-contingent only in those cases where compliance requires the export of US goods, or does the fact that the export of US goods may sometimes be required render the "extended FSC replacement scheme" export-contingent in its totality?

Reply

59. As the EC stated in reply to question 2, it considers that its claim is of *de jure* export contingency but appreciates that some may consider it *de facto* contingency.

[22] EC first submission, para. 119.

60. The Appellate Body has made clear that a *de jure* condition is one that arises from the words of the law or by *necessary implication* from those words.[23] That is the case here. It was clear from evident facts known to all at the time the law was adopted that respecting the foreign content limitation would require the use of US articles in many cases.

61. As also mentioned above, the EC considers that the term "*de facto* export contingency subsidy" is probably best reserved for cases where the export contingency is not apparent at all from the text of the law or even a necessary implication but arises out of the exercise of some separate power – for example when a discretion to grant a subsidy is exercised in a way that means that the grant "is in fact tied to actual or anticipated exportation or export earnings" (see the terms of footnote 4 to the *SCM Agreement*.)

62. Thus, turning to the Panel's precise questions: it is the EC's view that the extended FSC Replacement scheme is contingent *de jure* on export performance; the fact that the export of US goods may sometimes be required renders the "extended FSC replacement scheme" export-contingent in its totality.

Q26. The EC states that the basic FSC subsidy is contingent upon the use of domestic over imported goods because domestic US articles will "often" be necessary to ensure that the foreign content limitation is not exceeded.[24] Is it the EC's view that the frequency with which this will be the case is relevant to whether the 50% foreign content rule is inconsistent with Article 3.1(b)? Would the rule be inconsistent with Article 3.1(b) if domestic US goods were "sometimes" necessary? Occasionally? Rarely?

<u>Reply</u>

63. The EC considers the "50% foreign content rule" to be inconsistent with Article 3.1(b) by the reason of the fact that it give rise to a requirement to use US article in *any* case.

64. The FSC Replacement scheme is a subsidy programme – that is it is a general measure that gives rise to prohibited subsidies, and mandates the bestowal of such subsidies if certain conditions are met. The EC is contesting it as a general measure that mandates, and does nothing to preclude, the grant of individual subsidies which are contingent upon the use of domestic over imported products. A subsidy programme that gives rise to such subsidies is also prohibited under Article 3.1(b).

Q27. Is the Panel correct in its assumption that the EC's GATT Article III:4 claim is limited to the application of the "foreign content limitation" in the context of the "basic FSC replacement subsidy"? If not, please explain how Article III.4 could be applicable to the "extended FSC replacement subsidy" in light of the fact that Article III:4 relates to less favourable treatment for imported products in relation to laws, regulations and requirements affecting the internal use of such a product.

<u>Reply</u>

66. Yes.

Q28. Is it possible to establish on the basis of the Act itself, and without reference to external facts relating to the manufacture of particular products, that the 50% foreign content rules require a beneficiary in some cases to use domestic over imported goods? If not, and taking into account the view of the Appellate Body in Canada – Certain Measures Affecting the Automotive

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[23] Appellate Body Report, *Canada – Certain Measures Affecting the Automotive Industry ("Canada – Automotive Industry"),* WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, para. 99.

[24] EC first submission, para. 174.

Industry[25] that contingency in law is demonstrated "on the basis of the words of the relevant legislation, regulation or other legal instrument", please explain how the Act could be contingent in law on the use of domestic over imported goods.

Reply

67. The Appellate Body went on to say, after the sentence quoted in the question, that “[a]s we have already explained, such conditionality can be derived by necessary implication from the words actually used in the measure” and referred in its footnote to para. 100 of the Report.

68. Paragraph 100 of the Appellate Body Report states:

> The simplest, and hence, perhaps, the uncommon, case is one in which the condition of exportation is set out expressly, in so many words, on the face of the law, regulation or other legal instrument. We believe, however, that a subsidy is also properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfilment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.

69. Thus, *de iure* export contingency can result “clearly, though implicitly, in the instrument comprising the measure.” In the case before you, on the basis of the words of the law, that is on the basis of the words of the 50 per cent rule, it can be derived that one producer with a given cost structure will have to use US articles.

70. The implications of a law always require knowledge of certain facts (for example that companies want to make profits, that other countries impose taxes etc.). The EC considers that the fact that in the case of some products the value of articles used for production will account for more than half the final value of the product is such a known fact that a requirement to use US articles in such case arises by necessary implication from the terms of the FSC Replacement Act.

71. Identification of the producers who, in practice, need to use US articles is a question of fact, which need not be decided in reviewing a *de iure* claim. At any rate, the EC has provided indications on this matter relative to certain sectors.

Q29. The EC argues that, "if the Panel should not agree that the foreign content limitation applied to foreign producers [leads to the "extended" subsidy being a prohibited export subsidy], the EC argues in the alternative that Article 3.1(b) should be interpreted as also prohibiting the imposition of a foreign content limitation on foreign producers".[26] Article 3.1(b) prohibits subsidies contingent upon the use of domestic over imported goods. In the case of the application of the "foreign content limitation" to foreign producers, the alleged subsidy could be viewed as contingent upon the use of imported over domestic goods. Please comment.

Reply

72. Article 3.1(b) is drafted on the assumption that a government is providing a subsidy to its own companies, which would usually be located within its territory. The words “domestic” and “imported” therefore refer to “national” and “foreign” products. In the unusual case of a subsidy

[25] Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, para. 123.
[26] EC first submission, paras. 181-182.

granted to a foreign company, taking these words literally would give rise to absurd results that do not correspond to the evident intent of the parties.

73. An illustration of the fact that the terms of Article 3.1 must be interpreted from the point of view of the granting authority, rather than that of the recipient, is provided by the *Brazil – Aircraft* case. There the subsidies were granted to foreign airlines contingent upon the purchase of Brazilian aircraft. They were export contingent only from the point of view of the granting authority. From the point of view of the recipient they were rather import contingent.

74. Once it is accepted that the *SCM Agreement* applies to subsidies granted to foreign beneficiaries, a literal interpretation of the words “domestic” and “imported” in Article 3.1(b) gives rise to absurd results, manifestly contrary to the intent of the parties. As explained in the EC’s second written submission, these words must therefore be interpreted, in the context of subsidies to foreigners, as meaning “national” and “foreign” (see also question 29). This is justified under the *Vienna Convention on the Law of Treaties* by the fact that treaties are to be interpreted in good faith. An absurd interpretation is not in good faith.

Q30. The EC states that the Act's foreign content limitation constitutes a "requirement" within the meaning of Article III:4 of GATT 1994.[27] Is the Panel correct in understanding that the EC does not assert that the foreign content limitation constitutes a "law" or "regulation" within the meaning of that provision?

<u>Reply</u>

75. It is a requirement contained in a law. The word “requirement” is sufficiently broad to encompass requirements that are contained in legislative measures, and this is the reason why the EC used it.[28] Of course, this does not mean that the EC is denying, or not asserting, that it is legislative in nature, that is <u>of general application</u> – just as the rest of the FSC Replacement Act, as made clear in the whole of the EC’s argumentation.

Q31. The reference in Article III:4 of GATT 1994 to "laws" and to "regulations" appears to relate to the form of certain measures. By contrast, the term "requirements" could be taken to have implications with respect to the nature of the measures. Please comment.

<u>Reply</u>

76. Indeed, the word “requirement” is focusing on the content of the measure under review.

77. The use of the word “requirement” confirms that Article III:4 also applies to measures that are not in the form of laws or regulations.[29]

78. The EC does not consider that the nature of the prohibition in Article III:4 depends on the form of the measure.

[27] EC first submission, Section 3.7.1.

[28] See e.g. the review of subsidies and other benefits as “requirements” in the *Guide to EC Law and Practice*, Analytical Index, Geneva, 1995, Vol. 1, p. 173, which covers i.a. the legislative requirements addressed in *Italian Discrimination against Imported Agricultural Machinery* and in GATT Doc. L/695 (see *supra*, Question 18).

[29] For example, in *Canada - Autos* the panel found violation of Article III:4 of GATT 1994 with regard to the Canadian value added requirements contained in the Letters of Undertaking from private companies (see para. 10.130 of the Report).

79. In any event, the standard laid down in Article III:4 of GATT 1994 is the same both for "laws" and "requirements".

80. There is some degree of overlap in the words “laws, regulations or requirements” in Article III:4, in the sense that laws and regulations will typically lay down “requirements”.[30] The use of the broad term “requirement” aims presumably to avoid loopholes in Article III:4 coverage, thus to avoid that Members could escape its prohibition by selecting a particular form for their discriminatory measures.

Q32. What is the relationship, if any, between the scope of Article III:4 of the GATT and Article 3.1(b) of the SCM Agreement -- is one necessarily broader than the other-- could a measure fall within the scope of one of these provisions, but not within the scope of the other? Please substantiate your response with reference to past GATT/WTO dispute settlement reports and other materials.

Reply

81. Article 3.1(b) of the *SCM Agreement* has its roots in Article III:4 of GATT. The negotiating history of Article 3.1(b) indicates that the decision to prohibit subsidies covered therein was based on past experience under Article III:4 of GATT.

82. The *EEC – Animal Feed Proteins* case[31] was brought by the US under Article III:4 of GATT and concerned EEC legislation providing for a payment of subsidies to processors of oilseeds whenever they established by documentary evidence that they had transformed oilseeds of Community origin.

83. In the EC’s view there is a difference in scope in the sense that of course, Article III:4 is broader than Article 3.1(b). For example, many measures in breach if Article III:4 (i.e. local content requirements) do not involve a subsidy. It is hard to see how a measure violating Article 3.1(b) of the *SCM Agreement* would not be caught by Article III:4 of GATT 1994.

84. There is one paragraph of the Appellate Body Report in *Canada – Automobiles* that somehow sums this up. The Appellate Body considered Article III:4 as relevant “context” to interpret Article 3.1(b) of the *SCM Agreement* and took the following view:

> First, we note that Article III:4 of the GATT 1994 also addresses measures that favour the use of domestic over imported goods, albeit with different legal terms and with a different scope. Nevertheless, both Article III:4 of the GATT 1994 and Article 3.1(b) of the *SCM Agreement* apply to measures that require the use of domestic goods over imports.[32]

Q33. The EC states that "… the US review of its subpart F legislation is yet to be completed".[33] Please explain whether and how this statement is relevant to the current proceeding.

Reply

[30] For example, para. 1 of the Annex to the TRIMs Agreement states: "TRIMs that are inconsistent with … paragraph 4 of Article III of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, *and which require*…"

[31] Panel Report, adopted 25 January, 1990, 37S/86.

[32] Para. 140 of the Report (emphasis added).

[33] EC rebuttal submission, para. 29.

85. It simply refutes the US contention that the FSC Replacement Act represented the fruit of a review of US taxation of foreign income. It was simply a reformulation of the FSC scheme.

Questions of 16 March

Q34. Is the Panel to understand from Section 4.3.2 of the EC's rebuttal submission that the EC is not relying on the language "whether sole or as one of several other conditions" as a basis for its argument that the existence of "alternatives" to exportation as a means to gain entitlement to the alleged subsidy provided under the Act does not eliminate the alleged export contingency?

Reply

86. That is correct. The EC argument does not depend on these words. The presence of these words does however confirm the EC position.

Q35. Please comment on paragraphs 91, 108, 159 and 170-171 of the US Oral Statement.

Reply

Paragraph 91

87. In paragraph 91 the US argues that the EC arguments would make territorial tax systems export contingent subsidies.

88. This is incorrect. As already explained in the EC's answer to question 23 from the Panel,[34] under a territorial tax system, taxation depends on where income is earned. Income can be earned abroad even where goods are sold into the territory of the taxing country. (See also paragraph 40, second bullet of the second written submission of the EC).

89. Thus, the allegation by the US that export sales are taxed more favourably than domestic sales is incorrect. In addition, in a territorial system, the exemption of foreign-source income from tax does not require that ultimate use of a product (following resale or processing) to be outside the domestic

[34] EC's answer to Panel's question 23:

In a pure territorial system, business profits from domestic sales and exports are taxed in exactly the same way. Income tax is paid on all income generated in the country concerned. If a firm sells to unrelated customers on the domestic and export market, and obtains the same level of profit on both sales, they will be taxed the same.

If the firm sells through a foreign subsidiary on the domestic market, the parent will pay tax on the profit earned by it in selling to the related subsidiary in the transaction. Similarly, if the firm sells through a foreign subsidiary on the export market, the parent will pay tax on the profit earned by it in selling to the foreign subsidiary in the export transaction. In both case, the profit earned by the foreign subsidiary in these transactions through its activities in the country where it is located is not subject to tax on this profit in the country that applies the pure territorial system. This is because territorial systems tax only income earned from activities in its territory. The separation (attribution) of income is made on an objective basis – at arm's length (i.e. as if the transaction was concluded according to the commercial and financial terms, which would apply between unrelated parties). Unlike the FSC Replacement Act, a pure territorial system does not exempt income generated by activities undertaken within the territory, be it export or any other activity. Therefore, there is no revenue forgone and no subsidy."

market. A territorial system taxes income from economic activity – the final destination of the product is irrelevant.

90. Under the FSC Replacement scheme, taxation depends on whether goods are sold not "for ultimate use in the US". In the case of US goods, this necessarily means that they have to be exported.

91. Such export contingency is not a necessary feature of a worldwide tax system. Both territorial and worldwide systems are normally export neutral. Both are based on perfectly defendable and yet conflicting desires to achieve tax equity.

92. As the EC explained during the course of the original proceeding, the worldwide approach is sad to seek capital-export neutrality and the territorial approach capital-import neutrality.

93. According to the principle of capital-export neutrality, it is considered inequitable that taxpayers should pay less tax when establishing themselves abroad and a country should design its international tax rules so as to neither encourage nor discourage outflows of capital. According to the principle of capital-import neutrality, it is considered inequitable for companies establishing themselves abroad to be subject to a higher tax burden because of their links to the capital exporting country and a country should therefore adopt international tax rules that seek to avoid its multinational companies bearing a higher effective tax burden in foreign markets than the local domestic companies or the multinational companies of other countries.

94. Both systems have a rational basis and choosing one or the other cannot by itself, in the view of the EC, give rise to a subsidy. As the Panel observed in the original proceedings:[35]

> Thus, the United States is free to maintain a world wide tax system, a territorial tax system or any other type of system it sees fit. This is not the business of the WTO. What it is not free to do is to establish a regime of direct taxation, provide an exemption from direct taxes specifically related to exports, and then claim that it is entitled to provide such an export subsidy because it is necessary to eliminate a disadvantage to exporters created by the US tax system itself.[36] In our view, this is no different from imposing a corporate income tax of, say, 75 per cent, and then arguing that a special tax rate of 25 per cent for exporters is necessary because the generally applicable corporate tax rate in other Members is only 25 per cent.

Paragraph 108

95. In paragraph 108, the US claims, in answer to the EC claim under item (e), not to understand how a measure that makes no reference to exportation, does not require exportation, and applies to a broad range of non-export transactions can be said to be "specifically related to exports."

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[35]Panel Report, paragraph 7.122.

[36] The Panel's footnote reads:

As the Appellate Body has stated, "Members of the WTO are free to pursue their own domestic policy goals through internal taxation or regulation *so long as they do not do so in a way that violates Article III or any of the other commitments they have made in the WTO Agreement*" (emphasis added). *Japan – Taxes on Alcoholic Beverages*, WT/DS8/AB/R-WT/DS10/AB/R-WT/DS11/AB/R, Report of the Appellate Body adopted on 1 November 1996, p. 16.

96. The EC has already explained that the FSC Replacement scheme does require exportation even though it does not use the word "exportation" or "exports".[37]

97. The word "specifically" does not mean "expressly". It means, "having a special, precise or clearly defined relationship or connection to exports." [38]

98. The basic FSC Replacement subsidy (relating to US goods) has such a relationship to exports because it is necessary to export in order to benefit from the scheme. The extended FSC Replacement subsidy (relating to foreign-produced goods) has such a relationship because in many cases it will be necessary for US goods to be exported as components or raw materials in order to respect the foreign content limitation.

Paragraph 159

99. In paragraph 159 the US seeks to respond to the EC argument that the statements of the Appellate Body in Canada – *Automotive Products* (where the Appellate Body considered that a measure requiring 60 per cent domestic value does not necessarily lead to a conclusion of *de jure* contingency) were not pertinent in the present case, since the FSC Replacement Act is a legislative measure applying to an undetermined and unlimited series of instances whereas the *Canada – Automotive Products* case concerned *individual measures*, each one applying a specific local content requirement to individual companies.[39]

100. The US argues that the EC "misses the most significant feature" of the *Canada – Automotive Products* decision which is, according to the US, that "the Appellate Body concluded that it could not determine whether a value-based requirement was *de jure* contingent on the use of domestic over imported goods without understanding how the measure actually operated."

101. The US simply fails to respond to – indeed misses – the EC's point. That is that the FSC Replacement scheme is attacked a legislative measure *as such* not in its application to particular goods or companies. In such a case all that the EC has to show is that contingency on the use of domestic over imported goods can arise – or is not precluded.

Paragraphs 170 – 171

102. In paragraph 170 the US refers back to paragraphs 217-218 of its first written submission and to the panel and Appellate Body reports cited therein, allegedly supporting the US contention that "generally applicable measures" give rise to a higher evidentiary burden than measures concerning a "specific class of imported products".

103. In its second written submission the EC has refuted the US contention about two evidentiary standards under Article III:4 GATT of 1994, which has no basis in the text of that provision, and has shown that the standard required is the one most recently articulated by the Panel in *Canada – Autos*.[40] Previous panels have relied indifferently on panel reports dealing with product-specific and

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[37] E.g. first written submission of the EC, paragraph 71. It is worth noting that the definition of "qualifying foreign trade property" in the FSC Replacement Act is in this respect identical to the definition of "*export* property" under the FSC, which read "The term "export property" means property …(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct *use, consumption, or disposition outside the United States*." (emphasis added) The US had therefore no difficulty in using the word "export" to designate property "for disposition outside the United States".

[38] First written submission of the EC, paragraph 153.

[39] Second written submission of the EC, paragraph 171 to 173.

[40] Referred to in the first written submission of the EC, paras. 201-204; second written submission of the EC, para. 232.

with general measures.[41] This is most logical since otherwise WTO Members could easily circumvent the prohibition in Article III:4 of GATT 1994 by turning a series of product-specific measures – allegedly easier to challenge - into one single measure of general application.

104. Whatever its content, the US categorization is therefore plainly irrelevant to review the EC's Article III:4 claim.

105. Nonetheless, in view of the Panel's request the EC wishes to recall the following. In paragraphs 217-218 of its first written submission (referred to in paragraph 170 of the US oral statement) the US had exemplified its newly created category of requirements applicable to a "particular class of imported products" by referring to the *Canada – Autos* and *US – Gasoline* panel reports.[42] These reports were clearly concerned with product-specific measures (relating to cars and other motor vehicles in the former case, and to gasoline in the latter one). It follows that the phrase "particular class of imported products" means "product-specific measures", as those at issue in the two panel reports cited. The US then contrasted this category with that of "generally applicable measures".

106. In paragraph 171 of its Oral Statement the US appears to have changed the meaning of its self-created category of measures relating to "particular class of imported products", since it now employs that term to designate the measures reviewed in *EEC - Parts and Components*.

107. As explained by the EC,[43] the measures reviewed in *EEC - Parts and Components* did <u>not</u> relate to a "particular class of imported products", but applied horizontally to all possible components used in the production of all possible products subject to anti-dumping measures. Indeed, those measures were strikingly similar to the foreign content limitation laid down in the FSC Replacement Act, which applies to all possible products that can be exported from the US and used for the production of qualifying foreign trade property. [44]

108. As a last point, the EC notes that the US keeps referring to the panel report in *Japan - Film*[45] in support of its argumentation for a "heightened evidentiary burden". The EC would point out that in the very paragraph referred to by the US[46] the panel found that the measures challenged by the United States were <u>origin-neutral</u> and that the US had not shown that, notwithstanding their not being discriminatory on their face, these measures had a differentiated impact on imported products (i.e., it had not established a *de facto* case).

109. The situation before the panel in *Japan - Film* was therefore opposite to the present case. The EC has brought a *de iure* claim against a statutory requirement which is origin-based, since it specifically places a limit on <u>foreign</u> products only.

110. Therefore, referring to the "disparate impact" of these measures "in their application" on imported products is totally inapposite in this dispute. As noted by the panel in *Canada - Automotive Products*

[41] First written submission of the EC, para. 201; Oral Statement of the EC, para. 87. For example, in *Canada - Autos* the panel refered to *US - Section 337* (where a general measure was at issue) in para. 10.78 of its report.

[42] Similarly, in para. 218 the US refers to "like class of imported goods".

[43] Second written submission of the EC, paras. 240 ff.

[44] In any event, it is hard to see how a measure involving "imported component parts" could be termed as "involv[ing] a <u>specific</u> class of imported products", or indeed a "class of products" at all. There are products which can indifferently be sold and used in the state as they are or used as components in the production of other products. Thus, a category of that type would be undefined and open-ended.

[45] Panel Report, *Japan – Measures Affecting Consumer Photographic Film and Paper* ("*Japan - Film*"), WT/DS44/R, adopted 31 March 1998.

[46] Panel Report, *Japan – Film*, para. 10.381.

> 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. [47]

111. The EC would further point out that the only "meaningful nexus" referred to in that paragraph of the *Japan – Film* panel report is between two of the measures challenged by the US and the pre-existing market structure. Examination of the market structure pre-existing the adoption of a measure is not relevant to review a *de iure* claim.

112. The Panel will have also noticed that the phrase "heightened evidentiary burden" is nowhere used in the *Japan – Film* panel report.

113. The EC would also note that the *Japan – Film* report also supports its conclusions by referring to the *US - Section 337* panel report - that is, a report reviewing a measure which can genuinely be defined "of general application" .

Q36. In regard to the "extended" FSC Replacement subsidy scheme, is there "revenue forgone" that is "otherwise due"? What is the US legal rule that would apply to the foreign beneficiary of the extended scheme in the absence of the "extended" scheme? What is the "some other situation" for foreign beneficiaries of the "extended" regime, in which their income would be subject to the US taxation? If, in the EC's view, it is different from the legal rule -- normative benchmark -- applicable to the "basic" subsidy scheme, please specify.

Reply

114. The "some other situation" or applicable benchmark in the case of the extended FSC Replacement subsidy is that which would prevail if the conditions for obtaining the benefit of the FSC Replacement scheme were not fulfilled. That is the situation that would prevail if the goods were "for ultimate use in the United States" or if the foreign content limitation were not respected.

115. In these cases, the income from the transactions would not be "excluded" from tax but would be taxable under the generally applicable rules.[48]

116. In the case of US taxpayers (i.e. where a transaction is carried out by a foreign branch of a US corporation or involves distribution activities carried out in the US relating to foreign produced goods), the income would be taxable under Section 11 of the IRC[49] in conjunction with Section 61 (see further the answer to question 37 below).

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[47] *Canada - Automotive Products*, Panel Report, para. 10.82.

[48] In this and the next question, the EC will refer to provisions of the US law. The US has provided some of the provisions in its Exhibit US-4. Others are supplied in Exihibit EC-21. If the Panel wishes to consult other provisions of the IRC, it may wish to know that they are available on the internet (e.g. at www.fourmilab.ch/ustax/www/contents.htlm).

[49] Extracts from the IRC that are not already before the Panel are contained in Exhibit EC-21.

117. If a foreign corporation conducts the transaction, the income produced from the transaction would, if the FSC Replacement scheme did not apply, not normally be directly taxable in the US.

118. Foreign corporations only pay tax in the US on income "from sources within the US" (i.e. US source income) under section 881 of the IRC and on income "effectively connected with a US trade or business" under section 882 of the IRC. In this connection it may be noted that the definition of what is US source and foreign source (i.e. from "sources without the United States") is contained in sections 862 of the IRC.

19. Thus the foreign-source income of a foreign corporation that is not effectively connected with a trade or business in the US is not directly taxable in the US.

120. If the foreign corporation is a subsidiary of a US corporation, the income would be taxable when remitted to the US as dividends (section 61(a)(7) makes dividends received part of gross income). The dividends received deduction in section 243 of the IRC does not apply to dividends received from non-taxpayers such as the foreign subsidiary. The parent corporation may even have to pay tax earlier on deemed dividends if the anti-deferral provisions of sub-part F of the IRC are applicable.

121. The corporation may however, under the generally applicable US rules, claim a foreign tax credit for the tax borne outside the US but this is limited to foreign source income (section 904 of the IRC).

122. If a foreign corporation that is not a subsidiary of a US corporation conducts the transaction, the income would not be taxable in the US either directly or indirectly. In this case the application of the FSC Replacement scheme would not give rise to a subsidy because no revenue would be forgone.

123. The EC accepts that the extended FSC Replacement subsidy will in many cases not give rise to revenue forgone, in fact that it might only rarely do so. That is because deferral of tax on the income of a foreign subsidiary may, when it is available under US rules, often be more advantageous than the FSC Replacement scheme and because foreign corporations that are not subsidiaries of US corporations will not be subject to tax in the US on their foreign source income and will not therefore have any interst in using the (extended) FSC Replacement scheme. However, the extended FSC Replacement scheme is elective and it is clear that companies will only invoke it where it gives rise to a reduction in taxation. That is why it is a subsidy no matter how rarely it may be used.

Q37. What is the US “norm” which can constitute a “normative benchmark” for the purpose of Article 1 of the SCM Agreement? Can the EC specifically identify any US tax rules in addition to the new Section 941(a)(1) of the IRC, which defines the term “qualifying foreign trade income”? In other words, what is the statutory basis for the EC’s argument that the US is still maintaining its "worldwide" tax system?

Reply

124. One starting place for this analysis could be the US Constitution. The power to impose income taxes is derived from the Sixteenth Amendment to the Constitution.[50] It states in pertinent part that:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived... .

[50] The full text of amendment XVI is

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census of enumeration.

125. From the earliest days of the income tax, the Supreme Court has made it clear that this includes the power to tax the foreign source income of US citizens.[51]

126. Section 61 of the Internal Revenue Code[52] embodies the exercise by Congress of the broad power given to it by the Sixteenth Amendment. Section 61 states in pertinent part that

> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived... .

127. The Supreme Court has commented on the "sweeping scope" and "pervasive coverage" of the provision now codified in section 61, stating that "the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted."[53]

128. It should be noted that "taxable income" is defined in section 63 of the IRC as "gross income minus the deductions allowed by this chapter... ." And section 11 of the IRC specifies that corporations are subject to tax on their "taxable income." Thus US corporations are subject to tax on income "from whatever source derived... ."

129. This state of affairs is recognized by the various treatises on US taxation of foreign operations. For example, one treatise states that:[54]

> The United States generally taxes U.S. citizens, resident alien individuals, and domestic corporations on their worldwide incomes.

130. Another states that US domestic corporations:[55]

> are taxed by the United States on their worldwide incomes.

131. The maintenance of the world-wide taxation system by the US is also recently (in December 2000, that is, after the adoption of the FSC Replacement scheme) clearly recognised in a study prepared by the US Treasury on “the Deferral of Income Earned Through US Controlled Foreign Corporations”[56]. The fact that the US continues to have a tax system which is fundamentally based on current taxation of world-wide income of US taxpayers is in fact and according to the study the underlying reason for the need of anti-deferral measures (Subpart F of the IRC). This state of affairs is reflected throughout the study, of which the conclusions also suggest that as the US tax system continues to be based on the principle of current taxation of the world-wide income of US taxpayers and as corporations are treated as separate taxpayers and separate legal entities from their owners, there is a continuous need for anti-deferral regime in the US tax system. By way of example, in Chapter 8 of the study (Restatement of Conclusions) in relation to the background of the subpart F legislation it is stated:

> …subpart F was, more generally, one in a series of measures addressing tax avoidance problems caused by a structural tension in the tax system. This tension is

[51] See *Cook v. Tait*, 265 US 47 (1924).

[52] Text in Exhibit US-4.

[53] *Commissioner v. Glenshaw Glass Co*., 348 US 426 (1955).

[54] Kuntz and Peroni, *U.S. International Taxation*, vol. 1, at p. A1-19 (1992).

[55] Isenbergh, *International Taxation: U.S. Taxation of Foreign Persons and Foreign Income*, vol. 1, at p. 2:32 (2nd ed. 2000).

[56] *The Deferral of Income Earned Through US Controlled Foreign Corporations; A Policy Study*. Office of Tax Policy Department of the Treasury, December 2000, Chapter 8 (Restatement of Conclusions of this voluminous study is attached as Exhibit EC-22 – the EC would be happy to provide a complete copy if the Panel wishes).

> caused by the incompatibility of *certain fundamental features of the U.S. tax system, principally the current taxation of worldwide income* and the treatment of corporations as taxpayers and legal person separate from their owners. *These incompatible features are still a fundamental part of the U.S. tax system*.[57]

132. A relatively short list of items specifically excluded from gross income is set forth in sections 101 through 139 of the Code. The FSC Replacement Act added section 114 to that list. In keeping with their view that, in enacting the Internal Revenue Code, Congress intended to exercise quite fully its power to tax income, the Courts have long held that provisions granting deductions or exclusions of items from gross income are "matters of legislative grace" and are therefore to be "strictly construed."[58]

133. The EC has explained that section 114(a), in conjunction with the other conditions set out in the FSC Replacement Act, creates a fairly narrow exception to the general rule of US taxation of worldwide income.

134. In some respects, section 114 is similar to section 911 of the IRC. Section 911(a) states, in seemingly expansive terms, that the foreign earned income of a US citizen residing abroad is, at the election of such individual, to be excluded from such individual's gross income. Section 911(c), however, limits the amount that may be excluded to a stated annual amount ($78,000 in 2001).

135. Just as the US section 911 does not create a normative benchmark of non-taxation of the foreign earned income of US citizens resident abroad (particularly in light of the limitation and the elective nature of the exclusion), so also the new section 114(a) does not do so. Indeed, in both cases the existence of a limited exclusion or exemption in fact *confirms the general rule* of taxation.

136. The term "qualifying foreign trade income" is a creation of the new legislation. It is not a concept used elsewhere in the Code. Thus the statutory provisions that would apply to “qualifying foreign trade income” in the absence of the FSC Replacement scheme is section 11 of the IRC specifies that corporations are subject to tax on their "taxable income."

137. Finally, the EC would refer the Panel to the many reasons that the EC gave in paragraphs 40 to 52 and 55 of its first written submission to show that the exclusion of income from under the FSC Replacement scheme was in reality an exception and not the general rule.[59] Most significant perhaps is the fact that under the FSC Replacement Act (new section 941 of the IRC) provides that only a certain portion of US taxpayers income attributable to foreign trading gross receipts qualifies for the exclusion, i.e. the exclusion is only partial.

138. The EC submits that it is therefore clear that the FSC Replacement scheme does not represent the benchmark or the general rule but is an exception to it.

Q38. In paragraph 185 of the US Oral Statement, the US argues that “[a]s reflected in Article 19.1 of the DSU, the WTO does not provide retroactive relief for alleged past wrongs.” Please comment, in particular, on the US reference to DSU 19.1 and its relevance to the instant case.

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[57] *Id.*, page 96, emphasis added.

[58] See, e.g., *Interstate Transit Lines v. Commissioner*, 319 U.S. 590 (1943); *Jones v. Kyle,* 190 F.2d 353 (10th Cir. 1951), cert. denied, 342 US 886.

[59] An additional reason which the EC did not mention in its first written submission is the fact that the FSC Replacement scheme does not apply to property which is considered in short supply (and of which the Us does not want to encourage the export). See paragraph 15 of the closing statement of the EC to the meeting of the Panel.

Reply

139. Panel reports inevitably relate to facts that lie in the past. In some cases violations may be continuing and in others they will have terminated.

140. There is no general principle in the WTO that panels cannot rule on violations that have terminated. Not only is there no provision in the WTO to this effect, panels regularly do rule on terminated violations. The EC will give two recent examples:

➢ in *Korea – Dairy* violations of the notification deadlines in the *Safeguards Agreement* were found despite the fact that the notifications had been made prior to the request for the establishment of the panel;[60]

➢ In *United States – Import Measures*[61] violations of a series of WTO provisions were found despite the fact that the measure (provisional suspension of liquidation on certain imports from the EC) had ceased to exist prior to the request for the establishment of the panel.

141. The US seeks to derive such a principle from the fact that the WTO does not provide for retroactive remedies which it considers is reflected in Article 19.1 of the *DSU*.

142. However, the EC is not requesting any "remedy" in this proceeding. It is asking for a disagreement to be adjudicated. The DSB adopted the Panel and Appellate Body reports declaring the FSC scheme to be inconsistent with the obligations of the US under the *WTO Agreement* on 20 March 2000. It required the US to withdraw the subsidy and bring itself into conformity with its obligations with effect from 1 October 2000 and ultimately required the US to adopt the necessary measures by 1 November 2000.

143. Although the US failed to adopt the necessary measures by 1 November 2000, it persists in arguing that it "complied with the time period specified by the DSB."[62] The EC disagrees and asks the Panel to rule on this disagreement.

144. If the US were correct in its contention, panels would in particular never be able to rule on disputes concerning exclusively the *timeliness* of any measure (rather than its existence) since such disputes would relate to violations that have terminated. The timeliness of implementation is one of the matters that a panel is required to decide under Article 21.5 of the DSU.

145. The question of what, if any, recommendation a panel makes in such a case is a separate matter that only arises once it has decided the nature and extent of the violations. This is demonstrated by the fact that panels can make findings and then not find it necessary to make any recommendations, as the Appellate Body did, for example, in *United States – Import Measures*.[63]

146. Generally, panels established under Article 21.5 *DSU* are not called upon to make recommendations under Article 19.1, but simply to make findings and adjudicate the disagreement

[60] Panel Report, *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products ("Korea – Dairy Safeguards")*, WT/DS98/R, adopted 12 January 2000, as modified by the Appellate Body Report, WT/DS98/AB/R, para. 8.1.

[61] Panel Report, *United States – Import Measures on Certain Products from the European Communities ("United States – Import Measures")*, WT/DS165/R, adopted 10 January 2001, WT/DS165/AB/R, para.7.1.

[62] First written submission of the US, Section V. H. 2 (esp. heading).

[63] Appellate Body Report, *United States – Import Measures on Certain Products from the European Communities ("United States – Import Measures")*, WT/DS165/AB/R, adopted 10 January 2001, para. 129.

relating to implementation. As the Article 21.5 panel in *Canada – Aircraft* stated (when requested to make a suggestion under Article 19.1):[64]

> In our view, Article 19.1 envisions suggestions regarding what could be done to a measure to bring it into conformity or, in the case of Article 4.7 of the SCM Agreement, what could be done to "withdraw" a prohibited subsidy. It does not address the issue of surveillance of those steps. For that reason, we decline to make the suggestion requested by Canada.

147. The EC would remind the panel that Mr Suringa's statements reported by the BNA Daily tax report (see EC-Exhibit 14), and confirmed during the hearing, indicate that implementing regulations and guidance about three primary elections under the FSC Replacement Act are not issued yet. This statements put into question whether in fact the US has implement the DSB recommendations and rulings at all and leaves open the question of when the US will do so.

Q39 In the EC's view, would the Act be consistent with the SCM Agreement if the United States eliminated the requirements that the property be held for use "outside the United States" and the "foreign content limitation"?

Reply

148. Yes, there would no longer be a prohibited subsidy within the meaning of Article 3 of the *SCM Agreement*.

Questions for both parties

Q43. Can a measure of a Member provided in respect of the production of a good outside the territory of that Member be a subsidy within the meaning of Article 1 of the SCM Agreement? Please explain your answer, taking into account any relevant provisions of the SCM Agreement.

Reply

149. Article 1.1(a)(1) of the *SCM Agreement* provides that:

> For the purpose of this Agreement, a subsidy shall be deemed to exist if:
>
> there is a financial contribution by a government or any public body *within the territory of a Member*

150. The italicised words in Article 1.1(a)(1) above qualify the nature of "public body" that may also give a subsidy. It does not imply a territorial limitation on where a "financial contribution" may be given or received. If this had been meant a different word order would have been used.

151. The ordinary meaning of the text is confirmed by the negotiating history. The original Chairman's text of 18 July 1990[65] referred only to a "financial contribution" in defining a subsidy in the then Article 3.1(a). The next revision of the text[66] clarified the definition as "a financial

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[64] Article 21.5 Panel Report, *Canada – Measures Affecting the Export of Civilian Aircraft ("Canada – Aircraft")*, WT/DS70/RW, adopted 4 August 2000, as upheld by the Appellate Body Report, WT/DS70/AB/RW, para. 6.4.

[65] Doc. MTN.GNG/NG10/W/38 of 18 July 1990.

[66] Doc. MTN.GNG/NG10/W/38/Rev of 4 September 1990.

contribution by a government or any public body within the territory of a signatory (hereinafter referred to as "government").

152. This definition, while clarifying and arguably expanding the definition of government, qualified the definition of subsidy by making it clear that a financial contribution by a public body *outside* the territory of the Member concerned did not constitute a subsidy.

153. In any event, a financial contribution from a government, at least when created through the forgoing of revenue collected by that government, will always arise in the territory of the granting Member, since that is where the government in question is situated.

154. There is, on the other hand, no limitation in the text of the other component of a subsidy in Article 1 of the *SCM Agreement*, as to where this benefit should be conferred.

155. Where a taxpayer that benefits from the FSC Replacement scheme is situated outside of the US, it may be considered that the benefit is conferred outside the US. But nothing in the text of Article 1.1(b) of the *SCM Agreement* suggests that only benefits conferred within the territory of the granting Member are relevant. On the contrary the fact that the words “within the territory of a Member” do not apply to benefit in Article 1.1(b) although they are a feature of “financial contribution” in Article 1.1(a), implies that there is no territorial limitation on where the benefit can be enjoyed.

156. This was also, as the EC observed in paragraph 65 of its first written submission, the view taken by all the parties, the panel and the Appellate Body in the *Brazil-Proex* case, which also involved a subsidy granted to foreigners (foreign airlines).

157. The EC is aware that the US treats so-called "transnational subsidies" as being in principle non-countervailable under section 351.527 of the US countervailing duty legislation.

158. The EC doubts whether this non-countervailability of “transnational subsidies” is required under Part V of the *SCM Agreement* on countervailing duties. It notes that Part V does not limit participation in countervailing duty investigations but extends this to all “interested Members,” so that the non-subsiding country of export would also be able to participate. The EC takes no position on this question but would only point out that the difficulties that arise when applying a countervailing duty in such circumstances do not exist in the case of prohibited or actionable subsidies. This is because a countervailing duty can only be imposed on the country *exporting* the goods in question, which in the hypothesis under consideration is not responsible for the grant of the subsidy. A WTO dispute settlement proceeding concerning a prohibited or an actionable subsidy would however be brought against the country granting the subsidy (in this case, the US), not against the country in which the primary beneficiary of the subsidy is situated (in this case, the country of the foreign corporation).

159. Even if one were to construe Article 1 of the *SCM Agreement* as only relating to subsidies for the production of goods within the territory of the Member responsible for the measure, it would still be necessary to consider that the extended FSC Replacement subsidy was a prohibited export subsidy.

160. The FSC Replacement scheme is a direct subsidy to the production not “for ultimate use within the US” of qualifying foreign trade property. But the foreign content limitation also makes it an *indirect* subsidy to the production in the US of raw materials and components (“articles” in the words of the FSC Replacement Act) of all kinds that can be utilised in making qualifying foreign trade property while respecting the foreign content limitation.

161. In the case of the extended FSC Replacement subsidy, the *indirect* subsidy to the production in the US of articles of all kinds that can be utilised in making qualifying foreign trade property is

contingent upon export. It is contingent upon export because in those cases where articles make up more than 50% of the fair market value of the foreign produced goods, it will be necessary for goods to be exported from the US in order for the foreign content limitation to be respected.

162. It may also be noted that, according to the US itself, the extended FSC Replacement subsidy is also available to US companies that distribute from the US qualifying foreign trade property manufactured outside the US.

Q44. Assume for the sake of argument that the answer to question 43 is no. What relevance, if any, would such a conclusion have in respect of the issues of export contingency which are before the Panel in this dispute?

Reply

163. As explained in the answer to the last question, the extended FSC Replacement subsidy would still be an indirect subsidy to US articles which is contingent upon them being exported.

164. It would also have no effect on the export contingency of the basic FSC Replacement subsidy.

165. As the EC has argued at length, the fact that an advantage can in some circumstances be obtained without exporting does not stop it being export contingent in those circumstances where export is a necessary condition for obtaining the subsidy.[67] An export contingent subsidy does not cease to be so if it is included in a wider measure whereby a similar advantage is granted in an unobjectionable manner.

166. The extended FSC Replacement subsidy and the basic FSC Replacement subsidy are available in mutually exclusive circumstances – a good is either produced within the US or outside the US.

167. These arguments only become stronger if the tax advantage given to transactions involving foreign-produced goods is not considered to be a subsidy at all (and therefore not relevant for the purposes of the *SCM Agreement*). After all, the "advantage" of not paying tax can also be obtained by not producing any goods at all or by not making any profit on the sale of goods that are produced. This is clearly not a subsidy and is irrelevant for the purposes of the *SCM Agreement*.

Q45. Is export income foreign source income? Some may take the view that the "foreign-source income" referred to in footnote 59 should include export income since the footnote is accompanying item (e) that is dealing with a type of subsidy specifically related to export. Please comment.

Reply

168. The last sentence of footnote 59 is written in declaratory language:

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

169. It makes clear, for the case that there should be any doubt, that such measures are not prohibited export subsidies. This can be understood from the historical context represented by the

[67] First written submission of the EC, paragraphs 62 to 66 and 123 to 127, second written submission of the EC, paragraphs 8 to 15 and the oral statement of the EC, paragraphs 35 to 38.

decision in the panel reports in the *Tax Legislation* cases, which suggested that such measures could in some cases be export subsidies for the purpose of Article XVI:4 of GATT 1947.

170. If the sentence were intended to *derogate* from item (e) it would have been drafted differently, for example:

> Measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member shall not be considered export subsidies.

171. Indeed, to have the effect argued by the US item (e) it should have been drafted to read:

> The exemption, remission, or deferral of tax specifically on export income shall not be considered an export subsidy if related in some way to measures to avoid the double taxation of [foreign-source] income earned by its enterprises or the enterprises of another Member.

172. And clearly the foreign-source reference would have to be omitted as well.

173. Export income is not, by definition, foreign-source income. Export income represents the difference between the price of a product sold to a customer in a foreign country and the cost of producing that product. Therefore, although the customer is foreign, the costs are incurred by domestic economic activity and the income is therefore generated domestically. This point has been made in paragraph 206 of the EC's second submission and by Canada in its third party submission (paragraph 34). Indeed, Canada aptly describes it as "domestic income from export transactions".

174. It is hard to conceive of a situation in which such income would be subject to taxation by another Member, because none of the economic activity has been carried out in a foreign country.

List of Exhibits

EC-21 Extracts from US legal texts

EC-22 Extract from *The Deferral of Income Earned Through U.S. Controlled Foreign* Corporations*; A Policy Study*. Office of Tax Policy Department of the Treasury, December 2000. Chapter 8, Restatement of Conclusions.

ANNEX F-2

ANSWERS OF THE EUROPEAN COMMUNITIES TO THE QUESTIONS OF THE UNITED STATES

(27 March 2001)

Q1. What is the "prevailing standard" or "general rule" of taxation in a country which taxes some persons on a worldwide basis and some persons on an exemption basis, in some cases at their election (and subject in such cases to the discretion of the government)? Please explain the basis for your answer.

Reply

1. The EC finds it impossible to answer this question. It is not possible to extract a “general rule” or a prevailing standard” from one isolated feature of a tax system.

Q2. Is the tax exemption by a country of "foreign-source income" (for purposes of footnote 59) permissible under the SCM Agreement only if all "foreign-source income" is exempt from tax? Please explain the basis for your answer.

Reply

2. The last sentence of footnote 59 to the SCM Agreement does not require that all foreign-source income be exempted from tax.

3. However, as the EC has explained[1] , a tax system that a provides a more advantageous means of avoiding double taxation restricted to certain privileged taxpayers may be providing a subsidy and it may be that this subsidy is not covered by the terms of the last sentence of footnote 59 to the SCM Agreement.

Q3. Would the Act confer subsidies contingent upon export performance in the absence of §§ 942(a)(2)(A)(i) and 943(a)(1)(B) and (C)? Please explain the basis for your answer.

Reply

4. The EC refers the US to its answer to the same question from the Panel (number 39).

Q4. Are the EC member States prepared to relinquish all source-based taxation with respect to business profits in the absence of a "permanent establishment," as that term is defined in Article 5 of the OECD Model Income Tax Convention?

Reply

5. Nothing in the WTO Agreement prevents Members from taxing whatever they wish so long as they do not grant prohibited or specific and injurious subsidies.

6. However, the definition of a permanent establishment in Article 5 of the OECD Model Tax Convention is the basis of the respective provisions taken into all modern bilateral or multilateral tax

[1] First written submission of the EC, paragraph 221 and EC answer to Panel question number 16.

treaties concluded by EC Member States with other countries, that is to say, into the vast majority of all tax treaties entered into by the EC Member States. The EC Member States do observe these treaties and thus, do not seek to tax business profits of enterprises of their treaty partners unless these maintain permanent establishments in the EC Member States in question. The business profits in such cases are only taxed to the extent that they are attributable to such permanent establishments.

7. Accordingly, for example, where a US enterprise exports goods to a EC Member State, without maintaining a permanent establishment in this EC Member State the profits derived from the export activities of the US enterprise are not chargeable to tax in that EC Member State. Similarly, even if the US enterprise did maintain a permanent establishment in the EC Member State in question but no part of the profits derived from the exports to that EC Member State were attributable to that permanent establishment, the EC Member State would not tax the business profits derived from the export activities of the US enterprise.

Q5. Do most countries, under their own domestic statutes and regulations, condition source-based taxation of business profits upon the maintenance by a foreign enterprise of a "permanent establishment," as that term is defined in Article 5 of the OECD Model Income Tax Convention, within their territorial limits? Please explain the basis for your answer.

Reply

8. Not only is not possible for the EC to verify the concordance of the jurisdictional standards contained in all countries domestic statutes and regulations with the ‘permanent establishment’ standard, it is also not necessary for the resolution of the present dispute.

9. It is a well-known fact that Article 5 of the OECD Model Tax Convention and its commentary have had a significant ‘harmonising’ effect on the definition and the interpretation of the concept of a permanent establishment both in the bilateral tax treaties and in the national legislation of a large number of countries. This is in particular the case in industrialised countries with relatively sophisticated tax systems but also in many developing countries, either because of the endorsement of Article 5 of the OECD Model as such or because it has served as the basis for the equivalent Article (Article 5) of the UN Model Tax Convention. It is therefore that under these national provisions the permanent establishment concept is commonly used for the purpose of determining the limits of the taxing rights of a source country over the business profits of an enterprise resident in another country.

10. More importantly, the vast majority of the approximately 2000 mainly bilateral tax treaties which exist world-wide rely, as far as the definition of a permanent establishment and thus the source country’s right to tax the business profits of an enterprise resident in the other Contracting State is concerned, on the standard definition of the permanent establishment concept in Article 5 of the OECD Model Tax Convention. As these bilateral (or multilateral) treaties are agreements between independent countries, they are subject to the rules of public international law, in particular to the Vienna Convention.[2] Their status as a matter of national law varies but as a main rule they prevail over any conflicting national rule. In cases where under a particular legal system the national legislators have, in principle, the freedom to override such treaties, they are careful not to do so and in the absence of clear intention to override a treaty the national courts tend to assume an intention to observe it.

11. Given the large number of existing bilateral tax treaties and the fact that they cover the vast majority of such bilateral relationships in which the greater part of international trade and investment take place, the significance of the national rules of countries in respect of the conditions under which a source country may tax the business profits of an enterprise resident in another country is very

[2] The Vienna Convention on the Law of Treaties of 22 May 1969.

limited. This is because conflicting national rules, if any, would and could not be enforced wherever there is a treaty.

12. Additionally, many countries have incorporated into their national legislation rules defining the existence of a permanent establishment that is based on the definition in Article 5 of the OECD Model. Thus, for example many European Member States apply the same standards for the purpose of defining their taxing rights over the business profits of enterprises resident in countries with which they have not concluded bilateral tax treaties as they do in treaty situations.

Q6. Does the OECD Model Income Tax Convention contain a definition of the term "foreign-source income"? If so, please identify the provision containing such definition.

Reply

13. The OECD Model Income Tax Convention does not use the term "foreign-source income" as such. The OECD Model Convention expresses the same concept in different ways – as does the US IRC, which uses the expressions “sources within the US” and “sources without the US”.

14. Thus, for example, Article 4 of the OECD Model Convention (Resident) states:

For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is- liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

ANNEX F-3

ANSWERS OF THE UNITED STATES TO QUESTIONS FROM THE PANEL

(27 March 2001)

Preliminary Comment

1. Before addressing the Panel's questions, the United States first would like to comment briefly on the exhibits attached to the EC's closing statement of 16 March 2001. If the Panel were to consider this information, it tends to support, rather than undermine, the US position.

2. With respect to EC-19, which consists of a copy of pages from the 14 November 2000 edition of the *Congressional Record* dealing with the floor debate in the US House of Representatives on the bill that became the FSC Replacement and Extraterritorial Income Exclusion Act of 2000 ("the Act"), the United States should clarify for the Panel the significance of floor statements in discerning legislative intent under US law. While in appropriate situations courts may consider floor statements, as a general proposition, floor statements are treated as decidedly inferior to committee reports. This proposition was best expressed by the US Supreme Court – the highest court in the US judicial hierarchy – in *Garcia v. United States*, 469 US 70, 76 (1984) (copy attached as Exhibit US-19), in which the Court stated:

> In surveying legislative history we have repeatedly stated that the authoritative source for finding the Legislature's intent lies in the Committee Reports on the bill, which "represent[t] the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation." We have eschewed reliance on the passing comments of one Member, and casual statements from the floor debates. In *O'Brien*, we stated that Committee Reports are "more authoritative " than comments from the floor, and we expressed a similar preference in *Zuber* ... . (Citations omitted; bracket in original).

3. A similar principle was articulated by Justice Jackson – of Nuremberg Trial fame – in *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 US 384, 395-96 (1951) (concurring) (copy attached as Exhibit US-20), in which he stated:

> Resort to legislative history is only justified where the face of the Act is inescapably ambiguous, and then I think we should not go beyond Committee reports, which presumably are well considered and carefully prepared. . . . [T]o select casual statements from floor debates, not always distinguished for candour or accuracy, as a basis for making up our minds what law Congress intended to enact is to substitute ourselves for the Congress in one of its important functions.

4. Moreover, even when US courts do consider floor statements, they discount statements made by opponents of the legislation. As the Supreme Court stated in *Bryan v. United States*, 524 US 184, 196 (1998) (copy attached as Exhibit US-21): "As we have stated, however, '[t]he fears and doubts of the opposition are no authoritative guide to the construction of legislation.' 'In their zeal to defeat a bill, they understandably tend to overstate its reach.'" (Citations omitted).

5. Thus, if a US court were to consider the floor statements contained in EC-19, the statements to which a court most likely would give weight would be those of Representative Archer, then-chairman of the House Committee on Ways and Means, and Representative Crane, chairman of the Subcommittee on Trade of the House Committee on Ways and Means, who were important proponents of the Act. The EC does not quote the statements of these gentlemen. Here is what Representative Archer had to say:

> Mr. Speaker, I rise simply to say that the gentleman from California says that it is a corporate subsidy if we do not double tax all of the earnings overseas. We are one of the very few developed countries in the world that double taxes earnings overseas. So if we eliminate partially, only partially, the double taxation of those earnings to be only partially competitive with our foreign competitors, he calls it a subsidy. I do not believe the American people would agree with that.[1]

This statement provides further evidence that Congress intended that the Act serve as a measure to avoid double taxation.

6. With respect to Representative Crane, he made the following statement: "H.R. 4986 moves the US closer to a territorial tax system, more like the one governing the international activities of so many European businesses.[2] This statement provides further evidence that, by means of the Act, Congress consciously intended to incorporate territorial features into the US system of taxation.

7. In a similar vein, the EC's assertions regarding the reluctance of the US Executive Branch officials to speculate on Congress' motives in passing the Act are equally misplaced. To be clear, this reluctance does not stem from the fact that those officials have no knowledge regarding the drafting of the Act, but rather from the fact that any such knowledge is irrelevant for purposes of identifying Congress' intent. Instead, what is relevant is the legislative record created by Congress itself.

8. The Supreme Court has held that *post hoc* observations made by individuals involved in the drafting of legislation carry little weight with respect to discerning statutory meaning. *Bread Political Action Committee v. FEC*, 455 US 577, 582 (1982) (copy attached as Exhibit US-22). According to the Court, these statements have no probative weight because they only "represent the personal views of [the drafter]" and "the statements [a]re made after passage of the Act." *Id* . This is true even if such *post hoc* observations are made by a member of Congress. *Quern v. Mandley*, 436 US 725, 736 (1978) (copy attached as Exhibit US-23).

9. Thus, any *post hoc* speculation of the sort sought by the EC as to what Congress intended would be nothing more than that: mere, and legally irrelevant, speculation.

[1] EC-19, page H11892.
[2] *Id*., page H11891.

QUESTIONS FOR THE UNITED STATES

Question 7. The United States argues that, with the Act, it changed the general rule of US taxing jurisdictio[3], and thus, in regard to " extraterritorial income", there is no general rule of taxation that would apply "but for" the definition of gross income[4] The new Section 941(a)(1) of the IRC provides in relevant part:

> **"The term 'qualifying foreign trade income' means, with respect to any transaction, the amount of gross income which, if excluded, will result in a <u>reduction of the taxable income</u> of the taxpayer from such transaction…."(emphasis added)**

How can the US argument be reconciled or harmonized with the underlined words quoted above?

10. The above statements do not conflict. The reduction of taxable income referred to in the statute is the intermediate step in a formula for computing the amount of excluded income. Use of that intermediate step does not indicate that excluded income would be otherwise subject to tax in the United States.

11. A basic principle of US tax law is that a taxpayer may deduct the expenses it incurs in producing taxable income. A corollary to that principle is that a taxpayer may not deduct the expenses it incurs in producing income that is excluded from the tax base. To permit otherwise would allow a taxpayer to underpay its taxes.

12. The exclusion for extraterritorial income is an exclusion from gross income, not a reduction in taxable income. Under the US tax system, gross income refers to the income of the taxpayer without taking into account any deductions. Because excluded extraterritorial income is excluded from the US tax base, however, the Act denies deductions attributable to such income. This presents a computational problem: how are disallowed deductions to be removed if the excluded amount is based on gross income, which does not account for any deductions? The problem is solved by first computing taxable income, then denying deductions allocable to excluded extraterritorial income, and then "grossing up" the resulting figure into a gross income exclusion by attributing to the taxable income amount any allocable deductions. The legislative history of the Act provides the following summary: "[I]n order to calculate the amount that is excluded from gross income, taxable income must be determined and then "grossed up" for allocable expenses in order to arrive at the appropriate gross income figure."[5] A comprehensive numerical example of this process is contained in the legislative history of the Act.[6]

13. Thus, the exclusion for extraterritorial income is an exclusion from gross income, and the step of converting the amount of the exclusion into a reduction in taxable income is only a mechanism for determining the amount of the gross income exclusion.

14. More generally, one practical effect of any exclusion is that it has the ultimate effect of reducing taxes from what they would have been without the exclusion. This same issue arises in connection with exemption systems. To recognize this fact is separate from the question whether exclusion is part of a country's general rule of taxation.

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[3] US first submission, para. 72.
[4] US first submission, para. 77.
[5] *Senate Report* (US-2), page 12.
[6] *Id*., pages 11-14.

15. In this regard, in an oral follow-up question, the Panel asked whether Question 33 is relevant to Question 7. The United States does not believe that the Treasury subpart F study is relevant to the formula for calculating excluded extraterritorial income.

Question 8. The European Communities states that, in order for extraterritorial income to be excluded from taxation, "US articles must be used whenever the cost of other inputs (not articles or direct labour) (C) and profit (D) are less than 50% of the selling price (or more exactly the US-assessed fair market value) of the goods".[7] Is this a correct characterisation of Act? If not, could the US provide what it considers to be the correct description?

16. This is not a correct characterization of the Act. US articles do not have to be used in this situation because US labour could be used to meet the 50 per cent limitation without increasing the amount of US articles. For example, assume that the EC's (C) and (D) account for 49 per cent of the fair market value, leaving 51 per cent to be accounted for by articles and labour. Under the Act, all but 1 per cent of that 51 per cent could be accounted for by foreign labour and articles, while the remaining 1 per cent could be accounted for by US labour.

17. More generally, however, the EC has narrowed inappropriately the scope of the relevant question. The more appropriate question is whether the Act contains an affirmative requirement to use US articles. There is no such requirement in the Act.

18. This inaccurate description of the Act reflects the EC's limited understanding of the Act's structure and design. In this regard, the EC's algebraic breakdown fails to reflect the Act's distinction between the foreign labour and US labour components.

Question 9. In the Annex to its first and second submissions, the European Communities identifies cases where the cost of "articles" used to produce finished goods exceeds 50% of the value of the finished product, a situation in which the "requirement to use US articles must arise in practice".[8] How does the US respond to this allegation? Are such situations precluded by virtue of the Act ?

19. It is clearly possible to construct a hypothetical showing that the 50 per cent rule might not be satisfied in some situations. The EC claims that its hypotheticals are based on actual data, but, not having access to the data, the United States is unable to respond to the accuracy of the data or the validity of the conclusion derived by the EC from the data. The United States would note that it has been informed by a reliable source that the EC's percentage figures for aircraft engines and avionics are too high. From that, the United States can only assume that the other figures cited by the EC also may be inaccurate.

20. In an oral follow-up question, the Panel asked whether, if a particular company can only satisfy the 50 per cent rule by using US articles, the taxpayer is automatically entitled to the exclusion? The answer to this question is "no", satisfaction of the 50 per cent rule through the use of US articles would not guarantee eligibility for the Act's exclusion with respect to income from the sale of the finished product. The taxpayer still would have to satisfy all of the other requirements of the Act, such as the foreign economic process requirements of section 942(b).

[7] EC first submission, para. 112.
[8] EC first submission, para. 116.

Question 10. The European Communities submits[9] that "the term "export" in Article 3.1(a) of the SCM Agreement refers to the sale of:

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

Does the US agree with this definition of the term "export" for the purpose of the SCM Agreement?

21. The United States does not agree with this definition. The United States believes that the EC got the definition right the first time, when it followed the dictionary definition: "Send (esp. goods) to another country".[10] Thus, based on the ordinary meaning of "export", where a good is ultimately consumed is irrelevant to whether it is exported, and a product can be exported multiple times until it is finally consumed. The EC offers no support for its assertion that the ordinary meaning of "export" should be ignored.

Question 11. Where qualifying foreign trade property is manufactured, produced, grown or extracted within the United States, is there a possibility under the Act for a taxpayer to exclude any amount of gross income earned from the sale of a good - thus resulting in the reduction of its taxable income - if such a transaction does not involve the exportation of the said good from the United States into any other country?

22. Yes. A manufacturer of goods can earn excluded income by sales to domestic buyers, provided that the goods in question are used outside the United States. Use outside the United States could occur, for example, if the good in question is a fishing boat sold to a United States person for use outside the territorial waters of the United States. In that case, income from the sale of the boat could qualify notwithstanding that the boat was not "consumed" within a foreign jurisdiction. Use outside the United States also could occur in certain circumstances if the article is incorporated into a good that is sold for use outside the United States. Thus, for example, extraterritorial income could be earned if a US manufacturer sells an aircraft engine to a US aircraft manufacturer for incorporation into a finished aircraft to be used outside the United States. The foregoing examples follow from the language of the statute, but the precise scope of these rules will be the subject of proposed regulations to be issued in the future.

23. In an oral follow-up question, the Panel asked whether there is no way to benefit from the exclusion if the final destination of a good is the United States, and whether a good must cross the border before final use?

24. With respect to the first question, taxpayers may earn excluded extraterritorial income with respect to some transactions in which the "final destination" of the property is the United States. The legislative history provides as follows:

> [P]roperty that is sold to an unrelated person as a component to be incorporated into a second product which is produced, manufactured, or assembled outside of the United States will not be considered to be used in the United States (even if the second product ultimately is used in the United States), provided that the fair market value of such seller's components at the time of delivery to the purchaser constitutes less than 20 per cent of the fair market value of the second product into which the components

[9] EC first submission, para. 91.
[10] EC submission, para 85.

> are incorporated (determined at the time of completion of the production, manufacture, or assembly of the second product).[11]

Thus, for example, a US manufacturer of car tires may earn excluded extraterritorial income from the sale of tires to an unrelated US car manufacturer with a plant in Canada, even if the tires are installed on cars for sale in the US domestic market.

25. In addition, the foreign use requirement only requires *predominant* foreign use. Thus, some domestic use is permitted. According to the legislative history,

> property is considered to be used predominantly outside the United States for any period if, during that period, the property is located outside of the United States more than 50 per cent of the time.[12]

26. With respect to the second question, the Act does not generally require any border crossing. For example, a taxpayer may earn excluded income with respect to foreign-produced property that is produced and consumed within the same foreign jurisdiction.

Question 12. Where qualifying foreign trade property is manufactured, produced, grown or extracted within the United States by a US corporation or an individual permanently established in the United States, and where that corporation or individual does not maintain any permanent establishment outside the United States, are there situations in which extraterritorial income earned from the sale of such property can be taxed by another country than the United States ?

27. The United States believes that there are such situations, and the Act was designed to account for them. The United States, for example, subjects foreign persons to tax that do not have a permanent establishment in the United States.

28. The United States unfortunately is not in a position to opine regarding all the tax laws of the world. The United States would cite, however, certain examples of countries with which the United States has no income tax treaty and which may impose source-based taxation under domestic law in the absence of a permanent establishment:

- Brazilian domestic law does not contain a proper definition of the term "permanent establishment." In fact, there are no rules providing for special tax treatment of permanent establishments in Brazil.[13]

- Chilean source income is taxable in Chile even if it is earned by a non-resident with no establishment or agency in Chile. Chilean law does not provide for the concept of a permanent establishment. Chilean-source income is taxable even on occasional transactions.[14]

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[11] *Senate Report* (US-2), page 19.

[12] *Id*., page 20.

[13] International Bureau of Fiscal Documentation, *Taxation in Latin America*, Section C, Brazil 21-23 (LA, Suppl. No. 121, September 2000) (copy attached as Exhibit US-24).

[14] International Bureau of Fiscal Documentation, *Taxation in Latin America*, Section C, Chile 23, 26 (LA, Suppl. No. 117, September 1999) (copy attached as Exhibit US-25).

- Malaysia taxes non-residents on income accruing in or derived from Malaysia. The concept of permanent establishment is not part of Malaysian internal revenue law.[15]

- Panamanian-source income is subject to tax in Panama even if it is earned by a non-resident with no establishment or agency in Panama. Such income paid to non-residents is subject to a withholding tax. Whether or not income is Panamanian-source income does not depend on the nationality, domicile, or residence of the recipient, nor on the location at which the contract is concluded. Panamanian law does not recognize the concept of "permanent establishment".[16]

- Taiwan imposes income tax on all income derived from sources within Taiwan, whether earned by residents or non-residents. Taiwanese law does not use the term "permanent establishment". If a foreign individual or foreign "profit-seeking enterprise" without a "fixed place of business" or a "business agent" earns income in Taiwan, the income is subject to a final withholding tax.[17]

- Saudi Arabia levies tax on all income from Saudi Arabian sources. This is the case even in cases where the foreign entity has no presence in Saudi Arabia, and thus the government has no power to compel the foreign entity to file a tax return. In such cases, the payor of the income is liable for the tax, which is thus essentially transformed into a withholding tax. There is no concept of "permanent establishment" in Saudi Arabian law.[18]

The United States emphasizes that these are only a few examples of countries that do not provide for the concept of a permanent establishment in their domestic tax law.

29. Thus, the concept of a "permanent establishment" is not a universally adopted standard, as the EC suggests. Territorial systems do not define the scope of the exemption based upon the amount of income attributable to a foreign permanent establishment. Territorial systems simply exclude income earned outside the territorial boundaries of the country in question.

30. There are additional, independent reasons to reject the EC's approach. First, the United States recalls that it has income tax conventions with only 63 countries, leaving US business to face the domestic tax laws of all other countries without the benefit of a permanent establishment article.

31. Second, the EC's argument is internally inconsistent. If the concept of permanent establishment were an internationally accepted standard, as the EC alleges, then there would be no need for Article 7 of the OECD model, which is designed to override the domestic laws of the signatories to a tax treaty.

32. Third, the EC's argument is counter-textual. Even assuming that the concept of a permanent establishment were an internationally accepted standard, which it is not, footnote 59 nowhere refers to the term "permanent establishment", and nothing in footnote 59 states that a measure qualifies as a measure for the relief of double taxation only if it conditions relief upon the existence of a permanent establishment.

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[15] International Bureau of Fiscal Documentation, *Taxation and Investment in Asia and the Pacific*, Malaysia 33-34, 38, 43 (AP, Suppl. No. 189, May 2000) (copy attached as Exhibit US-26).

[16] International Bureau of Fiscal Documentation, *Taxation in Latin America*, Section C, Panama 4, 13, 14-16 (LA, Suppl. No. 113, March 2000) (copy attached as Exhibit US-27).

[17] International Bureau of Fiscal Documentation, *Taxation and Investment in Asia and the Pacific*, Taiwan 17, 19 (AP, Suppl. No. 111, November 1993) (copy attached as Exhibit US-28).

[18] International Bureau of Fiscal Documentation, *Taxation and Investment in the Middle East*, Saudi Arabia 43-46 (ME, Suppl. No. 90, August 2000) (copy attached as Exhibit US-29).

33. Fourth, validation of the EC's argument would be unwise, given the evolving standards for when double taxation may arise. Take the example of the recent developments in e-commerce. With respect to cross-border electronic transactions, the definition of permanent establishment is the subject of an ongoing debate. Different countries have taken different positions on what degree of activity constitutes a permanent establishment, giving rise to the spectre of double taxation despite the absence of a permanent establishment.

34. Accordingly, the approach suggested by the EC is unwise and unwarranted.

QUESTIONS FOR BOTH PARTIES

Question 13. Regarding the relationship between Article 3.1(a) of the SCM Agreement and item (e) of Annex I, would it be possible that a certain measure is not within the scope of the latter, but nonetheless within the scope of the former, and *vice versa*?

35. The United States explained its position on the relationship between paragraph (e) of Annex I and Article 3.1(a) at paragraphs 157-61 of its First Submission. There, the United States pointed out that paragraph (e) identifies a particular type of prohibited export subsidy - that is, a particular type of subsidy made contingent on export performance.

36. The United States made its comments in response to the EC argument that paragraph (e) broadens Article 3.1(a) and prohibits export subsidies that are not within the scope of 3.1(a). The United States recalled that, as a part of the Illustrative List of Export Subsidies, paragraph (e) provides an example of a prohibited export subsidy. The United States maintained, and remains of the view, that paragraph (e) helps to clarify and apply 3.1(a), but it does not prohibit something that 3.1(a) does not. The United States notes that the panel in the *Canada Autos* case appears to have taken a similar view.[19]

37. The key issue seems to be that the EC wants the Panel to find that the fact that a measure is available to exports is enough to violate the SCM Agreement. The United States submits that this cannot be the case. A tax exemption, remission, or deferral that is "specifically related to exports" requires a much closer connection to exportation than mere availability. The Panel need not even explore the relationship between paragraph (e) and Article 3.1(a) if that is the EC's theory. Even if such an attenuated connection could equal "specifically related to exports", the United States believes the connection to exports must still amount to a contingency. If not, then no violation of Article 3.1(a) can be shown.

Question 14. The Panel is well aware that the WTO-conformity of income tax regimes of European countries is outside the scope of our terms of reference for this case. In paragraph 96 of the US first submission, the US introduces examples of a few European tax systems which "refrain from taxing foreign income in a qualified or conditional manner."[20] Among those systems, is there one which excludes foreign income from the scope of taxable income on the following conditions:

[19] *Canada - Certain Measures Affecting the Automotive Industry*, WT/DS139/R, WT/DS142/R, Report of the Panel, as modified on other grounds by the Appellate Body, adopted 19 June 2000, para. 10.196 ("Indeed, the use of the words 'including' and 'illustrated' makes it clear that, while all practices identified in the Illustrative List are subsidies contingent upon export performance, there may be other practices not identified in the Illustrative List that are also subsidies contingent upon export performance."). This particular aspect of the panel report was not appealed.

[20] US first submission, para. 97.

(i) **the property for sale from which income arises must be held for ultimate use outside the country, (and not be sold for final consumption in that country); and**

(ii) **the same property must have foreign content of not more than a certain percentage of its fair market value.**

38. With respect to condition (i), every country that declines to tax income that domestic corporations earn outside the territory as fully as the income they earn domestically provides those companies a tax incentive to export. This is because any domestic corporation that exports and that can attribute some portion of the export income to offshore activities can, by virtue of territorial features found in certain European tax systems, be taxed at lower rates in the foreign jurisdiction. Exporters throughout Europe are keenly aware of this benefit and plan their business activities accordingly.

39. The conditions for taking advantage of this tax incentive in these European countries are similar, but not identical, to those in the Act. If a domestic corporation manufactures products domestically, it can earn exempt income only by exporting (a condition that is similar, but not identical, to the Act's requirement of a foreign sale). As a practical matter, in European countries that use the exemption method, it is undoubtedly the case that the primary beneficiaries of the exemption are exporters.

40. With respect to (ii), which is a feature of the Act that rarely comes into play, the United States is not aware of a similar provision in a European country. The US provision is probably unique.

Question 15. Is the term "foreign-source income," "foreign-source" or "source" used elsewhere in any provisions of other WTO Agreements than the SCM Agreement? What guidance, if any, may be drawn as to the meaning of these terms from the SCM Agreement or other WTO Agreements?

41. We have found two places in the Covered Agreements in which some or all of the above words are used. In paragraph 1(a) of the Annex to the Agreement on Trade-Related Investment Measures, the word "source" is used in reference to domestic content requirements. Specifically, the reference is to "the purchase or use by an enterprise of products of domestic origin or from any domestic <u>source</u> ... ." (Emphasis added). The use of "source" in this context appears to refer not to a situation in which a Member conditions an investment opportunity based on a requirement that goods be manufactured within its borders, but rather that goods be purchased from a domestic business or person (regardless of where the goods are made).

42. This use of "source" is consistent with the US position regarding the fifth sentence of footnote 59. The United States has noted that one attribute of income that may render it "foreign-source income" is that the purchaser of the good is foreign or the source of payment is foreign. The use of the term "source" in the TRIMs Agreement parallels this understanding of "source" in footnote 59.

43. Another reference is found in Article XIV of the General Agreement on Trade in Services, which provides as follows:

> [N]othing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:
>
> ...
>
> (d) inconsistent with Article XVII [national treatment], provided that the difference in treatment is aimed at ensuring the equitable or effective [6]

imposition or collection of direct taxes in respect of services or service suppliers of other Members.[21]

44. Footnote 6 to Article XIV(d) states in relevant part as follows:

Measures that are aimed at ensuring the equitable or effective imposition or collection of direct taxes include measures taken by a Member under its taxation system which:

(i) apply to non-resident service suppliers in recognition of the fact that the tax obligation of non-residents is determined with respect to taxable items <u>sourced</u> or located in the Member's territory ; or

...

(iv) apply to consumers of services supplied in or from the territory of another Member in order to ensure the imposition or collection of taxes on such consumers derived from <u>sources</u> in the Member's territory; or

...

(vi) determine, allocate or apportion <u>income</u>, profit, gain, loss, deduction or credit of resident persons or branches, or between related persons or branches of the same person, in order to safeguard the Member's tax base.

Tax terms or concepts in paragraph (d) of Article XIV and in this footnote are determined according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure. (Emphasis added.)

45. The purpose of paragraph (d) and its explanatory footnote is to make clear that, with respect to the taxation of service income, Members are entitled to depart from the normal rule of national treatment to ensure the "equitable or effective imposition of direct taxes". In other words, Members are permitted to take special measures to prevent evasion that might otherwise occur as a result of the foreign location of service suppliers or the foreign performance of services. A key point in footnote 6 for purposes of the present dispute is the fact that the final sentence provides that the tax terms used in the relevant text do not have universally agreed upon meanings. Thus, the final sentence indicates that the negotiators of *GATS* wanted to provide flexibility to capture the various instances in which income can be regarded as "sourced" within a Member.

46. An equally important point is that the drafters understood that taxes can be derived from sources in myriad ways. They recognized that WTO Members use different sourcing rules and have different jurisdictional boundaries. Thus, what one country might deem to be taxable income, another might view as outside the scope of its tax system. At a minimum, this language in the GATS indicates that the EC's "foreign economic processes test" is too narrow. For example, subpart (iv) makes clear that Members may tax income of foreign service providers by levying taxes on domestic customers where the services in question are "supplied in or from the territory of another Member". That such a service can be "sourced" within the country of the customer means that a "foreign

[21] "Direct taxes" is defined in GATS Article XXVIII to "comprise all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation." This definition of "direct taxes" is slightly different from, but not inconsistent with, the definition of "direct taxes" found in footnote 58 of the SCM Agreement.

economic processes test" is too rigid to capture the complexities of modern international business and taxation.

47. In other words, the drafters of the GATS, like the drafters of the SCM Agreement, wanted the term "source" to be given its ordinary meaning. "Source " may mean different things depending on the context in which it is used. They did not intend for it too have one unique meaning to be applied in all cases.[22] They also did not intend to incorporate an extrinsic definition of the term, including the "special meaning" of "foreign source income" the EC claims exists in the OECD Convention. The United States has previously noted that the OECD Convention contains no definition of foreign-source income and recognizes that income that is not attributable to any foreign economic processes – i.e., passive income derived from foreign "sources" – may be exempted from taxation.[23]

48. Finally, the United States notes that Article XIV(e) and Article XXII:3 of GATS confirm the flexibility built into the fifth sentence of footnote 59. Article XIV(e) provides an exception from Article II (MFN) where "the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound." Article XXII:3 provides that a Member may not invoke Article XVII (national treatment) under the GATS dispute settlement provisions "with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation." These provisions create an exception to GATS non-discrimination rules only to the extent that the relief of double taxation is provided for or allowed by another agreement. Footnote 59 contains no such limitation. Whether and how to avoid double taxation are questions left to individual WTO Members.

49. In an oral follow-up question posed at the Panel meeting, the Panel asked whether the Appellate Body's references to "foreign-source income" in its report in the *FSC* case have any relevance to the instant proceeding?

50. While the Appellate Body did not define the term "foreign-source income" within the context of footnote 59, it did apply the term broadly and did not tie the concept to a particular Member's tax

[22] Because the fifth sentence of footnote 59 speaks of not imposing limits on the ability of a WTO Member to take measures to avoid double taxation, the United States believes that the term "foreign source income" in the context of footnote 59 should be interpreted broadly. A broad interpretation in this case would account for the real possibility that a foreign jurisdiction could tax excluded extraterritorial income. As noted before, the United States believes that extraterritorial income has many attributes that make it "foreign" and, as a result, it could be subject to foreign tax. If the Panel were to adopt the EC's cramped interpretation of foreign-source income here, the Panel 's ruling would have the effect of preventing Members from relieving double taxation in certain cases as a matter of WTO law.

[23] If the drafters of the SCM Agreement had intended to incorporate the OECD Convention in the fifth sentence of footnote 59, they would not have done so silently. By contrast, item (k) of Annex 1 contains a specific reference to extrinsic sources. Item (k) of Annex I refers to "an international undertaking on official export credits to which at least 12 original Members to this Agreement are parties as of 1 January 1979 (or a successor undertaking which has been adopted by those original Members)". The United States is aware of only one undertaking that meets this description, and it is the OECD Arrangement on Guidelines for Officially Supported Export Credits. Thus, the fact that the drafters of the SCM Agreement did not tie the fifth sentence of footnote 59 to extrinsic documents cannot be assumed to be "merely accidental or an inadvertent oversight on the part of either harassed negotiators or inattentive draftsmen." *United States - Restrictions on Imports of Cotton and Man-made Fibre Underwear*, WT/DS24/AB/R, Report of the Appellate Body adopted 25 February 1997, page 17.

In this regard, at the meeting with the Panel, the Panel asked whether the reference in the fourth sentence of footnote 59 to bilateral tax treaties and the OECD suggests that the drafters intended extrinsic documents to apply for purposes of the fifth sentence. In the view of the United States, the answer to this question is "no." Indeed, the absence of a similar reference in the fifth sentence suggests the opposite conclusion; *i.e.*, that the drafters did not intend to incorporate standards or definitions from extrinsic sources.

law. More generally, the Appellate Body reaffirmed that Members have the right not to tax a particular category of foreign-source income.[24] This reaffirmation supports the US position, which is that excluded extraterritorial income is a category of "foreign-source income" that the United States has chosen not to tax. By contrast, the EC appears to argue that a Member cannot refrain from taxing foreign-source income unless it decides to refrain from taxing *all* foreign-source income. Under the EC view, anything less than a full exclusion would give rise to an "exception" from a "general rule" of taxation. The Appellate Body's opinion demonstrates that the EC's argument is without merit.

51. Moreover, the EC's approach is incoherent at best. The EC seems to ask the Panel to rule that the term "foreign-source income" has whatever meaning assigned to it by US domestic law. This approach proves the US case, because excluded extraterritorial income would be foreign-source income under US sourcing rules, as set forth in section 862(a)(4) and 863(b) of the IRC. Nevertheless, the United States notes that the EC's approach is internally inconsistent because the EC simultaneously asserts that the income in question must be subject to tax under foreign law. Unless the EC is prepared to assert that the entire world employs the US domestic-law sourcing rules, then the EC must admit that these two approaches to determining source often will generate different results. The difference between US sourcing rules and foreign sourcing rules reflects the basic fact that no general international consensus exists on how best to source income from cross-border transactions, transactions such as those that generate excluded extraterritorial income. Despite the absence of such a consensus, the EC is inviting the Panel to impose one rule – with no relevant theoretical justification – upon the tax authorities of all WTO Members.

Question 16. The European Communities claims that[25]:

> **"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…. This additional advantage would also be a subsidy,…. This unwarranted *overcompensation* is also a subsidy….**
>
> **(For the EC): Please provide a textual analysis of how the alleged *additional advantage* and *overcompensation* constitute subsidies under Article 1 of the SCM Agreement.**
>
> **(For the US): How does the US respond to this allegation?**

52. The United States explained in paragraphs 35-38 of its Second Submission why countries can and do rely on alternative methods of avoiding double taxation. This is a common and well-accepted practice. For example, in France, with the permission of the Ministry of Economy and Finance, a French company may elect to be taxed on its worldwide income and obtain relief from its worldwide losses. Thus, in the context of export subsidies, alternative methods of double taxation relief should be irrelevant, especially where no unique or special benefits are provided exclusively to exporters. This is the case with respect to the Act, which is not uniquely applied to exporters or export income.

Question 17. The EC seems to argue that a Article 3.1(b) violation may exist if a certain measure gives an "incentive" to domestic production for export.[26] In the same vein, the EC argues that "Article 3.1(b) prohibits local-content contingency to <u>any</u> degree,… [and] there is no *de minimis* rule for prohibited subsidies in the SCM Agreement.".[27]

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[24] *FSC (AB)*, para. 99.
[25] EC second submission, paras. 221-222.
[26] *See* EC first submission, para. 165.
[27] EC second submission, para. 160.

(For the EC): How would this argument be supported by a textual analysis of Article 3.1(b) in accordance with Article 31 of the *Vienna Convention*? Can the European Communities cite any Appellate Body or panel reports in which the term "incentive" was explicitly used in the context of Article 3.1 of the SCM Agreement, or Article XVI:4 of the GATT Agreement?

(For the US): Would a textual analysis of Article 3.1(b) lead to a conclusion that the EC's above argument is without merit? If so, why and how? Would the US take the view that there is *de minimis* rule for prohibited subsidies in the SCM Agreement? If so, what is the qualitative or quantitative threshold for that rule? Is the Appellate Body Report in *Canada - Certain Measures Affecting the Automotive Industry*[28] relevant to this question? Please give reasons for your responses.

53. The EC's "textual" analysis of Article 3.1(b) is incomplete. The EC notes that the dictionary (which for some reason known only to the EC is useful here but not in connection with other parts of the SCM Agreement) defines "over" as "in preference to". However, instead of interpreting "in preference to", the EC decides to abandon the dictionary and simply equates "preference" with "incentive" or "boost." However, the same dictionary relied on by the EC – *The New Shorter Oxford English Dictionary* – defines "in preference to" as "rather than."

54. Thus, a textual analysis would lead to the conclusion that the EC's argument is without merit. The key words in Article 3.1(b) are "contingent" and "use." "Contingent upon the use of domestic goods" simply is not the same thing as "incentive to use domestic goods."

55. With respect to the second part of the question, the question omits part of the quoted phrase; i.e., the phrase "even a slight bias in favour of domestic goods." In the view of the United States, "a slight bias" is not a contingency. A measure – at least a measure challenged on a *de jure* basis – either is contingent or it is not. The United States is not arguing that a *de minimis* contingency is permissible under Article 3.1(b); rather, the United States is arguing that a "slight bias" or incentive does not amount to a contingency. For these reasons, the United States does not see how the *de minimis* concept relates to a determination of contingency.

56. As for *Canada Autos*, the United States considers the Appellate Body report extremely relevant. In that case, the Appellate Body said that value-based requirements cannot automatically be deemed as creating a contingency within the meaning of Article 3.1(b). Instead, there must be an analysis of how the requirements operate for individual manufacturers. In the view of the United States, the EC has failed to demonstrate that the 50-per cent rule actually requires any manufacturer, whether located in the United States or abroad, to use US articles.

57. In this regard, the EC is making the same argument regarding Article 3.1(b) as the one rejected in *Canada Autos*; namely, that the standard of Article 3.1(b) is satisfied if a measure "favors or gives preference to the use of domestic over imported goods."[29] Neither the panel nor the Appellate Body accepted this interpretation. Although the Appellate Body did not expressly reject this interpretation, it is clear from the report that the Appellate Body implicitly rejected it. The Appellate Body's analysis set forth in paragraphs 126-131 indicates that a "slight bias" is not enough to establish a contingency for purposes of Article 3.1(b). Instead, it is necessary to analyze how value-based requirements operate for individual manufacturers.

[28] WT/DS130/AB/R, WT/DS142/AB/R.

[29] This argument is reflected in para. 10.214 of the panel report and para. 119 of the Appellate Body report in *Canada Autos*.

Question 18. Relating to Article III:4 GATT, EC has cited[30], *inter alia*, the Panel Report on *Italian Discrimination against Imported Agricultural Machinery.[31]* We note that two other documents -- GATT Doc. L/695 (1957) and GATT Doc. L/740 (1957) -- address similar issues. Are these relevant to the question of whether Article III:4 of the GATT in the first place covers exemptions to the tax on the "firm"? Please comment on whether and how these reports are relevant to our case.

58. These cases appear distinguishable on their face from the present dispute. At the most basic level, these cases involved programmes that applied directly to products. The governments provided subsidized financing or grants that could only be used for the purchase of domestic products. Because like imported products were ineligible for similar financing, the programmes violated the national treatment provisions of GATT Article III:4. By contrast, the present case does not deal with a measure that directly affects products, but rather, income taxes. A closer analogy to the agricultural machinery financing cases would exist if a country imposed differing levels of excise tax on imported, as opposed to domestic, products; such a case would properly be brought under Article III:2, rather than Article III:4.

59. Indeed, there is support in the history of the GATT that Article III:4 was never intended to apply to income taxes. The Reports of the Havana Convention, at which Article 18 of the Havana Charter[32] (the immediate predecessor to GATT Article III, with essentially identical text) was drafted, specify that "neither income taxes nor import duties fall within the scope of Article 18 which is concerned solely with internal taxes on goods."[33] It is striking that in over 50 years of GATT and WTO jurisprudence, few cases have been brought that alleged that income tax measures violated Article III:4[34], and there have been no panel decisions on the issue. A WTO panel, expounding generally on the scope of Article III, noted in passing that, "subsidies granted in respect of direct taxes are generally not covered by Article III:2, but may infringe Article III:4 to the extent that they are linked to other conditions which favor the use, purchase, etc. of domestic products."[35] This statement is purely *dicta*, because none of the measures within the panel's terms of reference involved an income tax.

QUESTIONS FOR THE UNITED STATES

Question 19. The United States appears to contend that, when a company manufactures goods in the United States and sells them abroad, the income generated may be partly domestic-source and partly foreign-source. If so, is it not equally true that, when a company manufactures goods abroad and sells them in the United States, the income generated may also be partly domestic-source and partly foreign-source? If so, and given your assertion that the Act is a measure to avoid the double taxation of foreign-source income, please explain why the exclusion provided by the Act for "extraterritorial" income is limited to instances where property is sold or leased for use outside the United States.

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30 EC first submission, para. 98.

31 GATT Doc. L/833 (1958), adopted 23 October 1958, BISD 7S/60.

32 Final Act of the United Nations Conference on Trade and Employment, March 24, 1948.

33 Interim Committee for the International Trade Organization, *Report of Committees and Principal Sub-Committees,* Report of Sub-Committee A of the Third Committee on Articles 16, 17, 18 and 19, E/CONF./2/C.3/59, para 44, page 63, Geneva, 1948.

34 The *Analytical Index, Guide to GATT Law and Practice,* Vol. 1, Geneva, 1995 cites a 1952 complaint by Austria that Italy granted a remission of income tax to firms that used domestically-produced ship's plate, L/875; a 1971 Working Party on the United States Temporary Import Surcharge held an exchange of views on the Job Development Tax Credit, a credit against United States income taxes which was allowed only on domestically-manufactured equipment, L/3575; and a 1987 EEC complaint concerning the temporary extension of tax credits and depreciation for passenger aircraft assembled in certain US states, L/6153.

35 *Indonesia - Certain Measures Affecting the Automobile Industry,* WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, Report of the Panel adopted 23 July 1998, para. 14.38.

60. Depending on the circumstances, a portion of the income would be US-source income and a portion would be foreign-source income. The extraterritorial income exclusion, however, is limited to the foreign-source income that arises when property is sold or leased for use outside the United States because the United States has determined not to cede primary taxing jurisdiction over US-source income. Thus, in the case of a foreign person that earns US-source income from sales in the US domestic market, the United States would retain primary taxing jurisdiction over such income, and relief from double taxation would be left to the foreign jurisdiction to provide. In this respect, the Act provides parallel treatment with the exemption method. Just as the United States generally cedes taxing rights over excluded extraterritorial income, so, too, would a foreign exemption system generally cede taxing rights over US-source income in the case of a foreign person earning US-source income from sales in the US domestic market.

61. More generally, however, nothing in footnote 59 requires that a measure for the relief of double taxation resolve the problem of double taxation completely or precisely. Footnote 59 provides that paragraph (e) "is not intended to limit" a Member from taking measures to avoid double taxation. Indeed, it is highly unlikely that any system for the relief of double taxation would result in the complete elimination of double taxation without creating instances of double non-taxation. Such precision is probably impossible, given the many differences in taxation systems from one country to another and the many different ways that international commerce can be structured. This persistent problem in melding different systems is one reason that the OECD has provided only general guidelines regarding the relief of double taxation. It is also the reason that the United States suggests that the panel should not attempt to impose a single interpretation of the term "foreign-source" income in footnote 59. To interpret footnote 59 in the way suggested by the EC would effectively dictate to countries the manner in which they must structure their domestic tax systems with respect to international activities. It is safe to say that the drafters of the footnote had exactly the opposite goal, which was to allow Members to continue to determine how best to avoid double taxation of income.

Question 20. Assume that the US legislation provided that: "Gross income does not include income generated from export activities". Would there be revenue foregone which is "otherwise due" such that there was a financial contribution within the meaning of Article 1? How, if at all, would you distinguish this situation from the exclusion of "extraterritorial income" from gross income under the Act?

62. The ordinary meaning of the terms of Article 1.1(a)(ii) suggests that in such a situation there would <u>not</u> be a financial contribution within the meaning of Article 1.1(a)(1). This is because the tax revenue on export activities would not be "otherwise due" under the law of the Member, which is the normative benchmark for an Article 1 analysis. Although this would arguably permit countries to exclude narrow categories of income from tax if they were willing to so modify their general rule of taxing authority, it is the reading that the ordinary meaning of the terms most directly suggests.

63. If the Panel believes that it is necessary to depart from the ordinary meaning of Article 1 and to interpret it more broadly, the only defensible broader interpretation, we believe, would be that gross income (or a comparable concept in a country other than the United States) can be defined in any manner that a sovereign state chooses, <u>except</u> that if the general rule creates an exclusion that is expressly specific within the meaning of the meaning of Article 2, then that exclusion would constitute a financial contribution within the meaning of Article 1.1(a). Under this interpretation, an exclusion that was applicable only to a specific universe of firms, as defined by Article 2, would constitute a financial contribution, and thus a subsidy, within the meaning of Article 1.

64. The reason that a broader interpretation would not be defensible is that if the exclusion were not expressly specific, then panels would have to determine what generic exclusions, of which some specific group was a part, would cause the exclusion to be a financial contribution. This would be impractical because in any given case, the mix of users from a specific group and users from a

non-specific group could range from one end of the spectrum to the other. Would, for example, territorial limits constitute a financial contribution if it were shown that 30 per cent of the beneficiaries of territorial limits were exporters? 70 per cent? 95 per cent? There would be no criteria by which rational line-drawing in such a situation could be done.

65. Hence our answer is: (a) the ordinary meaning of the text suggests that the answer to the Panel's question 20 is "no"; (b) if the ordinary meaning is considered unacceptable, a broader reading of the text could find that an exclusion incorporated into a general rule would constitute a financial contribution if the exception were expressly applicable to only a specific group; and (c) any broader rule would not be principled or workable.

66. If the Panel were to apply our alternative broader principle to this case, we do not believe that the Act's exclusion would be specific within the meaning of Article 2.3, because, for the reasons previously articulated, the exclusion is neither export contingent nor contingent upon the use of domestic over imported goods. Similarly, there has been no allegation made, or evidence submitted, that the exclusion is specific within the meaning of Articles 2.1 or 2.2, and we do not believe that any sort of credible case could be made that it is.

Question 21. Assume that the "qualified" exemptions from taxation of foreign-source income described in paragraph 96 of the United States' first submission are "subsidies" within the meaning of Article 1 of the SCM Agreement. Would such subsidies be specific within the meaning of Article 2?

67. The United States has two answers: one based on the US approach and one based on the EC approach.

68. The qualified exemptions created by territorial limits in European tax systems are, for purposes of specificity, similar to the new US legislation. In our opinion, neither the European exemptions nor the exclusion in the US Act is specific, for the reasons that follow.

69. For purposes of discussion let us assume, as the EC asserts will be the case, that most of the US taxpayers that will take advantage of the Act's exclusion are exporters. Let us also assume for purposes of discussion, as the United States believes the case to be, that most of the European taxpayers that benefit from the qualified exemptions created by territorial limits are also exporters. This would mean, as a factual matter, that most of the universe of beneficiaries for both the exemptions and the exclusion would be exporters who would realize the advantage of the exemption or exclusion by exporting.

70. The issue of law would then be whether, under those assumed facts, the exemption and exclusion are specific within the meaning of Article 2. In each case, a significant subgroup of the universe of beneficiaries would be exporters who could realize the benefit by exporting. As a matter of law, then, would the entire exemption or the entire exclusion be specific because a significant subgroup of the beneficiaries of each consists of exporters?

71. The answer to this question becomes clearer when one recalls that exporters are one type of "specific" group. Part II of the SCM Agreement is reached only in the case of programmes that are "subsidies" under Article 1 and "specific" under Article 2. Article 1.2 expressly provides that if these two standards are not met, one does not reach Article 3. Exporters come within the Article 2 definition of "specific" because Article 2.3 expressly provides that subsidies that are contingent on export performance are "deemed to be specific." Thus, subsidies contingent on export performance are subsidies that are deemed to be subsidies that are "specific to an enterprise or industry or group of enterprises or industries" ("certain enterprises").

72. This construct, which the structure and the language of Articles 1 and 2 make clear, is helpful then in answering the Panel's question. If, as Article 2 specifies, export subsidies are one form of "specific" subsidy, then the question of law set forth above becomes easier to answer. Assume, for example, that the sub-group of the universe of beneficiaries was not exporters but rather was a group of industries, say, service industries, or natural resources industries. Assume also that the remainder of the universe of users was not a specific group of industries or enterprises. Would the subsidy be "specific" because one subgroup of the universe of beneficiaries, considered in isolation, was "specific"? The answer is, of course, no. To the contrary, the conventional way of making a specific subsidy non-specific is to expand the universe of users or beneficiaries. Once it is expanded beyond a specific group of "certain enterprises," it ceases to be specific.

73. For precisely the same reasons, a subsidy that is provided to a broad group of users is not specific because a subset of the users consists of exporters. Rather, the way to cure an export subsidy is to ensure that the benefit is provided to a larger group than just exporters; that is, to a non-specific group. (This was a question raised by the Panel in the original proceeding that the EC essentially refused to answer.)[36] It would be no more appropriate to find a subsidy specific by parsing the universe of users until one finds a subset of exporters than it would be to find a subsidy specific by parsing the universe of its users until one finds a subset of "certain enterprises." To do either would have the effect of draining all content from the Article 2 concept of specificity.

74. For these reasons, the qualified exemptions created by territorial taxing limits should not be considered specific, for the same reasons that the new US exclusion should not be considered specific.

75. On the other hand, if one were to accept the EC's standard for export contingency – which is that export transactions are taxed more favorably than comparable domestic transactions – then the United States believes that the subsidies described in the question would be specific, because these measures result in exports being taxed more favorably than comparable domestic transactions. Under Article 2.3 of the SCM Agreement, "[a]ny subsidy falling under the provisions of Article 3 [*e.g.*, any subsidy that is export contingent] shall be deemed to be specific."

Question 22. In the case of a FSC in existence on 30 September 2000, at what point in time would the unconditional legal right of a FSC-beneficiary to receive the tax reduction arise -- before or after 30 September 2000?

76. In the case of a FSC in existence on 30 September 2000, section 5(c) of the Act confers the legal right to a tax exemption by allowing the exemption despite the repeal of the FSC provisions effective on that date. This right, however, is not unconditional because it is subject to the conditions described in the Act.

QUESTIONS FOR BOTH PARTIES

Question 32. What is the relationship, if any, between the scope of Article III:4 of the GATT and Article 3.1(b) of the SCM Agreement -- is one necessarily broader than the other-- could a measure fall within the scope of one of these provisions, but not within the scope of the other? Please substantiate your response with reference to past GATT/WTO dispute settlement reports and other materials.

77. Article III:4 is broader than Article 3.1(b), so that a measure could fall within Article III:4, but not Article 3.1(b). This follows from the ordinary meaning of the terms used in the two provisions. Article III:4 speaks of "treatment no less favorable" and of requirements "affecting" internal sale, while Article 3.1(b) speaks of subsidies "contingent upon the use of domestic over

[36] FSC (Panel), para. 4.1068, note 468.

imported goods." Based on the Appellate Body's interpretation of "contingent", this would seem to be a more difficult standard to satisfy than the standard of Article III:4.

78. The panel in *Canada Autos* reached a similar conclusion, stating in paragraph 10.215 as follows:

> We recognize that Article 3.1(b) in some sense has its roots in Article III:4 of GATT and in certain interpretations of that provision, which relates to non-discrimination. We do not consider however that Article 3.1(b) *ipso facto* has the same scope as Article III:4. To the contrary, while Article III:4 of GATT speaks of "treatment no less favorable" and of requirements "affecting" internal sale, Article 3.1(b) speaks of subsidies "contingent upon the use of domestic over imported goods." We are unwilling to import into Article 3.1(b) legal principles derived from the interpretation of a text which differs so markedly from that of Article 3.1(b).

This particular aspect of the report was not appealed.

Question 33. The EC states that "… the US review of its subpart F legislation is yet to be completed".[37] Please explain whether and how this statement is relevant to the current proceeding.

79. The statement by the EC is incorrect. The subpart F study was published in December 2000. If the EC had actually read the study, moreover, the EC would have recognized its irrelevance. The study deals with US anti-deferral mechanisms, which have no particular relationship to any of the issues in this case.

QUESTIONS FOR THE UNITED STATES

Question 40. Please comment on paragraph 36 of the EC oral statement.

80. In paragraph 36, the EC made the following statement:

> The Appellate Body, in *Canada-aircraft*, stated that benefit does not exist in the abstract. In the same way, export contingency does not exist in the abstract; it must be analyzed with regard to the recipient, transaction and product concerned. The US approach would render the SCM disciplines completely ineffective.

81. To the extent that the EC is saying nothing more than that the existence of an export contingency under Article 3.1(a) of the SCM Agreement can be determined only on the basis of the measure or facts before a Panel, the United States cannot disagree with the proposition. However, the EC's claim that the Panel must focus on "the recipient, transaction and product" in a case it styles as a *de jure* one seems rather strange. Indeed, the quoted passage reflects a significant flaw that permeates the EC's case: its inability to base its arguments on the relevant text of WTO provisions and its resulting need to incorporate concepts and principles not found in that text to compensate for this fundamental deficiency.

82. For example, in paragraph 36, the EC cites a statement made by the Appellate Body regarding the term "benefit" and tries to apply it to "export contingency". This statement is reflective of a circular argument that flows from the schizophrenic approach taken by the EC in interpreting Article 3.1(a).

83. In paragraph 35 of its oral statement, the EC explained that:

[37] EC rebuttal submission, para. 29.

> In the case of the FSC Replacement subsidy, the EC does not dispute the theoretical possibility for the benefit to become available without exporting. However, the fact that this possibility exists does not mean that all subsidies granted under the Act are not export-contingent.
>
> Thus, paragraph 35 suggests that the EC is attacking the Act because (allegedly) particular transactions qualifying for the Act's exclusion may be export contingent.

84. However, in paragraph 4 of the *Preliminary Answers of the European Communities to the Questions of the Panel* (16 March 2001) ("*EC Preliminary Answers*"), the EC says that this is not what it is doing. In paragraph 4, the EC stated as follows:

> The EC is contesting a subsidy *scheme* (or *programme*) to use the word employed in the *SCM Agreement*), rather than individual subsidy *payments*. It is therefore the conditions of the *law* that need to be considered, not the "legal circumstances in which it is granted on a *case-by-case* basis." (Italics in original).

85. Fundamentally, the EC is trying to have it both ways. In one breath, it says its challenging the Act as a whole, but in the next breath tries to divide the Act into separate alleged subsidies. The EC needs to do this, of course, because the Act, when taken as a whole, simply cannot be regarded as export contingent, as that term has been interpreted by the Appellate Body, because a taxpayer can earn excluded income without ever exporting.

86. Moreover, as the United States previously has explained, the EC's analysis is analogous to an application of the "specificity" standard of Article 2 under which a government measure would be found specific because some subset of users within the universe of users constitutes a specific group. Such a result would be clearly erroneous.

87. Finally, the EC's assertion that "[t]he US approach would render the SCM disciplines completely ineffective" is circular and incorrect. It is circular because it assumes the answer to the question posed; *i.e.*, whether a "subsidy" that is not limited to exporters is export contingent because exporters are eligible. It is incorrect because one method of curing a prohibited export "subsidy" is to broaden eligibility so that the "subsidy" is no longer export contingent, as that term has been defined by the Appellate Body. Thus, SCM disciplines are not "ineffective" to the extent that they do not prohibit non-export contingent "subsidies."

Question 41. In paragraphs 110-114 of the US oral statement, the US argues that the EC's approach to interpreting footnote 59 "never attempts to analyze the ordinary meaning of the text". Why and how would the US analysis of "the ordinary meaning of the text" lead to a different conclusion?

88. The differing approaches taken by the EC and the United States to interpreting the fifth sentence of footnote 59 lead to different conclusions regarding the application of that provision to this dispute. The EC attempts to narrow the scope of the fifth sentence of footnote 59 in ways that its language simply does not allow. The EC tries to do so in a number of ways:

- First, the EC asks the Panel to adopt wholesale the provisions of the OECD Model Convention.

- Second, as a result of the EC's undue reliance on the OECD Convention, the EC maintains that a measure to avoid double taxation must require taxpayers to maintain a "permanent establishment" with respect to every country and every transaction that results in extraterritorial income.

- Third, the EC claims that foreign-source income is limited only to income that is directly attributable to foreign economic processes performed by the taxpayer.

- Fourth, the EC argues that a country may institute a measure to avoid double taxation only upon a showing that it is "necessary" to do so.

- Fifth, the EC suggests that a measure that allows an overall tax savings does not come within the fifth sentence of footnote 59 because it permits improper "overcompensation".

89. The United States disagrees with all of these points. This disagreement stems from the fact that the United States and the EC have taken very different approaches in interpreting the fifth sentence of footnote 59. Unlike the EC, which has turned to extrinsic sources for supplying meaning to the provision in question, the United States has focused on the ordinary meaning of the relevant text.[38] It is the United States rather than the EC that is employing the correct method of interpretation under public international law. This is not merely a theoretical distinction. It results in a starkly different meaning of the fifth sentence of footnote 59 as applied in this case.

90. The United States submits that the text of the fifth sentence of footnote 59 does not prescribe the *types* of measures that may be measures to avoid double taxation. It leaves it to individual WTO Members to determine the nature and methodology of measures to avoid double taxation. It also allows Members to take a prophylactic approach, rather than waiting for a double tax actually to be levied and providing relief only after the fact. This can be seen in the language of the fifth sentence of footnote 59, which says that paragraph (e) of Annex I does not "limit" the "ability" of Members" to take "measures" to "avoid" double taxation. Footnote 59's focus is on not limiting the ability of members to fashion double tax relief.

91. The flexibility accorded to Members is also reflected by the fact that the ordinary meaning of the fifth sentence of footnote 59 essentially says in one sentence what treatises and treaties are written to achieve. These topics are the subject of considerable debate among WTO Members.

92. As a result, the United States does not believe that there are internationally accepted "special meanings" that can be used to fill in any perceived "gaps " in footnote 59. It may be convenient for the EC to point to the OECD Convention to supply requirements and conditions that are not contained in the SCM Agreement, but such reasoning is simply not in accordance with a proper interpretation under the Vienna Convention and the DSU. In contrast to the EC, the United States has cited these agreements only as evidence in support of its textual arguments. It has not attempted to substitute them for the text of the SCM Agreement.

93. Thus, respectfully, the Panel cannot assume that the concept of "permanent establishment" is a part of footnote 59. As the United States has explained, many countries do not rely on "permanent establishments" and have more aggressive tax systems. Even if it were part of footnote 59, there is no one internationally accepted definition of a "permanent establishment". The term "permanent establishment" as used in the OECD Convention can mean a fixed and enduring place of business, but it also can mean an agent acting on behalf of a non-resident. Moreover, it has a different meaning in the U.N. Model Agreement.

94. Indeed, one of the main reasons these agreements impose some "permanent establishment" requirement is because many countries tax non-residents who do not have "permanent establishments". WTO members should be able to protect their taxpayers from double taxation even where those taxpayers do not have a "permanent establishment " in a foreign country.

[38] *See US First 21.5 Submission* , paras. 166-167.

95. Likewise, the Panel should not read “foreign source income” as meaning only income directly attributable to foreign economic processes. Such a test is incompatible with the ordinary meaning of those words, which would seem to apply to income that has a foreign origin or comes from or is attributable to a foreign source. The EC not only is unable to explain why the words “foreign source income” have the unique meaning it advances, but the EC also cannot explain how foreign economic activities are to be valued or allocated. Furthermore, the wide application of double tax avoidance measures to passive income (dividends, interest, etc.), including in the EC, would not be proper under the EC’s argument because there are no economic activities associated with such income.

96. The EC also is unable to explain why a WTO Member must demonstrate “necessity” to institute a measure to avoid double taxation. The SCM Agreement does not impose such a requirement. The drafters of the WTO agreements clearly knew how to impose a “necessity” requirement – they did so elsewhere – but did not in the fifth sentence of footnote 59. Moreover, the fact that a Member has one method to avoid double taxation does not mean that it cannot adopt another. That is a matter left to the Member to decide. Many countries, including France, offer taxpayers alternative methods.

97. Finally, the fifth sentence of footnote 59 does not require that Members provide double tax relief in manner that is precisely calibrated to offset – dollar-for dollar, pound-for-pound, or euro-for-euro – foreign taxes actually paid. The essence of the fifth sentence of footnote 59 is that it leaves Members unlimited in their ability to avoid double taxation. This means that such relief can be preventive in nature. That is why a number of countries rely on the exemption method for avoiding double taxation. Unlike the credit method, which provides relief based on the amount of foreign taxes paid, the exemption method looks to whether income could be taxed elsewhere. As the Commentary to the OECD Convention explains, “[f]undamentally, the difference between the methods is that the exemption methods look at income, while the credit methods look at tax”.[39]

98. Accordingly, the Act is a measure to avoid double taxation for purposes of the fifth sentence of footnote 59 because the ordinary meaning of that provision allows the United States to exclude from taxation income that could be taxed by another country. The transactions that give rise to extraterritorial income must involve the sale, use, or disposition of products outside the United States. The purchasers of such products may be foreign, title to the products may be transferred abroad, and any contracts involved may be executed outside the United States and may be subject to foreign law. In addition, the Act requires that at least a minimum amount of economic activities must occur abroad. In so crafting the Act, the United States has adopted a flexible approach to providing relief for its taxpayers against the myriad ways in which they might face double taxation.

Question 42. Is the EC correct in its statement that the "foreign economic process" requirements in Section 942(b) of the Act may be satisfied even where the functions were in fact performed within the United States? Please explain.

99. The EC is incorrect. Section 942(b) expressly provides that the Act’s exclusion applies with respect to a particular transaction “only if economic processes with respect to such transaction take place outside the United States”.[40] The Act does not allow this requirement to be met by performing the enumerated functions within the United States, as the EC asserts. As one of the legislative reports accompanying the Act’s enactment explains:

> [u]nder the bill, gross receipts from a transaction are foreign trading gross receipts only if certain economic processes take place outside the United States. The foreign economic processes requirement is satisfied if the taxpayer (or any person acting

[39] US-7.
[40] Section 3 of the Act, amending IRC Section 942(b)(1).

> under a contract with the taxpayer) participates outside of the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to such transaction and incurs a specified amount of foreign direct costs attributable to the transaction. For this purpose, foreign direct costs include only those costs incurred in the following categories: (1) advertising and sales promotion; (2) the processing of customer orders and the arranging for delivery; (3) transportation outside of the United States in connection with delivery to the customer; (4) the determination and transmittal of a final invoice or statement of account or the receipt of payment; and (5) the assumption of credit risk.[41]

100. Merely because the taxpayer can arrange by contract for an agent to perform the activities on its behalf does *not* mean that the agent may perform the activities within the United States. That agent, for example, still must negotiate or solicit sales outside the United States on behalf of the taxpayer. Accordingly, the United States is at a loss as to why the EC would contend that this requirement can be satisfied exclusively through domestic (US) activities. The EC's assertion is contradicted by the language of the Act and the legislative report explaining it.

QUESTIONS FOR BOTH PARTIES

Question 43. Can a measure of a Member provided in respect of the production of a good outside the territory of that Member be a subsidy within the meaning of Article 1 of the SCM Agreement? Please explain your answer, taking into account any relevant provisions of the SCM Agreement.

101. Yes. Although the provisions of the SCM Agreement that address this issue in general terms are not entirely clear, certain paragraphs of Annex I clearly contemplate the provision of subsidies to recipients located outside the territory of the Member providing a subsidy. Thus, the United States does not disagree with the statement made by the EC in paragraph 65 of its First Submission.

102. At the outset, the United States notes that the reference in the question to "in respect of the production" may be somewhat inaccurate in light of the Appellate Body's recent decision in *United States - Lead Bar.*[42] Although the United States previously was of the view that subsidies are provided to productive operations, the Appellate Body rejected this approach, finding instead that subsidies are provided to natural or legal persons.[43]

103. With this as a background, there are several provisions of the SCM Agreement that arguably touch upon the question posed by the Panel. Article 1.1(a)(1) refers to "a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as 'government') ... ." The phrase "within the territory of a Member" arguably could modify either "financial contribution" or "any public body". However, the location of the parenthetical suggests that "within the territory of a Member" modifies "any public body", so that the public body providing a financial contribution must be within the territory of the Member allegedly providing a subsidy, but that the recipient of a financial contribution need not be within the territory of that Member. If the latter had been intended, the provision presumably would have read "a financial contribution *within the territory of a Member* by a government, etc."

104. Article 8.2(b) – which is no longer in effect – refers to "assistance to disadvantaged regions within the territory of a Member ... ." However, this provision does not shed any light on the Panel's

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[41] *Senate Report* , pages 8-9, US-3.

[42] *United States - Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom,* WT/DS138/AB/R, Report of the Appellate Body adopted 7 June 2000.

[43] *Id*.

question, because the reference to "territory of a Member" arguably simply limited the circumstances under which a subsidy could be considered non-actionable, as opposed to the question of whether a subsidy existed at all.

105. Article 28.1 refers to "[s]ubsidy programmes which have been established within the territory of any Member ... ." However, this reference does not preclude the possibility that the recipient of a subsidy could be outside the territory of a Member.

106. Paragraph 6 of Annex IV – which also is no longer in effect – provided that subsidies provided by "different authorities in the territory of a Member shall be aggregated." However, this provision, like Article 1.1(a)(1), arguably refers to the location of the entity providing the subsidy, as opposed to the location of the recipient.

107. Finally, insofar as the concept of "territory" is concerned, paragraph 2 of Annex IV, which deals with the calculation of an overall rate of subsidization, provided *inter alia* that "the value of the product shall be calculated as the total value of the recipient firm's sales ... ." Footnote 63 to this paragraph stated that "[t]he recipient firm is a firm in the territory of the subsidizing Member." One can interpret this footnote two different ways. One interpretation is that it simply restates what is assumed in the remainder of the SCM Agreement; *i.e.*, that the recipient of a subsidy must be located within the territory of the subsidizing Member. Another interpretation, however, is that the footnote is necessary because it is *not* assumed in the remainder of the Agreement that the recipient must be located within the territory of the subsidizing Member. This latter interpretation would appear to be more in accordance with the principle of effectiveness of treaty interpretation.

108. Another relevant term is "jurisdiction", which in Article 2.1 refers to enterprises, industries or groups thereof "within the jurisdiction of the granting authority ... ." In the case of an alleged subsidy taking the form of a tax measure, it would seem appropriate to interpret the term "jurisdiction" as referring to the taxing jurisdiction of the Member in question.

109. Finally, certain provisions of Annex I involve practices that frequently entail the provision of a subsidy to a recipient located outside the territory of the Member providing the subsidy. In the case of export credits covered by paragraph (k), credits frequently are provided in the form of "buyer credits" that are received by a foreign person. Similarly, the types of subsidies covered by paragraph (j) often are provided to foreign persons.

110. Although US countervailing duty practice is not binding on the Panel, the United States notes that the practice of the US Department of Commerce is generally to treat what it calls "transnational subsidies" as non-actionable. In other words, a subsidy may exist when the government of one country provides a financial contribution to a recipient in another country, but Commerce does not countervail it. However, this policy is subject to certain exceptions.

Question 44. Assume for the sake of argument that the answer to question 43 is no. What relevance, if any, would such a conclusion have in respect of the issues of export contingency which are before the Panel in this dispute?

111. This conclusion would seem to be irrelevant for purposes of analyzing export contingency, and, indeed, could have unintended adverse consequences if it were considered relevant.

112. The fact that a particular financial contribution may be labelled as a "subsidy" when provided to certain recipients and as not a "subsidy" when provided to others would seem to have little relevance to the question of whether the measure is export contingent. Again, referring to the concept of specificity – of which export contingency is a part – helps to clarify things.

113. Assume a government loan programme that provides loans to thousands of firms in a wide variety of industries at a standard interest rate of, say, 10 per cent. For all loan recipients but one, the government financial contribution – in the form of a loan – does not provide a "subsidy" because there is no "benefit." More specifically, for all recipients but one, a 10 per cent interest rate does not result in a difference between what the recipient pays on the government loan and the amount it would pay on a comparable commercial loan within the meaning of Article 14(b) of the SCM Agreement.

114. However, for one firm – which is in worse financial straits than other participants in the programme – the interest rate of 10 per cent *does* result in a difference, so that a subsidy exists. In analyzing whether this subsidy is specific, would one ignore the fact that loans on the same terms were provided to thousands of other industries, even though these loans did not technically satisfy the definition of "subsidy" under the SCM Agreement? The answer clearly has to be "no."

115. Thus, an analysis of specificity or export contingency which focused solely on those government outlays (or foregone revenue) that satisfied the technical definition of "subsidy" would generate peculiar and unintended results. In all probability, measures that previously were regarded as non-specific would be suddenly transformed into specific subsidies.

116. Indeed, insofar as the taxation of foreign-source income is concerned, an approach which focused on only one category of transactions capable of earning foreign-source income, such as exports, to the exclusion of other categories could result in labeling the tax regimes of most Members as subsidies. This follows from the fact that if, of the categories of transactions capable of generating foreign-source income, one excludes all categories involving products produced abroad, all one may be left with is the category of export transactions. Under the logic assumed in the question, the non-taxation (in whole or in part) of foreign-source income earned in export transactions automatically would be export-contingent, notwithstanding the fact that the tax rule applied to foreign-source income earned in export transactions is the same as the rule applied to foreign-source income earned in other types of transactions. The absurdity of this result demonstrates that this approach must be incorrect.

Question 45. Is export income foreign source income? Some may take the view that the "foreign-source income" referred to in footnote 59 should include export income since the footnote is accompanying item (e) that is dealing with a type of subsidy specifically related to export. Please comment.

117. Export income can and usually does involve some amount of foreign-source income. By their very nature, exports involve more than two countries in a business transaction. They can involve foreign purchasers, foreign use of the product, foreign sales and promotion activities, foreign distribution, foreign formation and execution of contracts, foreign passage of title, foreign origin of payment, and other foreign attributes. Some or all of these attributes can give rise to income being subjected to tax by a taxpayer's country of residence as well as another, or foreign, country.

118. Whether or not a country considers income taxable or not turns on domestic law. Countries around the world employ two sets of widely varying rules that may bear on this question: taxing jurisdiction rules and sourcing rules. With regard to jurisdiction, some countries tax businesses only if they have a fixed and enduring place of business that has active and even profitable operations, while others require some lesser presence and some require no fixed or established presence at all. With regard to sourcing, some countries would view a large portion of an export transaction as being "foreign", others a smaller part, and some relatively little. There is no internationally accepted rule establishing under what circumstances exporters may be taxed in the country to which their products are sent, and there is no rule governing which parts of income earned in an export transaction can be said to be "foreign".

119. Footnote 59's connection to paragraph (e) confirms that export income may be foreign-source income, at least in part. Paragraph (e) makes clear that "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes" is prohibited by Article 3.1(a). That the fifth sentence of footnote 59 provides that paragraph (e) does not limit the ability of Members to take measures to avoid double taxation of foreign-source income means that Members may do so even through an exemption, remission, or deferral that is "specifically related to exports". If export transactions do not produce "foreign source income" within the meaning of footnote 59, then it is hard to understand why the drafters inserted the fifth sentence into a footnote attached to paragraph (e).

QUESTIONS TO THE EC

120. The United States would like to comment on the following questions posed by the Panel to the EC.

Question 1. In section 3.2.5. of its first submission, the European Communities expresses the view that the FSC Replacement scheme gives rise to two distinguishable subsidies : the "basic FSC Replacement subsidy" and the "extended FSC Replacement subsidy".

- **Does this mean that the EC is requesting the Panel to make two separate rulings, one on each of the alleged subsidies?**
- **Does the EC consider that the application of a different portion of the FSC Replacement scheme may involve different types of subsidies under the SCM Agreement?**
- **Please identify the relevant portion of the *FSC Repeal and Extraterritorial Income Exclusion Act* ("the Act") framing these two "distinguishable" alleged subsidies.**
- **Does the EC believe that the status of a subsidy under the SCM Agreement is determined by the particular legal circumstances in which it is granted on a case-by-case basis?**

121. In the view of the United States, it would be inappropriate for the Panel to bifurcate the Act in the manner suggested by the EC. The EC would like the Panel to examine the Act as if it has one category for income derived from export transactions and another for income from all other types of transactions. As the United States has explained, the Act does not treat exports differently than other transactions that may give rise to extraterritorial income. There is a single exclusion that applies to different types of foreign transactions.

122. Instead of the artificial analysis the EC advances, the United States proposes that the Panel examine the measure as it is. The United States submits that the Panel should determine whether excluding (at least in part) extraterritorial income from a wide array of foreign sales, leases, and other transactions is a subsidy or an export subsidy (among other things). If the Panel were to adopt the EC's approach, it would in effect signal that the appropriate method for analyzing any tax exclusion or exemption of foreign income would be to first examine how it applies solely to exports, and then examine how it applies to other transactions. This approach would condemn many export-neutral tax measures simply because a sub-category of taxpayers subject to the measure happen to be exporters. This approach also would create an artificial distinction that is not supported by the text of the SCM Agreement and that does not exist with respect to the measure at issue.

123. Ironically, while the EC asks the Panel to divide what the Act does not, it takes the 50-per cent value rule and attempts to integrate it into all aspects of the Act. Whereas there is no part of the Act that treats qualifying transactions differently, there is a separate provision of the Act that imposes

the 50-per cent rule. Because the Act institutes the rule through a stand-alone provision, the United States suggests that it is appropriate for the Panel to rule on the EC's claims concerning the rule separately. For example, if the Panel were to find that the Act confers subsidies or exports subsidies because of the 50-per cent rule, the Panel should say so. The Panel should not condemn all provisions of the Act merely because it finds one potentially severable part to be problematic.

124. Thus, in reviewing the Act, the Panel should distinguish among its provisions where those provisions are separate within the architecture and design of the measure. The United States does object to imposing distinctions that the EC claims exist, but that cannot be found in the Act.

Question 3. The European Communities states that it "… sees no reason to contest that the last sentence of footnote 59 may be an exception to Article 3.1(a)."[44] Does this mean that the EC is of the view that measures satisfying the requirements for the last sentence of footnote 59 constitute " [m]easures referred to in Annex I as not constituting export subsidies" under footnote 5 of the SCM Agreement?

125. The United States respectfully refers the Panel to paragraphs 170-76 of its First Submission where it explained why, by virtue of footnote 5, a measure to avoid double taxation under footnote 59 is not prohibited by Article 3.1(a) or any other provision of the SCM Agreement. Neither the EC nor any third party has disputed this point.[45]

126. In this regard, several of the follow-up questions posed by the Panel to the EC appear to relate to the following: if the Act should be found export contingent by virtue of Article 3.1(a), rather than paragraph (e), would footnote 59 apply? In the view of the United States, the answer clearly is "yes."

127. Footnote 5 of the SCM Agreement reads as follows: "Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement." "[M]easures to avoid the double taxation of foreign-source income" are "referred to in Annex I [specifically, in footnote 59] as not constituting export subsidies ... ." Therefore, such measures are subject to footnote 5, regardless of the particular paragraph in Annex I to which footnote 59 is attached.

128. Any other outcome would have the absurd and perverse result that double taxation avoidance measures that are "specifically related to exports", within the meaning of the narrower standard of paragraph (e), are permitted, but comparable measures that are *not* "specifically related to exports" but nonetheless are export contingent under Article 3.1(a) are prohibited.

Question 5. Please provide further clarification of the point made in paragraph 227 of the EC second submission.

129. It is unclear to the United States how, under the Act, "income earned by a US company by distributing foreign goods may in large part be earned in the US." It would seem to the United States that, if a company is distributing foreign goods, it is doing so outside the United States. If a company is earning income by distributing goods for use within the United States, that income may not be excluded.

[44] EC second submission, para. 181.

[45] The United States notes that in its first submission in *Brazil - Export Financing Programme for Aircraft - Second Recourse by Canada to Article 21.5 of the DSU*, WT/DS46 (2 March 2001), para. 54, note 42, Canada takes the position that footnote 59 is one of four provisions in Annex I that are subject to footnote 5. The United States adds that Canada, like the United States, routinely makes public its submission in WTO dispute settlement proceedings.

130. The United States is at a loss to understand how income earned from wholly-foreign transactions would not give rise to income subject to tax in a foreign jurisdiction and thus be subject to double taxation. The United States notes that Canada has agreed with the United States on this point. As it stated in its submission, "the 'foreign income' component of 'extraterritorial income' is the type of income typically subject to a measure to avoid double taxation." Accordingly, it is entirely appropriate for the United States to provide relief from double taxation with respect to this income.

131. The United States also would note that the EC has focused throughout these proceedings on the case where the taxpayer's activities in the foreign jurisdiction do not amount to a permanent establishment. What the EC has ignored is that taxpayers can earn excluded extraterritorial income when the taxpayer's activities *do* amount to a permanent establishment. The Act would provide relief from double taxation in such a case, even under the EC's argument.

Question 6. The European Communities claims that the FSC Replacement scheme is a prohibited export subsidy contrary to Article 3.1(a) *and* item (e) of Annex 1 of the SCM Agreement. Are these alternative claims? In the EC's view, which claim must be addressed first by the Panel?

132. In the view of the United States, there is only a single obligation – not to provide export subsidies – and a single claim – that the United States has not abided by this obligation. The EC simply may be making alternative arguments to support what is really a single claim.

ANNEX F-4

ANSWERS OF THE UNITED STATES TO QUESTIONS FROM THE EC

(27 March 2001)

Q1. The US does not contest that the benefit to taxpayers available under the FSC scheme is arithmetically equivalent it [*sic*] that available under the Act. Is their [*sic*] any reason why transactions and taxpayers that would have benefited from the FSC scheme would not in future, obtain equivalent benefits under the Act?

Reply

The "benefit" of the FSC regime is **not** "arithmetically equivalent" to the computation of excluded extraterritorial income, because the numbers used to determine the quantitative component of the Act's exclusion are not identical to the numbers used in the FSC regime. Even if there were arithmetic equivalence, moreover, this issue is irrelevant. Neither the Panel nor the Appellate Body in *FSC* found objectionable the percentages contained in the FSC provisions. The EC's attempts to compare the provisions of the FSC and the Act therefore are neither accurate nor meaningful.

Under the Act, the category of income excluded from US gross income is defined based on both a quantitative component and a qualitative component. The percentages contained in section 941 supply the quantitative component. The qualitative component defines a broader category of income subject to the exclusion than would have been eligible for the FSC exemption under the prior FSC regime. Most significantly, the qualitative definition of the category of income the United States has chosen not to tax applies without regard to whether the income is earned from exports, and without regard to whether the income is earned by a US or foreign individual, a US or foreign corporation, or a partnership or other pass-through entity. Accordingly, it is misguided to attempt to compare the prior FSC regime to the Act based on similarities in the quantitative measures.

Q2. According to the Congressional Budget Office, the new scheme will involve an increase in tax expenditure compared to the FSC. Please provide details as to how this increased tax expenditure arises?

Reply

The Act defines a category of income that is excluded from gross income and thus is not subject to tax. Because, unlike the FSC regime, the Act applies to a defined category of income, without regard to whether the income arises from an export sale and without regard to the taxpayer earning the income, the estimated revenue loss for the Act is independent of and greater than the revenue loss for the former FSC regime. In this regard, the CBO would publish the same type of projected revenue loss if Congress were to reduce the general corporate income tax rate.

More generally, the EC consistently misuses the term "tax expenditure." This misuse appears to stem from the EC's misunderstanding of the term. The determination of whether a provision is a tax expenditure is made on the basis of a broad, theoretical concept of "income" that is larger in scope than is "income" as defined under US income tax law. The Appellate Body in *FSC* rejected the use of benchmarks based upon what income theoretically could be subject to tax, in favour of the benchmark established by the member's actual law. Accordingly, the EC's use of tax expenditure analysis is not particularly helpful to the resolution of this case.

Q3. What part of that estimated increased tax expenditure is attributed to transactions involving goods manufactured abroad? What are the other sources of the increase in tax expenditure?

Reply

See answer to questions 2 and 4.

Q4. Has the US government produced any other studies or estimates of the impact of the Act?

Reply

The United States is not aware of any other published studies or estimates of the impact of the Act.

Q5. Why does Section 942(a)(3) of the Act allow taxpayers the option to exclude any transaction from being Foreign Trade Income under the Act and therefore from the exclusion of extraterritorial income from tax?

Reply

The following reason is set forth in the legislative history of the Act: "A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a consequence of such an election, the taxpayer could utilize any related foreign tax credits in lieu of the exclusion as a means of avoiding double taxation." *Senate Report* (US-2), page 8; *see also House Report* (US-3), page 21.

Q6. Why does Section 943(a)(3) of the Act exclude five categories of property from being capable of giving rise to excluded income under the Act? Why does Section 943(a)(4) allow the President to exclude other property that he determines to be in short supply from being capable of giving rise to excluded income under the Act?

Reply

Neither the Act nor the legislative history of the Act, as set forth in the reports of the relevant congressional committees, articulates the legislative intent behind sections 943(a)(3) and (4).

Q7. Why does the new Section 943(d)(1) provide that: "For purposes of section 114(d), any withholding tax … shall not be treated as paid or accrued with respect to extraterritorial income which is excluded from gross income under section 114(a)."? Why does new Section 943(d)(2) make an exception for the case that qualifying foreign trade income is calculated under 941(a)(1)(A)?

Reply

Neither the Act nor the legislative history of the Act, as set forth in the reports of the relevant congressional committees, articulates the legislative intent behind section 943(d).

Q8. What guidance or regulations relating to the Act has the US government produced or is planning to produce?

The US Department of the Treasury ("Treasury") and the US Internal Revenue Service ("IRS") already have released Form 8873, for use in calculating the amount of the exclusion. Treasury and the IRS currently intend to release the following additional guidance: (i) a revenue procedure providing guidance with respect to elections under the Act, (ii) a notice containing guidance with respect to specific issues under the Act, and (iii) proposed regulations interpreting the Act.

Q9. When imposing countervailing duties on *pasta from Italy* (Case C-475-819 ; 14 June 1996), DOC found that the Italian government was granting a subsidy because it exempted firms in the South of Italy from local income tax for a period of 10 years, while firms in the North of Italy had to pay such taxes. If the Italian government were to contract its taxing authority, and exclude the relevant profits of firms in the South of Italy from its definition of gross income (thus modifying its prevailing domestic benchmark), does the US consider that no subsidy would exist ?

Reply

See answer to Question 11.

Q10. Under section 80HHC of the Income Tax Act of India, the Government of India allows exporters to deduct profits derived from the export of merchandise from taxable income. In a number of countervailing duty investigations e.g. *Certain Iron-Metal Castings From India: Preliminary Results of Countervailing Duty Administrative Review* (Case C-533-063, 64 FR 61592 12 November 1999), the DOC has countervailed this exemption from income tax on export profits as an export subsidy. If the Indian government were to contract its taxing authority, and exclude the relevant profits derived from exports from its definition of gross income (thus modifying its prevailing domestic benchmark), does the US consider that no subsidy would exist ?

Reply

See answer to Question 11.

Q11. More generally, how would the US react if a WTO Member were to exclude all profits from sales of goods for final consumption abroad from its jurisdiction to tax?

With respect to Question 9, the Italian measure in question constituted an exception to the prevailing domestic benchmark. Similarly, with respect to Question 10, the Indian measure provided a special deduction with respect to income that would be taxed under India's prevailing domestic benchmark. Questions 9-11 essentially ask the same question: how would the United States react if another Member altered its prevailing domestic benchmark.

With respect to these questions, the United States refers the EC to the US answer to Question 20 from the Panel.

Q12. In discussing export subsidies in Section 351.514 of its CVD regs, DOC states :

> **However, under the new standard contained in Section 351.514, if exportation or anticipated exportation was either the sole condition or one of several conditions for granting Pioneer status to a firm, we would consider any benefits provided under the program to the firm to be export subsidies unless the firm in question can clearly demonstrate that it had been approved to receive the benefits solely under non-export-related criteria. In such situations, we would not treat the subsidy to that firm as an export subsidy.**

Does the US consider that this practice is in conformity with the *SCM Agreement*?

Reply

Just as the EC has declined to address in detail how the tax regimes of its own member states would fare under the interpretations of the SCM Agreement that the EC has advanced in this case, the United States declines to speculate on the status of section 351.514 under the SCM Agreement. The United States simply notes that this regulation was promulgated prior to any of the Appellate Body reports elaborating on the meaning of the term "contingent" as used in Article 3.1(a) of the SCM Agreement.

The United States also would add that the quoted language refers to exportation being a "condition" for the granting of Pioneer status, and, in fact companies can be required to agree to export a certain percentage of their production in return for Pioneer status, as reflected in the portion of the DOC notice that the EC omitted.[1] This is quite different from the Act, under which a given taxpayer can earn excluded income through export transactions, but is not required to export in order to earn excluded income.

Q13. A firm based in Texas produces only farm tractors and sells them directly to two unrelated customers. One customer is in California, the other in France. The firm makes the same profit on each transaction. On which of these transactions can the firm claim the benefit of the FSC Replacement Act? Please explain why.

Reply

The firm can earn excluded extraterritorial income on sales to both the customer in California and the customer in France. As the United States explained in response to question #11 from the Panel, the Act permits a US manufacturer of goods to earn excluded income from sales to domestic buyers, provided that the goods in question are used outside the United States. As long as the farm tractors are used outside the United States, the firm can earn excluded extraterritorial income in the sale to the customer in California and the customer in France.

This can occur in a number of ways. For example, a customer in southern California may purchase farm tractors for use in farming operations across the border in Mexico. The hypothetical firm's sale of the farm tractors under such circumstances would generate excluded income under the Act, assuming that the Texas firm satisfied the other requirements of the Act.

Q14. The same firm then begins producing lawn tractors. In what circumstances can it use this product to obtain further benefits under the Act?

Reply

The Act provides significant flexibility to the Texas firm in its production decision. The firm could earn excluded extraterritorial income by (i) selling or leasing tractors produced in the United States (ii) selling or leasing tractors purchased from a related or unrelated US company with a foreign production facility, (iii) selling or leasing tractors produced under a consignment arrangement with a related or unrelated US company with a foreign production facility, (iv) selling or leasing tractors purchased from a related or unrelated foreign manufacturing corporation that has made a domestication election, (v) selling or leasing tractors produced under a consignment arrangement with a related or unrelated foreign manufacturing corporation that has made a domestication election, or

[1] To be technically correct, the EC has not quoted the regulation itself, but rather the preamble to the regulation which explains the regulation and addresses comments from the public submitted in the course of the rulemaking proceeding that led to the regulation.

(vi) establishing its own foreign production facility and selling or leasing tractors produced in that facility.

More generally, it is immaterial whether the firm in question makes farm tractors, lawn tractors, or a totally different line of production.

Q15. Can the US explain the economic, social, political or fiscal objectives/goals that the 50 per cent foreign content limitation aims to achieve?

Reply

Neither the Act nor the legislative history of the Act, as set forth in the reports of the relevant congressional committees, articulates the legislative intent behind the 50 per cent rule.

Q16. What effects does the US anticipate that the 50 per cent foreign content limitation will produce?

Reply

It is not clear what the EC means by "effects" in this question. Moreover, the provision in question is not properly referred to as "the 50 per cent foreign content limitation" because it imposes no general restriction on foreign content; "qualifying foreign trade property" could consist of a product composed entirely of foreign content. In the context of the issues raised by the EC regarding the 50 per cent rule, the United States does not anticipate that the rule will have the "effect" of requiring taxpayers to use domestic over foreign goods in order to earn extraterritorial income.

Q17. Does the US agree that where more than 50 per cent of the fair value of a product is attributable to articles and direct labour costs within the meaning of section 943(a)(1)(C) IRC then not all of that 50 per cent may be foreign?

Reply

See the US answer to Question 8 from the Panel.

Q18. Does this not mean that some of it must be US-origin?

Reply

To the extent that the "it" the EC is referring to is articles, the answer is "no." See the US answer to Question 8 from the Panel.

Q19. How does the FSC Replacement scheme apply to the sale of foreign-produced agricultural products. How is the foreign content limitation applied to growing crops, freshly harvested crops and graded and cleaned agricultural commodities?

Reply

The Act contains no special provisions in respect of agricultural products.

In this regard, the EC appears to take the position that statements made by the United States in the initial phase of this proceeding regarding the FSC definition of "export property" and the application of that definition to agricultural products somehow constitutes an admission by the United States in the instant proceeding that an agricultural product produced abroad could never satisfy the 50 per cent limit on certain foreign value, and, thus, could never be eligible for the Act's exclusion.

EC First 21.5 Submission, paras. 220-221. Of course, in the statement quoted by the EC, the United States merely was expressing its opinion that, given the likely sourcing patterns of US producers of agricultural products, the FSC definition of "export property" was unlikely to have any practical effect.

To be clear, however, the United States has never made the admission ascribed to it by the EC, and the EC's assertion ignores the differences between the FSC definition of "export property" and the Act's 50 per cent rule. Under the FSC, one of the criteria for "export property" was that no more than 50 per cent of the property's fair market value could be attributable to imports. Under the Act, however, the criteria for "qualifying foreign trade property" is that no more than 50 per cent of the fair market value of a good may be attributable to the sum of foreign articles and foreign direct labour. The United States believes that agricultural products produced abroad are capable of satisfying this rule, and, thus, are capable of earning excluded extraterritorial income.

Of course, as the complainant, the burden of proving that agricultural products could not satisfy the definition of qualifying foreign trade property is on the EC, and the EC has submitted no evidence whatsoever on this point. Although the United States does not bear the burden of disproving the EC's unsubstantiated assertions, the United States nonetheless would note that a available data demonstrates that agricultural products produced abroad would be capable of satisfying the 50 per cent rule.

For example, based on data from the US Department of Agriculture (USDA) for US production in 1999, the "total gross value of production"[2] for soybeans (in dollars per planted acre) was $178.00. The cost of items that arguably could be considered "articles" (seed, fertilizer, soil conditioners, manure, and chemicals) amounted to $52.98. The cost for hired labour and the opportunity cost of unpaid labour amounted to $20.90. Thus, the total cost of articles and labour was $73.88, a figure well below 50 per cent of $178. In fact, this figure is below the single biggest item of cost, which was the opportunity cost of land (rental rate), which amounted to $77.66.

Of course, these are US data, but they are no more nor less representative than the purported European data provided by the EC in the annexes to its submissions. And, of course, it bears repeating that it is the EC, not the United States, that bears the burden of proof.

Q20. The US argues that the exclusion of 'extraterritorial income' from tax is justified as a measure to avoid double taxation. This necessarily implies that such income could be taxed in foreign countries. Therefore, would the US agree that foreign countries, which either have no bilateral tax treaties with the US or terminate them, may require US exporters to pay tax the profits made by them from exporting to their territories.

<u>Reply</u>

As the United States explained in its prior submissions to the Panel, the Act 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 so as to render US taxpayers potentially subject to foreign taxation.

Transactions giving rise to extraterritorial income involve goods that must be used, consumed, or disposed of outside the United States. Thus, 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. In addition, certain required levels of foreign economic activities must be performed with respect to the sales and

[2] "Gross value of production" may not correspond precisely to "fair market value" as used in the Act, but it is the closest term used in the data.

distribution functions associated with qualifying transactions. These foreign attributes can lead a foreign taxing regime to tax the profits earned on sales of goods sold by US exporters to foreign customers. The United States, in response to Question 12 from the Panel, has provided several examples of foreign taxing regimes that may tax extraterritorial income earned in export sales.

Accordingly, the United States believes that a significant risk of double taxation exists with respect to excluded extraterritorial income, which is why the Act provides necessary relief with respect to this category of foreign-source income. The question of whether foreign tax jurisdictions *should* seek to impose tax upon excluded extraterritorial income is a question more appropriately addressed to foreign tax policy officials.

Q21. If a US producer sells a good directly to a customer in a third country, is the income derived from this transaction foreign sourced?

Reply

See the US answer to question 45 from the Panel.

Q22. How can the exemption of such income be a measure to avoid double taxation?

Reply

The extraterritorial income exclusion is a measure for the relief of double taxation precisely because excluded extraterritorial income may be subject to tax in a foreign jurisdiction. See the US answers to questions 12 and 45 from the Panel and 20 from the EC.

Q23. If the intention of the Act is to avoid double taxation, why is the foreign content limitation present?

Reply

That the 50-per cent rule may operate so as to narrow the class of transaction producing excluded extraterritorial income is irrelevant to whether the exclusion comes within footnote 59. As the United States explained in response to question 19 from the Panel, nothing in footnote 59 requires that a measure for the relief of double taxation must resolve the problem of double taxation completely or precisely. Stated differently, all income that may be subject to double taxation need not be covered by a particular double taxation avoidance measure for that measure to be "intended" to avoid double taxation or for that measure to come within the scope of the fifth sentence of footnote 59. This is most clearly evident in the use of tax credits, which apply only to certain foreign taxes and, even where they do apply, often provide less than full relief.

Therefore, the United States submits that the 50-per cent rule has no bearing on the interpretation and application of footnote 59.

Q24. According to the US, is it compatible with the *SCM Agreement* for a WTO Member to allow its favoured companies the right to opt for a more generous system of double taxation relief, that is not available to other taxpayers?

Reply

The United States does not know what the EC means when it refers to "favoured companies". The United States submits that the Act in no way applies to a limited or "favoured" group of taxpayers.

Similarly, while the United States is pleased to see the EC acknowledge once again the advantages of the exemption method, the United States does not believe it is accurate to say that the exemption method is always "a more generous system of double taxation relief." Depending on the circumstances of a particular taxpayer, there may be situations where the use of the credit method is more favorable from the perspective of the taxpayer.

To the extent that this question is another way of the EC again raising its point that the United States should not be allowed to provide different mechanisms for avoiding double taxation, the United States notes that it explained in paragraphs 35-38 of its Second Submission why countries can and do rely on alternative methods of avoiding double taxation. This is a common and well-accepted practice. For example, in France, with the permission of the Ministry of Economy and Finance, a French company may elect to be taxed on its worldwide income and obtain relief from its worldwide losses. Thus, in the context of export subsidies, alternative methods of double taxation relief should be irrelevant, especially where no unique or special benefits are provided exclusively to exporters.

In the view of the United States, the key point is that US foreign tax credits are not available for excluded income. Thus, there is no "more generous system of double taxation relief."

Q25. According to the US is it compatible with the *SCM Agreement* to allow favoured companies to double the amount of benefit that is available under the Member's system for the relief of double taxation for certain beneficiaries?

Reply

See answer to question 24.

Q26. Does the US legislation contain any such anti-avoidance rules that were designed to prevent unwarranted exclusion of "qualifying foreign trade income" in all those cases where no other country will tax that income and thus, where there is no double taxation? The US Subpart F rules are designed to prevent unwarranted tax deferral but is the US contemplating any measures to prevent possible abuse of the FSC Replacement Act?

Reply

The Act does contain certain measures to prevent tax avoidance. For example, under section 943(e)(1), a foreign corporation that elects to be treated as a US corporation under the Act must waive all treaty benefits. If the electing foreign corporation could claim US treaty benefits, then it could claim under a US treaty that it remained a resident of its original jurisdiction under the "tie-breaker" rule of the treaty, thus obtaining an exemption for all of its income that is covered by the treaty. This would defeat the very purpose of the domestication election, which is to place all foreign manufacturing activities on par with respect to the US tax system. Although the EC has voiced its strenuous objection to this rule, it is a rule designed to prevent tax avoidance and to prevent the double non-taxation of income.

ANNEX F-5

COMMENTS OF THE EUROPEAN COMMUNITIES ON THE ANSWERS OF THE UNITED STATES TO THE QUESTIONS PUT FOLLOWING THE MEETING OF THE PANEL

(3 April 2001)

1. The EC[1] believes that the Panel is aware of the EC position on most of the points made by the US in its answers to the questions of the EC and the Panel following the meeting of the Panel with the parties. It will confine its comments to the following brief observations on matters where the EC position may not be fully clear to the Panel or where the EC considers that a comment on its part may be of assistance to the Panel.

1. Pertinence of the Legislative History

2. The US prefaces its answers to the Panel's questions with some remarks on the elements of legislative history that the EC presented at the meeting of the Panel in its Closing Statement.[2]

3. The US argues that US courts do not attach much importance, when interpreting US laws, to floor statements in the US Congress, but consider more important Committee reports in discerning the will of Congress. It concludes by stating that:

> Thus, any *post hoc* speculation of the sort sought by the EC as to what Congress intended would be nothing more than that: mere, and legally irrelevant, speculation.[3]

4. The EC would simply recall that it was not invoking legislative history for the purposes of interpreting the FSC Replacement Act. The terms of that measure are quite clear. The EC was responding to the US' refusal to respond to a series of questions about the *purposes* pursued by the US (not only Congress) in adopting this measure. (The US has invoked an alleged purpose of the FSC Replacement Act in its defence when it claimed that the FSC Replacement Act was "influenced by ongoing congressional review" of the US tax system.[4])

5. The US claims not to know why the FSC Replacement Act contains a foreign content limitation, why it excludes from its benefit products in short supply and why an alleged double taxation measure only applies to goods with limited foreign content "not for ultimate use in the US."[5] The legislative history demonstrates that the US in fact knew the reasons why these provisions were carried over from the FSC regime or inserted in the FSC Replacement scheme.

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[1] In the interests of conciseness, the European Communities abbreviates both its own name and that of the United States to EC and US respectively. It would request however that the term "European Communities" be used in the Panel Report.

[2] Closing Statement of the EC to the meeting of the Panel, paragraphs 3 to 9 and exhibits EC-16 to 19.

[3] Answers of the US to the questions from the EC, preliminary comments.

[4] First written submission of the US, paragraphs 24 and 25.

[5] As noted in paragraphs 3 to 9 of the Closing Statement of the EC to the meeting of the Panel and confirmed in the US' answers to Questions 2, 3, 4, 6,7, 15 and 16 from the EC.

2. US Erroneous statements about the FSC Replacement Act

6. The US has made some erroneous factual allegations concerning its FSC Replacement Act. The EC is astounded that the US should do this at such a late stage in the proceedings.

7. In paragraph 51 of its Answers to the Questions from the Panel the US states that:

> … excluded extraterritorial income would be foreign-source income under US sourcing rules, as set forth in section 862(a)(4) and 863(b) of the IRC.

In the same vein the US claims in paragraph 60 that:

> The extraterritorial income exclusion, however, is limited to the foreign-source income that arises when property is sold or leased for use outside the United States because the United States has determined not to cede primary taxing jurisdiction over US-source income.

8. These statements are demonstrably wrong and contradict what the US stated during the meeting with the Panel.[6] The EC feels obliged to explain why foreign-source income and extraterritorial income are entirely unconnected concepts.

9. Extraterritorial income is a new creation of the FSC Replacement Act. The foreign-source income concept is well established in the US tax law as a means of addressing primary tax jurisdiction for purposes of the statutory provisions that have the effect of eliminating or at least alleviating double taxation. Thus, a foreign corporation is generally subject to US tax on its US-source income, but not its foreign-source income.[7] A US corporation, while subject to tax on its worldwide income, is generally eligible for foreign tax credit based on the portion of its income that is sourced outside of the US.[8]

10. Extraterritorial income could be entirely US-source, entirely foreign-source or a mixture of the two. If a product were manufactured in the US and then sold by the manufacturer to another party for use outside the US in a transaction in which title passed from the manufacturer to the buyer within the US, the income realised by the manufacturer would be entirely US-source. Conversely, if the product were manufactured and sold in Europe by a US corporation or an electing foreign corporation, the income realised by the manufacturer would be sourced entirely outside the US. As a middle case, if the product were manufactured in the US but sold in a transaction in which title passed to the buyer outside the US, the transaction would produce a combination of US-source and foreign-source income. All three scenarios could produce the same extraterritorial income, provided that the other requirements of the Act were satisfied.

3. Existence of a subsidy – qualifying foreign trade income defined as a reduction in taxable income

11. Question 7 from the Panel to the US asked the US to comment on the fact that the new section 941(a)(1) of the IRC defined qualifying foreign trade income as "the amount of gross income which, if excluded, will result in a reduction of taxable income of the tax payer from such transaction" by a defined amount.

[6] In its oral answer to what became EC Question 21 to the US, the US replied (correctly) and repeated a number of times that the source of income is not relevant for determining extraterritorial income. In its written answers the US avoids responding to this question.

[7] IRC, sections 881 and 882 (Exhibit EC-21).

[8] IRC, section 904 (Exhibit EC-21).

12. This formulation is effectively converting a given reduction in taxable income into an equivalent reduction in gross income. The US explanation of why it does this is revealing. It states that:[9]

> Because excluded extraterritorial income is excluded from the US tax base, however, the Act denies deductions attributable to such income. This presents a computational problem: how are disallowed deductions to be removed if the excluded amount is based on gross income, which does not account for any deductions? The problem is solved by first computing taxable income, then denying deductions allocable to excluded extraterritorial income, and then "grossing up" the resulting figure into a gross income exclusion by attributing to the taxable income amount any allocable deductions.

13. In other words, the above formulation is necessary because extraterritorial income is excluded from gross income and therefore taxable income must be "grossed up" in order to allow expenses to be deducted correctly. It refers to the explanation in the legislative history:

> [I]n order to calculate the amount that is excluded from gross income, taxable income must be determined and then "grossed up" for allocable expenses in order to arrive at the appropriate gross income figure."[10]

14. The US explanation serves to demonstrate the fact that the US is excluding part of a category of income from tax. Expenses are normally associated with a type of income or arise out of the activities required to produce the income. The reason why the "computational problem" arises is that the US is excluding from tax only part of a "category" of income, properly so-called.

15. The FSC Replacement scheme "exclusion" is in fact a formula-derived fraction of a type or category of income. Looking at the example contained in the Committee Report referred to by the US, it appears that the best measure of the actual taxable income derived from the sale of qualifying foreign trade property is "foreign trade income." In fact, the IRC defines "foreign trade income" as "the taxable income of the taxpayer attributable to the foreign trading gross receipts of the taxpayer."[11] In the example, this is $100. Yet the exclusion in the example is $60. Thus, the IRC is not excluding or giving up jurisdiction over all of the income attributable to a defined economic activity.

16. Thus, the US answer to this question simply underlines that qualifying foreign trade income cannot be regarded as a true category of income.

4. Could other countries tax extraterritorial income?

17. Question 12 of the Panel to the US asked whether

> Where qualifying foreign trade property is manufactured, produced, grown or extracted within the United States by a US corporation or an individual permanently established in the United States, and where that corporation or individual does not maintain any permanent establishment outside the United States, are there situations in which extraterritorial income earned from the sale of such property can be taxed by another country than the United States?

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[9] US answers to the questions from the Panel, paragraph 12.
[10] The US refers to the Senate Report in Exhibit US-2, page 12.
[11] Section 941(b) of the IRC.

18. The US replies by referring to the laws of 6 countries, Brazil, Chile, Malaysia, Panama, Taiwan and Saudi Arabia, which it claims do not rely on the concept of "permanent establishment" as a basis for taxation of income. The US statements are inaccurate. Even based on the partial quotations from the documents of the *International Bureau of Fiscal Documentation*[12], it can be understood that many of the countries mentioned by the US do have rules that are based on or analogous to the "permanent establishment" notion as far as taxation of business profits of foreign enterprises is concerned. For example:

- Brazil: under Brazilian legislation foreign enterprises pay tax on income derived through branches or agencies. As to the former, according to point 4.04 of exhibit US-24 branches are commonly understood to be registered (that is, to be "permanent" offices, or in other words, "fixed places of business" through which a foreign corporation carries out business operations). Thus, a branch is within the permanent establishment concept as defined in Article 5 of the OECD Model Convention). As to agencies, the rules set out in the third paragraph of point 4.05 are clearly based on Article 5.5 of the OECD Model Convention. A "dependent agent" under the OECD Model Convention constitutes a "permanent establishment".

  Moreover, in point 4.06 (direct trading) it is said: "payments for imported goods to non-resident sellers are not subject to income tax since imported goods are not from Brazilian sources".

- Chile: in point 4.04 of Exhibit US-25 it is stated that "the tax administration has declared that a foreign enterprise acting in Chile through a person who is not a representative with authority to conclude contracts and who rather makes contacts and provides information on potential clients, *is not deemed to have a permanent establishment* in Chile" (emphasis added). This language closely resembles that of Article 5 of the OECD Model Convention. Still in the same point (4.04) it is stated that "The Chilean income of agencies, branches and other permanent establishments of foreign enterprises operating in Chile is established..." This language also strongly suggests that Chile indeed is recognising the same or a very similar standards to the OECD Model Convention.

- Malaysia: in point 11.3 of Exhibit US-26 it is stated: "The OECD model definition of permanent establishment is generally used in Malaysian double taxation treaties".

19. More fundamentally, the EC would note that:

- The US does not identify any double taxation problem with these or any other country that the FSC Replacement scheme is designed to solve. It simply suggests that there may be a theoretical possibility of double taxation.

- It is clear from the US description of these tax regimes and the annexes that all of these six countries only tax the *domestic-source income* of foreign corporations.

20. Even if it is true that some countries may not rely on an easily identifiable concept of "permanent establishment" as a basis for taxation, it is clear that no country tries to tax foreign corporations on foreign-source income. Countries only seek to tax the *domestic source income* of foreign corporations.

21. The question is therefore really whether qualifying foreign trade income of US exporters would be considered domestic-source income by foreign countries.

22. The FSC Replacement Act excludes from US tax income that would never be considered domestic source income in any other country – that is does not arise from economic activity or

[12] Exhibits US-24 to US-29.

processes conducted in another country. The FSC Replacement scheme foreign economic process requirements simply require a certain minimal amount of *foreign costs* – not any *foreign income* at all. Countries tax the *income* arising from activities – not the *costs*!

23. The US has not identified any country in the world which considers that taxes the income of foreign exporters simply because they sell goods to customers in its territory and have some minimal costs in its territory. So far as the EC is aware, all countries only tax the domestic source income of foreign corporations and this requires that the income *arises* in their territories, not simply that some costs are incurred in their territories.

24. The US is effectively inviting WTO Members to impose a novel kind of tax on imports – to require foreign exporters to pay tax in their territories on the profits they make from exporting to those territories!

25. Finally, the EC would repeat that it is not relying on the OECD Model Convention to fill a "gap" in footnote 59 as alleged by the US[13] but simply as evidence of international practice. The EC and the US in fact agree on that the OECD Model Convention is only relevant as evidence of international tax practice. Reference to the concept the "permanent establishment" as a basis for taxation of business income is relevant as:

- A description of how most countries with developed taxation systems agree to apportion taxation authority;

- A demonstration that for income to be considered to arise in a country, that is have its source in that country, and to be taxable when earned by foreigners, there must be physical presence by which the income can be earned;

- A recognition of the fact that, *in practice*, countries cannot collect tax on foreign business income if there is no lasting physical presence on which the tax can be levied and against which enforcement procedures can be directed.

5. The use of alternative means for the avoidance of double taxation

26. In reply to Question 16 from the Panel, the US argues that other countries do provide alternative mechanisms for the avoidance of double taxation.

27. The EC is not in a position to comment on whether and to what extent the tax systems of other countries do provide alternative mechanisms for the avoidance of double taxation.

28. The EC would only comment that allowing certain companies a choice of mechanisms for the avoidance of double taxation gives rise to revenue forgone that would otherwise be due and thus a subsidy under Article 1 *SCM Agreement*, at least where this is allowed transaction by transaction, since it can be assumed that companies will use this possibility to reduce their tax burden in a way not available to other companies.

29. The subsidy element in the FSC Replacement scheme, even if it is accepted as a mechanism for the avoidance of double taxation, is even clearer due to an additional feature – that it is not confined to foreign-source income. US taxpayers may, under general US tax rules, only obtain double taxation relief on their foreign-source income.[14] The FSC Replacement scheme allows what is claimed to be double taxation relief on both foreign-source income and domestic-source income. That

[13] Answers of the US to the questions of the Panel, paragraph 92.
[14] Section 904(a) of the IRC (exhibit EC-21).

is an advantage that no other US taxpayers are allowed, gives rise to revenue forgone and is contingent upon export performance.

30. The availability of double taxation relief on domestic-source income under the FSC Replacement scheme is also not covered by the last sentence of footnote 59. First, such an advantage is not an "exemption, remission or deferral of tax". Second the last sentence of footnote 59 is specifically limited to measures for the avoidance of double taxation on *foreign-source income*.

31. As a final comment in this Section, the EC would like to formally refute, again[15], the US suggestion in its response to question 24 from the EC[16] where it states "the US is pleased to see the EC acknowledge once again the advantages of the exemption method..." To be clear, the EC recognises that each system has its own advantages for taxpayers and tax authorities in different circumstances. It does not however acknowledge that either system in itself presents any advantage for exports.

6. The meaning of the term "foreign-source income"

32. The EC has already set out its views on the meaning of the term foreign-source income in footnote 59 but would like to make two comments on the US answer to Question 15 from the Panel.

33. First, the US refers the Panel[17] to the use of this term in footnote 6 to Article XIV of GATS, which states in its final paragraph that

> Tax terms or concepts in paragraph (d) of Article XIV and in this footnote are determined according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure.

34. The US seeks to use this text to assert that:[18]

> A key point in footnote 6 for purposes of the present dispute is the fact that the final sentence provides that the tax terms used in the relevant text do not have universally agreed upon meanings. Thus, the final sentence indicates that the negotiators of GATS wanted to provide flexibility to capture the various instances in which income can be regarded as "sourced" within a Member.

35. The EC does not agree that this text reflects a desire to allow flexibility in the sense desired by the US – that foreign-source income can mean whatever suits at any time. It provides, on the contrary, *precise* meanings to taxation terms and concepts – those used in the tax system of the Member.

36. The EC does not consider that the fact that something is stated expressly in one of the WTO agreements means that the same must necessarily be considered to apply under another agreement. Particular caution is required in the case of footnote 6 to the GATS because of the different concerns that it was addressing, arising out of the special features of trade in services.

[15] See also answers of the EC to Questions 23 and 35 from the Panel (esp. paragraphs 56 and 94).

[16] Answers of the US to the questions from the EC, paragraph 39.

[17] The US also refers the Panel to the use of the term "source" in the TRIMS agreement. Since this is not referring to income or taxation, the EC does not consider that it adds anything to the use of the term in the trade defence agreements referred to by the EC; They all simply demonstrate that "source" has a similar meaning to " origin".

[18] US answers to the questions from the Panel, paragraph 45.

37. However, if the approach reflected in the last sentence of footnote 6 to Article XIV GATS were to apply to footnote 59 to the *SCM Agreement*, the FSC Replacement scheme would not come within its scope because the benefit it grants is not limited to foreign-source income, within the meaning that term is given under the US tax system.

38. The US seems to have misunderstood paragraph (iv) of footnote 6 to Article XIV GATS.[19] This appears to relate to measures to ensure the collection of taxes of income of *consumers* derived from sources in the Member's territory. It does not support the apparent US view that the "source" of income can be the place where the customer is located.[20]

39. Equally irrelevant is the US argument that "source" must be given a "broad" meaning in footnote 59 so as to cover the different ways in which passive income can arise. Footnote 59, being attached to item (e), relates to tax exemptions etc that are "specifically related to exports". It therefore applies to income derived from trade in goods, not to "passive income".

40. Second, the US refers to the use of the term "foreign-source income" by the Appellate Body in the original proceedings. The US misrepresents the Appellate Body report.

41. The Appellate Body did not "apply the term broadly;" it was clearly referring to income arising abroad. Also, although it did not expressly refer to the meaning of the term in the tax system under consideration, it did not exclude this interpretation. Indeed, elsewhere in the Report the Appellate Body says that:

> We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question.[21]

7. The US Specificity Argument

42. In response to Questions 20 and 21 from the Panel and in particular the fact that according to the US interpretation of Article 1 of the *SCM Agreement* the exclusion of all export income from gross income and therefore tax would not constitute a subsidy, the US invents, as an alternative argument, a novel theory according to which an exclusion of certain income from "gross income" (or an equivalent notion) would become a subsidy within the meaning of Article 1 of the *SCM Agreement* if it is specific in the sense of Article 2 of the *SCM Agreement.*[22]

43. The EC considers this argument completely misguided because the *SCM Agreement* clearly provides that the question of specificity only arises once it has been established that a subsidy exists.

44. The argument also appears pointless since Article 2.3 of the *SCM Agreement* **deems** all subsidies falling under the provisions of Article 3 to be specific. It cannot therefore save the FSC Replacement scheme.

45. The US is effectively arguing that an exception be made from Article 3 the *SCM Agreement* for prohibited subsidies that are non-specific within the meaning of Article 2.1 and 2.2 of the *SCM Agreement*. There is no basis for this in the text of the Agreement; indeed the text says the opposite. In any event, the EC does not accept that the FSC Replacement subsidies are non-specific.

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[19] US answers to the questions from the Panel, paragraph 46.

[20] The US also quotes but does not comment on paragraphs (i) and (vi) of the footnote. Paragraph (i) also does not support the US theory, but on the contrary is simply referring to the place income arises, and therefore supports the EC view of "source." Paragraph (vi) does not refer to the notion of source at all.

[21] Appellate Body report, paragraph 90.

[22] US answers to the questions from the Panel, paragraph 63.

8. The EC's Demonstration of the effect of the 50 per cent rule (Question 8)

46. Question 8 from the Panel to the US asked the US:

> The European Communities states that, in order for extraterritorial income to be excluded from taxation, "US articles must be used whenever the cost of other inputs (not articles or direct labour) (C) and profit (D) are less than 50 per cent of the selling price (or more exactly the US-assessed fair market value) of the goods".[23] Is this a correct characterisation of Act ? If not, could the US provide what it considers to be the correct description?

47. Apart from repeating its view that the EC can only prevail if it demonstrates that "the Act contains an affirmative requirement to use US articles,"[24] the US response is limited to alleging that the EC' statement is inaccurate because:[25]

> … the EC's algebraic breakdown fails to reflect the Act's distinction between the foreign labour and US labour components.

48. The reason for this is simply that the EC made the simplifying assumption that there would be no US direct labour costs in foreign production.

49. The US does not respond to the Panel's request to provide an alternative description of the effect of the Act. A more sophisticated description of the effect of the Act that entirely takes account of the US criticism is easy to formulate, as the EC stated at the meeting with the Panel. It is simply necessary to split the component representing direct labour costs into two parts, B1 representing US direct labour and B2 representing foreign direct labour. Paragraph 112 of the first written submission of the EC can then be rewritten as follows:

> Since A2 + B**2** may not exceed 50 per cent of SP, (i.e. A2 + B**2** must be = or < SP/2), then mathematically,
>
> A1+**B1**+C+D must constitute at least 50 per cent of SP (i.e. A1+**B1**+C+D must be = or > SP/2 which can be expressed as A1 = or > SP/2-C-D**-B1**). This means that A1 will be positive whenever SP/2 > C+D**+B1**
>
> In other words, US articles must be used whenever the cost of **US labour (B1) and** other inputs (not articles or direct labour) (C) and profit (D) are less than 50 per cent of the selling price (or more exactly the US-assessed fair market value) of the goods.[26]

50. With this correction, the EC' description of the effect of the Act meets the only criticism the US has made. It can then also be used to demonstrate in what circumstances the Act requires the use of US articles in the production of qualifying foreign trade property in the US.

9. Export Contingency

51. In its first written submission, the EC offered a relatively detailed discussion of the meaning of the terms "export" or "exportation" in the *SCM Agreement.*[27] The EC sought to go beyond the

[23] The Panel referred the US to EC first submission, para. 112.
[24] US answers to the questions from the Panel, paragraph 17.
[25] US answers to the questions from the Panel, paragraphs 16 and 18 (quotation from paragraph 18).
[26] Bold type indicates changes from the original description to take account of the US criticism.
[27] First written submission of the EC, paragraphs 85 to 92.

dictionary definition stating that the definition "send (esp. goods) to another country" was not of much help, that is, did not fully exhaust the question.

52. The Panel invited the US to comment on this issue in its Question 10 to the US. The US does not attempt to debate the issue but states that

> The United States believes that the EC got the definition right the first time, when it followed the dictionary definition: "Send (esp. goods) to another country".[28]

53. The EC does not consider that this can be an exhaustive definition of the meaning of the terms "export" in the *SCM Agreement* or in the *WTO Agreement.* But it can at least agree that it may not be necessary for the Panel to examine all the nuances of the term for the purposes of the present case.

54. Since, in order to qualify for the FSC Replacement scheme, a transaction involving US-produced goods must not be " for ultimate use in the US," it follows that these goods must be sent across the border of the US in order for the transaction to qualify.

55. Conscious that this means naturally that the goods must therefore be sent to another country, the US claims in answer to the Panel's next question, Question 11, that export may not always be necessary since a fishing boat could be not for ultimate use in the US even though it never arrives in a foreign country.

56. It is noteworthy that the US is unable to definitively assert that such a transaction would benefit from the FSC Replacement scheme stating that:

> … the precise scope of these rules will be the subject of proposed regulations to be issued in the future.[29]

57. But even if the US were to adopt rules that allowed transactions involving fishing boats and the like to benefit from the FSC Replacement scheme and even if it were accepted that such transactions are not "exports", it would remain the case that goods which are destined to be used in the territory of a country (the vast majority of goods) need to be exported in the sense of being sent to another country in order to benefit from the FSC Replacement scheme. For those goods, the FSC Replacement scheme is, even on the basis of the US definition, contingent upon export performance.

58. The other arguments of the US in relation to these questions relate to goods that may return to the US after exportation in the sense of being sent to another country, such as aircraft and tyres installed on foreign produced cars.

59. The EC would point out that these examples need not concern the Panel if it adopts the simple definition of export advanced by the US. Being sent to another country is in any event a condition that must be fulfilled by such goods if the FSC Replacement scheme is to apply.

60. The EC would draw the Panel's attention to one final point that simplifies the debate on this issue. It is that the requirement of not "for ultimate use in the US" in the FSC contained in the definition of "qualifying foreign trade property" in the FSC Replacement Act is in all material respects identical to the definition of "export property" under the FSC scheme.[30]

61. Thus, the FSC Replacement scheme is just as export-contingent as was the FSC scheme.

[28] US Answers to the questions from the Panel, paragraph 21.
[29] US Answers to the questions from the Panel, paragraph 22.
[30] See comparative table in paragraph 160 of the EC's first written submission.

10. The applicability of Article III:4 of GATT 1994 to local content requirements contained in tax measures

62. In its reply to Question 18 from the Panel the US takes the view that income tax measures do not fall within the scope of Article III:4 of GATT 1994.

63. Article III:4 of GATT 1994 is concerned with laws, regulations of requirements affecting the internal sale, purchase, use of products. However, Article III:4 does not specify, and therefore does not limit, where the requirements (including legislative ones) must be written in order to be caught by its prohibition.

64. As indicated since its First Written Submission, the EC has not challenged under Article III:4 the tax benefit, but rather one of the conditions to obtain it (the foreign content limitation).

65. The passage of the Panel Report in *Indonesia - Cars* to which the US refers correctly analyzed the issue and is not an *obiter dictum*. Assessing the meaning and scope of Article III was necessary for the Panel in order to dispose of Indonesia's defence, which turned on Article III as a whole.

66. If the measure in which a local content requirement is written were to be relevant in deciding whether it is covered by Article III:4, it would be quite easy to circumvent the prohibition in that provision of providing advantages to domestic products.

67. As recalled by the EC at the hearing, subsidies embodying a local content condition have indeed been reviewed under Article III:4.[31] There has been no discussion on, nor limitation to, this possibility of review. The US even recognizes in its reply that there have been cases where claims against *income taxes* benefits were brought.

68. The US tries to belittle this practice by referring to the drafting history of GATT 1947. Even if the drafting history could be relevant in the presence of a clear and unqualified prohibition in the text of Article III:4[32], and even if the drafting history of GATT 1947 meant what the US contends, this would not entail that such history be relevant to interpret Article III:4 of GATT 1994. GATT 1994 was negotiated after some practice was developed – including the cases that the US itself now brings to the Panel's attention – in the sense of making claims against subsidies and income tax measures under Article III:4. The EC would add that the in *United States – Taxes on Automobiles*[33] the Panel reviewed i.a. a US measure (the "CAFE" requirement) which did not concern products, but which was a penalty imposed on persons (enterprises). That dispute, started on 20 May 1992, further shows that the scope of Article III:4 was not viewed as being limited to measures directly concerning products, inasmuch as these embodied "requirements" favouring the sale, purchase or use of domestic products.

69. In the light of the practice recalled by the Panel in its question, by the EC and by the US, it is clear that if the drafters of the Uruguay Round agreements were on notice that such interpretations were possible and if they had intended to limit the scope of Article III:4 they would have been able to

[31] *EEC – Animal Feed Proteins* (see EC's reply to Question 32 from the Panel).

[32] Article 32 of the *Vienna Convention on the Law of Treaties* provides that

"Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to *confirm the meaning resulting from the application of article 31*, or to *determine* the meaning when the interpretation according to article 31:

(a) *leaves the meaning ambiguous or obscure*; or

(b) leads to a result which is manifestly absurd or unreasonable." (emphasis added)

[33] DS31/R, 11 October 1994.

do so – for example by annexing an *Understanding* on that specific provision. The text of and footnote to Article XIV (d) of GATS, also recalled by the US, further show that the drafters did provide for specific rules to address direct taxation when they so wanted.

70. Thus, there is no reason why Article III:4's unqualified prohibition would not cover other measures directly concerning persons, like direct taxes subsidies, inasmuch as these embodied a "requirement" favouring the use of domestic products.

11. Applicability of FSC Replacement scheme to Agricultural production

71. The EC has argued that the FSC Replacement scheme is a prohibited export subsidy, regardless of its extension to foreign- produced goods. The EC also argued that the alleged alternative means of obtaining the subsidy, i.e. production abroad, is also export contingent. The EC has argued that the extension of the FSC Replacement scheme to foreign produced goods is subject to a 50 per cent rule which creates in many cases a requirement for exports to be made from the US.

72. As regards agriculture, specific characteristics inherent to agricultural production and in particular to commodities make the qualification of foreign-grown agricultural products for the FSC Replacement scheme fraught with additional obstacles. The US example in fact illustrates very well the EC's point.

73. In question 19, the EC asked how the FSC replacement scheme is applied to foreign-produced agricultural products. The US gives no specific indication (which is hardly surprising, as the US has provided no guidelines on how it will apply the 50 per cent rule). It provides an example, using US data, whose stated objective is to demonstrate that foreign-grown agricultural products could qualify as qualifying foreign trade income and benefit from the extended FSC Replacement subsidy.

74. Even taken at their face value[34], the US methodology and data highlight very clearly the obstacles to benefiting from the scheme by growing agricultural products abroad. A more complete look at the USDA set of data cited as regards US production of soybeans immediately reveals that, based on the exact application of the US methodology, the limitation of 50 per cent value attributable to "articles" and labour is reached and surpassed in several regions of the US both in 1998 and 1999. In 1999 for example, articles + labour > 50 per cent in the US regions of the Southern Seaboard (76.59 per cent) and Mississippi Portal[35] (59.9 per cent). In 1998, 50 per cent was surpassed in the Eastern Uplands (57.27 per cent) and Mississippi Portal (52.6 per cent).[36]

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[34] The EC will not enter into a discussion of the methodology used by the US, as it judges that an examination of the US example as it stands is sufficient at this stage to illustrate the EC's point.

[35] These are regions defined by USDA, each including several States.

[36] The US proceeds as follows in paragraph 29 of its reply to EC Question 19 (emphasis added):

> based on data from the US Department of Agriculture (USDA), for US production in 1999, the 'total gross value of production' for soybeans (in dollars for planted acre) was $178.00. The cost of items that arguably could be considered 'articles' (seed, fertilizer, soil conditioners, manure, and chemicals) amounted to $52.98. The cost for hired labour and the opportunity cost of unpaid labour amounted to $20.90. *Thus, the total cost of articles and labour was $73.88, a figure well below 50 per cent of $178*".

For "articles" (seed, fertiliser, soil conditioners, manure and chemicals) and "labour" the EC has taken the same factors as identified by the US, and the same gross value of production in $/planted acre.

<u>Eastern Uplands</u>:

1998: "articles" + labour = 100.43$; value of production = 175.36$; percentage of sum of articles and labour = 57.27

75. What is also extremely revealing is that the same producers, for the same commodity, for the same US region could one year hypothetically "qualify" for the exemption and the following year find themselves well above the 50 per cent ceiling. In one region, the Southern Seaboard, articles and labour jumped from 43 per cent in 1998 to 76 per cent of value of production in 1999.

76. Similar patterns can be found in other commodities in the USDA set of data. As regards wheat, for instance, the US-wide data show that, between 1998 and 1999, the proportion of the identified factors passed from 45.56 per cent to 50.44 per cent. As regards specific areas, the proportion was always above 50 per cent in the Basin and Range region (54.97 per cent in 1998 and 53.43 per cent in 1999), in the Heartland region (57.7 per cent in 1998 and 56.5 per cent in 1999), and in the Southern Seaboard region (83.7 per cent in 1998 and 87.6 per cent in 1999). It was above 50 per cent in the Fruitful Rim region (50.08 per cent) in 1998, and in 1999 in the Northern Great Plains region (50.49 per cent).[37]

<u>Southern Seaboard</u>:

1998: "articles" + labour = 94.29$; value of production = 217.20$; percentage of sum of articles and labour = 43.4

1999: "articles" + labour = 92.65$; value of production = 120.96$; percentage of sum of articles and labour = 76.59

<u>Mississippi Portal</u>:

1998: "articles" + labour = 75.51$; value of production = 143.50$; percentage of sum of articles and labour = 52.6

1999: "articles" + labour = 72.40$; value of production = 120.75$; percentage of sum of articles and labour = 59.9

[37] <u>US-wide data</u>:

1998: "articles" + labour = 50.55$; value of production = 110.95$; percentage of sum of articles and labour = 45.56

1999: "articles" + labour = 48.04$; value of production = 95.23$; percentage of sum of articles and labour = 50.44

<u>Basin and Range region</u>:

1998: "articles" + labour = 87.19$; value of production = 158.6$; percentage of sum of articles and labour = 54.97

1999: "articles" + labour = 82.74$; value of production = 154.84$; percentage of sum of articles and labour = 53.43

<u>Heartland region</u>:

1998: "articles" + labour = 72.73$; value of production = 125.97$; percentage of sum of articles and labour = 57.7

1999: "articles" + labour = 68.28$; value of production = 120.69$; percentage of sum of articles and labour = 56.5

77. A situation in which the factors identified by the US are above 50 per cent is thus very common even in the very data set cited by the US. The actual proportion of the relevant factors may vary from region to region of the same country, and what's more, from year to year for the same region. The US set of data thus precisely illustrates another obstacle to the application of the scheme to foreign-grown agricultural products - the impossibility for producers to predict with any certainty whether they will be able to qualify for the exemption.

78. Price variation is of course at the heart of this situation. This is an inherent aspect of agricultural production. It is well known that the price volatility of agricultural commodities is very high, and bears little or no relation to cost variations.[38]

79. The practical consequence of this is that producers cannot be certain that they will meet their cost target to qualify for the FSC replacement, as the final price will not normally be known until after costs are incurred.

80. The US example proves the EC's point because prices and costs vary, not only by region within the same country but also in time. Even if in some areas and/or at some times a producer may be tempted to believe that its foreign-grown agricultural product could conceivably qualify, the certainty will escape him because of the inherent characteristics of agricultural production such as the relationship between agricultural prices and costs. Taxpayers will therefore be well advised to turn to US production if they wish to be able to rely on the benefits of the FSC Replacement scheme.

12. The foreign process requirements

81. Question 42 of the Panel to the US concerned the foreign economic process requirements in the FSC Replacement Act.[39]

Southern Seaboard:

1998: "articles" + labour = 92.33$; value of production = 110.25$; percentage of sum of articles and labour = 83.7

1999: "articles" + labour = 89.30$; value of production = 101.91$; percentage of sum of articles and labour = 87.6

Fruitful Rim:1998: "articles" + labour = 84.87$; value of production = 169.44$; percentage of sum of articles and labour = 50.08

Northern Great Plains:

1999: "articles" + labour = 42.76$; value of production = 84.69$; percentage of sum of articles and labour = 50.49

[38] Going no further that the USDA data cited by the US, soybeans gross value of production in 1999 fell 37 per cent from 1997 and 21 per cent from 1998 levels. The above-cited increase in percentage of the US-identified relevant factors in the Southern Seaboard soybean production from 43.4 per cent in 1998 to 76 per cent was in fact accompanied by a decrease of costs of these factors.

[39] Question 42 reads:

> Is the EC correct in its statement that the "foreign economic process" requirements in Section 942(b) of the Act may be satisfied even where the functions were in fact performed within the United States? Please explain.

82. The EC had not devoted much attention to the foreign economic process requirements so far in this proceeding merely noting that they bore no relationship with the amount of excluded income.[40] The US had also said little about the foreign economic process requirements and has not contested that they bear no relation to the amount of the excluded income.

83. The EC statement that may have given rise to the Panel's question was in its closing statement to the meeting of the Panel:[41]

> ... the foreign economic processes requirement in the FSC Replacement Act is based on a percentage cost test and that it can be met without undertaking any activities outside the US. In this context it is equally important to bear in mind that US taxpayers wishing to be eligible for the subsidy can outsource to independent third parties all the activities, if any, that are to be performed outside the US.

84. In view of the US' answer to Panel Question 42, and in case the Panel may consider it relevant, the EC will now set out its views on the foreign economic process requirements of the FSC Replacement Act in some more detail.

85. The foreign economic process requirements, now found in section 942(b) of the IRC are not materially different from the corresponding FSC scheme requirements found in section 924(d) of the IRC and are more symbolic than substantive. The Conference Committee Report specifically mentions the foreign economic process rules as one of the areas in which the existing FSC rules are to apply until rules are issued under the new statute.[42]

86. The FSC regulations state that

> Any person, whether domestic or foreign, and whether related or unrelated to the FSC, may perform any activity required to satisfy this section, provided that the activity is performed pursuant to a contract for the performance of that activity on behalf of the FSC.[43]
>
> And that:
>
> If no direct costs are incurred by the FSC in a particular category, that category shall not be taken into account for purposes of determining satisfaction of either the 50-per cent or the 85-per cent foreign direct cost test. If any amount of direct costs is incurred in a particular category, that category shall be taken into account for purposes of the foreign direct costs test.[44]

87. Thus, while costs cannot literally be zero, they can be small. If one satisfied the 85 per cent test with respect to any two categories set forth in section 942(b)(3) of the IRC, one would satisfy the requirement of section 942(b)(2)(B) even if the costs involved in each of those two categories were minimal.

88. For example, a US company could satisfy the foreign direct cost requirement with respect to advertising costs by placing an advertisement in a foreign trade journal. Incurring a cost of this nature

[40] First written submission of the EC, paragraph 59 and second written submission of the EC, paragraph 220.
[41] Paragraph 28.
[42] Technical Explanation of the Joint Committee on Taxation, 1 November 2000, page 22 (Exhibit EC-5A).
[43] Reg. § 1.924(d)-1(b)(1).
[44] Reg. § 1.924(d)-1(d)(1).

would certainly not cause the income realised from a sale of the advertised product to be foreign-source income.

89. One of the treatises regarding FSCs states that:

> Some exporters satisfy the advertising costs requirement by taking out an annual advertisement in a foreign trade journal which includes all export products marketed by it. Although the foreign direct costs allocated to each export transaction will be minimal, this fact will not prevent the FSC from meeting the foreign direct costs test. If there are no domestic sales promotion expenses attributable to the export property…, then this activity will satisfy the advertising and sales promotion direct cost category for those products.[45]

90. The regulations make this test even easier to satisfy, because they provide that:

> Costs relating to advertising in United States publications are not treated as direct costs even if the publication also has a foreign edition in English.[46]

91. The EC would also remind the Panel that, as under the FSC scheme, there is no requirement to incur any cost for "foreign economic processes" for taxpayers whose foreign trading gross receipts do not exceed US$ 5 million in any taxable year.[47]

92. For further illustration of how minimal the foreign economic process requirements are in practice, the Panel may wish to refer back to the explanations provided in the original proceedings, including Exhibit EC-31.

[45] BNA Tax Management Portfolio No. 934, *Foreign Sales Corporations*, at A-29 (1998).
[46] Reg. § 1.924(e)-1(a)(1)(iii)(C).
[47] Section 942(c)(1) of the IRC.

ANNEX F-6

COMMENTS OF THE UNITED STATES ON THE EC'S ANSWERS TO QUESTIONS FROM THE PANEL

Q1. In section 3.2.5. of its first submission, the European Communities expresses the view that the FSC Replacement scheme gives rise to two distinguishable subsidies : the "basic FSC Replacement subsidy" and the "extended FSC Replacement subsidy".

- **Does this mean that the EC is requesting the Panel to make two separate rulings, one on each of the alleged subsidies?**
- **Does the EC consider that the application of a different portion of the FSC Replacement scheme may involve different types of subsidies under the SCM Agreement?**
- **Please identify the relevant portion of the *FSC Repeal and Extraterritorial Income Exclusion Act* ("the Act") framing these two "distinguishable" alleged subsidies.**
- **Does the EC believe that the status of a subsidy under the SCM Agreement is determined by the particular legal circumstances in which it is granted on a case-by-case basis?**

Reply

1. With respect to the EC's answer to this question, the United States refers the Panel to the US answer to this question,[1] and reiterates that there is a single exclusion that applies to different types of foreign transactions. To restate in an accurate manner the first sentence of paragraph 2 of the EC's answers, "there is a single exclusion that covers different situations."

2. In this regard, the lengths to which the EC will go in its attempt to bifurcate the Act is revealed in paragraph 3 of the EC's answers, where the EC asserts that "domestication" is a condition of what the EC refers to as the "extended FSC Replacement subsidy". Of course, the EC conveniently omits the fact that a foreign branch of a US corporation can earn the "extended subsidy" without any "domestication".

3. Also in paragraph 3, the EC slips in the assertion that "it will *often* be necessary to use US articles" under the "extended subsidy." (Emphasis added). Of course, the EC has provided no evidence whatsoever to support the assertion that the necessity to use US articles will arise "often." The EC has not provided evidence that such a necessity actually will arise even once.

4. Finally, in paragraph 4 of the EC's answers, second bullet, the EC reiterates the argument that the United States quoted in paragraph 84 of its own answers to the Panel's questions. The United States refers the Panel to paragraphs 80-87 of the US answers, which explain how the EC is trying to have it both ways in this dispute; *i.e.*, in one breath, it says its challenging the Act as a whole, but in the next breath tries to divide the Act into separate alleged subsidies.

Q**2. The European Communities claims that the FSC Replacement scheme is *de facto* export contingent and therefore contrary to Article 3.1(a) of the SCM Agreement.[2] Please explain how the legislation as such -- which, by its terms, at least in the case of FSCs in existence on**

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[1] *US Answers to Questions from the Panel*, paras. 121-124; *see also id.*, paras. 67-75 and 80-87.

[2] EC first submission, para. 145.

30 September 2000, does not apply to transactions occurring before 1 January 2002 -- can constitute a *de facto* violation of Article 3.1(a) of the SCM Agreement. Can the EC cite any GATT/WTO reports in which legislation as such was found to be a *de facto* violation of *any* obligations under the GATT/WTO Agreement?

Reply

5. With respect to paragraph 8 of the EC's answer to Question 2 and the EC's statement that the "standard of contingency is the same, whether the subsidy arises *de facto* or *de jure*", the United States reiterates that throughout this case the EC has ignored the meaning of the term "contingent" as interpreted by the Appellate Body. The relevant decisions of the Appellate Body are discussed in the *First US 21.5 Submission* at paragraphs 109-110, which for the convenience of the Panel, the United States reproduces here:

> 109. According to the Appellate Body, the "key word" in Article 3.1(a) is "contingent." The Appellate Body has explained that the term "contingent" has an ordinary meaning of "conditional" or "dependent for its existence on something else." Thus, an export subsidy within the meaning of Article 3.1(a) is a subsidy that requires recipients to export in order to obtain it. Or, in the words of the Appellate Body, "the subsidy is available only upon fulfilment of the condition of export performance."
>
> 110. It is not enough for a subsidy to be granted upon the mere expectation that the subsidy will lead to new or additional exports; the grant of the subsidy in and of itself must be conditioned on export performance. As the Appellate Body has said, "It does not suffice to demonstrate solely that a government granting a subsidy *anticipated* that exports would result. The prohibition in Article 3.1(a) applies to subsidies that are *contingent* upon export performance ... . A subsidy may well be granted in the knowledge, or with the anticipation that exports will result. Yet, that alone is not sufficient, because that alone is not proof that the granting of the subsidy is *tied to* the anticipation of exportation." (Footnotes omitted).

6. By contrast, the EC standard for export contingency in this case ignores applicable Appellate Body teachings. Because the Act, on its face, clearly allows a taxpayer to earn excluded income without exporting, it cannot be regarded as "conditional", "dependent" or "tied to" exportation. As discussed above in connection with the EC's response to Question 1, in an effort to avoid the Appellate Body's teachings, the EC improperly bifurcates the Act's exclusion into two separate exclusions.

7. With respect to paragraph 11 of the EC's answer, if the EC actually is making an alternative claim of *de facto* export contingency, it has provided absolutely no evidence to support such a claim. Significantly, the EC does not even cite to any evidence that it has submitted which would support a claim of *de facto* export contingency.

Q3. The European Communities states that it "¼ sees no reason to contest that the last sentence of footnote 59 may be an exception to Article 3.1(a)."[3] Does this mean that the EC is of the view that measures satisfying the requirements for the last sentence of footnote 59 constitute "[m]easures referred to in Annex I as not constituting export subsidies" under footnote 5 of the SCM Agreement?

Reply

[3] EC second submission, para. 181.

8. The EC assertion in its answer to Question 3 that footnote 59 is simply a hortatory reminder that double taxation avoidance measures are not subsidies is implausible. First, if this is what the drafters had intended, they would have made footnote 59 a footnote to Article 1, as they did in footnote 1 with respect to the exemption of indirect taxes.[4]

9. Second, the EC's answer to Question 3 is inconsistent with its prior position in this dispute. Previously, the EC took the position that the "last sentence of footnote 59 may well guide the interpretation of Item (e) in a manner that is narrower than an alternative interpretation that might prevail in its absence."[5] Translated, this constitutes an admission by the EC that the fifth sentence of footnote 59 qualifies the scope of paragraph (e). The United States will address footnote 59 further in its comments on the EC's answer to Question 45.

Q5. Please provide further clarification of the point made in paragraph 227 of the EC second submission

Reply

10. The EC does not adequately explain why it believes that extraterritorial income earned in a wholly foreign transaction is not foreign-source income. The EC merely refers to an example in which a US company distributes foreign-made goods. This example would result in extraterritorial income if the US company distributed foreign-made goods to foreign purchasers or for foreign use. In fact, this example would almost certainly involve distribution outside the United States. It is unclear why such activities would be "domestic source" or would involve exportation at all.

Q13. Regarding the relationship between Article 3.1(a) of the SCM Agreement and item (e) of Annex I, would it be possible that a certain measure is not within the scope of the latter, but nonetheless within the scope of the former, and *vice versa*?

Reply

11. In the view of the United States, the EC did not answer the Panel's question, which was aimed at whether the standard of "contingency" is narrower in paragraph (e) than in Article 3.1(a).

12. The United States also notes that the example provided by the EC in paragraph 26, first bullet, is incorrect. The United States does not know what the EC means by its reference to "export promotion", but in the case of "shipping companies", shipping companies provide a service. Thus, if a tax exemption constituted a subsidy to shipping companies, such a subsidy would not fall under the SCM Agreement at all.

Q14. The Panel is well aware that the WTO-conformity of income tax regimes of European countries is outside the scope of our terms of reference for this case. In paragraph 96 of the US first submission, the US introduces examples of a few European tax systems which "refrain from taxing foreign income in a qualified or conditional manner."[6] Among those systems, is there one which excludes foreign income from the scope of taxable income on the following conditions:

> **(i) the property for sale from which income arises must be held for ultimate use outside the country, (and not be sold for final consumption in that country); and**

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[4] *See FSC (AB)*, para. 93.
[5] *FSC (Panel)*, para. 4.949.
[6] US first submission, para. 97.

(ii) the same property must have foreign content of not more than a certain percentage of its fair market value.

Reply

13. The United States refers the Panel to the US answer to Question 14, and our comments on the EC's answer to Question 23. In the view of the United States, the fact that exports are taxed more favourably than domestic transactions under European tax regimes cannot be seriously contested.

14. With respect to paragraph 28 of the EC's answer to Question 14, the United States has not argued that "the term 'foreign-source income' should be interpreted widely so as to signify export income." The United States merely has argued that export transactions are one type of foreign transaction that typically generates foreign-source income. As an evidentiary matter, the EC has not established that the types of transactions capable of earning excluded income under the Act do not have a "foreign-source income" component, nor has the EC established that the Act somehow excludes domestic-source income.

Q15. Is the term "foreign-source income," "foreign-source" or "source" used elsewhere in any provisions of other WTO Agreements than the SCM Agreement? What guidance, if any, may be drawn as to the meaning of these terms from the SCM Agreement or other WTO Agreements?

Reply

15. The United States notes what the Panel probably has figured out on its own; namely, that with respect to the Panel's question regarding the use of the term "foreign-source income" in the *FSC* panel and Appellate Body reports, the EC did not answer the Panel's question, but instead engaged in a seemingly irrelevant discussion of the *Tax Legislation Cases*. The United States respectfully refers the Panel to the US answer to Question 15.

16. The European Communities claims that[7]: "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. This additional advantage would also be a subsidy,. This unwarranted *overcompensation* is also a subsidy.

(For the EC): Please provide a textual analysis of how the alleged *additional advantage* and *overcompensation* constitute subsidies under Article 1 of the SCM Agreement.

(For the US): How does the US respond to this allegation?

Reply

16. The United States is pleased to note that in its answer to this question, the EC appears to have abandoned its specious argument that the existence of a choice between the use of foreign tax credits and the exclusion somehow constitutes a subsidy. This argument is not credible given that: (1) the OECD Convention considers it acceptable to use credits, exemptions, or both methods of double

[7] EC second submission, paras. 221-222.

taxation avoidance,[8] (2) the EC previously has acknowledged that most countries use a combination of methods to avoid double taxation,[9] and (3) EC member states, such as France, allow for such a choice.[10]

17. The United States also reiterates that the Act and its legislative history make clear that there is no "double double taxation relief", as the EC puts it. Foreign tax credits may not be used with respect to excluded extraterritorial income.[11] As the United States has explained previously, the Act does not provide a special advantage to a privileged class of taxpayers. Instead, it merely provides an alternative form of double taxation relief that is broadly available to taxpayers. The availability of an alternative in this context is no different than similar choices found in tax systems around the world. Either the Act's incorporation of the exemption method itself is problematic under WTO rules or it is not. To hold, as the EC suggests, that the Act can be a prohibited export subsidy because it provides an alternative mechanism of relief – even if that method is otherwise unobjectionable – simply cannot be correct.

Q17. The EC seems to argue that a Article 3.1(b) violation may exist if a certain measure gives an "incentive" to domestic production for export.[12] In the same vein, the EC argues that "Article 3.1(b) prohibits local-content contingency to <u>any</u> degree, [and] there is no *de minimis* rule for prohibited subsidies in the SCM Agreement.".[13]

> **(For the EC): How would this argument be supported by a textual analysis of Article 3.1(b) in accordance with Article 31 of the *Vienna Convention*? Can the European Communities cite any Appellate Body or panel reports in which the term "incentive" was explicitly used in the context of Article 3.1 of the SCM Agreement, or Article XVI:4 of the GATT Agreement?**
>
> **(For the US): Would a textual analysis of Article 3.1(b) lead to a conclusion that the EC's above argument is without merit? If so, why and how? Would the US take the view that there is *de minimis* rule for prohibited subsidies in the SCM Agreement? If so, what is the qualitative or quantitative threshold for that rule? Is the Appellate Body Report in *Canada - Certain Measures Affecting the Automotive Industry*[14] relevant to this question? Please give reasons for your responses.**

<u>Reply</u>

18. With respect to paragraph 43 of the EC's answer to this question, the United States believes that it is the EC that has provided a selective interpretation that fails to give meaning to all of the words used in Article 3.1(b). For reasons previously expressed, the EC has ignored the meaning of "contingent." Similarly, the EC's interpretation of the phrase "domestic over imported goods" is not based on the ordinary meaning of the words used, and the conclusion the EC draws from the phrase already has been rejected by the Appellate Body.[15]

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[8] *See First US 21.5 Submission*, para. 181.

[9] *See US Oral Statement*, para. 141, citing to EC-2, page 2 (US-5).

[10] *See US Answers to Questions from the Panel*, para. 52.

[11] *See* the Act § 3, amending IRC § 114(c)-(d) (US-1); *Senate Report*, page 2 (US-2); *House Report*, page 10 (US-3); *First US 21.5 Submission*, para. 26; *Second US 21.5 Submission*, paras. 36-38; and *US Oral Statement*, paras. 148-151.

[12] *See* EC first submission, para. 165.

[13] EC second submission, para. 160.

[14] WT/DS130/AB/R, WT/DS142/AB/R.

[15] *See US Answers to Questions from the Panel*, paras. 53-57.

19. With respect to paragraph 44 of the EC's answer, the EC quotes the Appellate Body statement that Article III:4 "also addresses measures that favour the use of domestic over imported goods."[16] From this, the EC appears to draw the conclusion that the Appellate Body has found that the standard for Article 3.1(b) is one of "favouring" domestic products.

20. This is a classic *non sequitur*. A measure that is "contingent" upon the use of domestic over imported goods, within the meaning of Article 3.1(b), would "favour" domestic goods, but that does not mean that the standard under Article 3.1(b) is transformed from "contingent" into "favour." Moreover, the next sentence in *Canada Autos* that immediately follows the sentence quoted by the EC states: "Nevertheless, both Article III:4 of the GATT 1994 and Article 3.1(b) of the *SCM Agreement* apply to measures that <u>require</u> the use of domestic goods over imports."[17] The 50 per cent rule does not "require" the use of domestic goods over imports.

Q23. The EC argues that, "for owners of US produced goods, export is a condition for obtaining the benefits under the scheme for those goods"[18] and that there is accordingly an export subsidy. Assume the existence of an exclusion from taxation for all foreign-source income based upon application of a pure territorial system. Would export not be a condition for owners of domestically-produced goods to obtain the exclusion in that case as well? Does this mean that the application of a pure territorial system would also involve an export subsidy? Please explain.

<u>Reply</u>

21. The EC contends that export transactions under a territorial system are taxed the same way as non-export transactions.[19] This contention is incorrect.

22. For a taxpayer to earn excluded income under a territorial system, the taxpayer must export the goods to a foreign jurisdiction. It is irrelevant what happens to the goods after they are exported. Certain goods may be imported back into the home jurisdiction in a "round-trip" sale for consumption in the domestic market.[20] Other goods may be sold through the taxpayer's foreign branch or subsidiary for consumption in a foreign market. Regardless of their ultimate destination, however, the goods *first must be exported* to the taxpayer's foreign branch or subsidiary in order for the taxpayer to earn exempt income.

23. When the goods are exported – which again they must be to qualify for the exemption – they are taxed more favourably than comparable domestic sales, as the EC admits: "More favourable treatment of export sales through a foreign distribution [*sic*] compared with domestic sales through a domestic distribution subsidiary may arise out of the fact that the foreign country has a lower tax rate (but not when the foreign tax rate is higher)."[21] Accordingly, the EC's defence of its member states' use of the territorial exemption method conflicts with its own attack on the Act's exclusion of extraterritorial income.

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[16] As a technical point, the United States observes that the EC failed to note that it added emphasis to the quotation that is not in the original.

[17] *Canada - Certain Measures Affecting the Automotive Industry*, WT/DS139/R, WT/DS142/R, Report of the Appellate Body adopted 19 June 2000, para. 140 (underscoring added).

[18] EC rebuttal submission, para. 102.

[19] *EC Answers to Panel Questions*, para. 54. The United States also respectfully notes that the Panel's question is based on a false premise; *i.e.*, in the real world, there are no "pure" territorial systems. Indeed, as the United States previously has demonstrated, the territorial exemptions applied by various EC member states are all subject to various qualifications and conditions. *First US 21.5 Submission*, para. 96.

[20] *Second EC 21.5 Submission*, para. 112.

[21] *Id.*, para. 56. When the foreign tax rate is higher, taxpayers presumably will choose not to route sales through the foreign distribution subsidiary.

24. The EC's attempt to treat the export-related activities of foreign subsidiaries as *non-export* activity is not new. The panel in the *Tax Legislation Cases* saw through the same artificial distinction the EC is now attempting to draw. As one leading scholar has explained regarding those cases:

> Given that the three European defendants had chosen not to assert the bilevel pricing defence [under GATT Article XVI], the only real issue in the three counterclaims was whether the failure to tax foreign earnings was an export subsidy in the first place. The key to the panel's finding on this point was its decision to treat the two parts of the tax-haven transaction – the exporter's initial export to its foreign alter ego and the alter ego's resale to the ultimate buyer – as a single export transaction ... . The implication was that what went on outside the country – the resale – was also part of the same 'process'. By not taxing the income from second sale, therefore, governments were granting a tax exemption to the exporting process.[22]

25. The EC most significantly errs in asserting that sourcing determinations for tax purposes must be based strictly upon arm's-length transfer prices. This assertion is invalid, and, in the present case, dangerous. Although broadly consistent with economic activities, sourcing determinations apply numerous rules of administrative convenience. For example, many jurisdictions simply rely upon the residence of the payor to determine the source of income, regardless of where the income was economically generated.

26. Nevertheless, the EC invites the Panel: (1) to define the term "foreign-source income" using the domestic laws of the alleged subsidizing party, and (2) to rule that "foreign-source income" for purposes of those very laws must be determined on the basis of arm's-length transfer prices. Such a finding might suit the EC's present convenience, but it would contravene the intent expressed in footnote 59, which was to avoid placing any "limit" on the ability of Members to take measures to

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[22] Robert E. Hudec, *Reforming GATT Adjudication Procedures: The Lessons of the DISC Case*, 78 Minn. L. Rev. 1443, 1482 (1988) (copy attached as Exhibit US-30). Professor Hudec added: "Everyone in the tax business knew that a territorial tax system could be used to make the taxation of export operations significantly lower than the taxation of identical domestic operations. *Id*.

In paragraph 57 of the EC's answer to this question, the EC disputes the fact that the panel in the *Tax Legislation Cases* "made 'factual findings' that territorial systems provide better treatment to export sales." However, if the panel did not make such findings, then the post-1976 behaviour in the GATT Council of the EC and the member states involved becomes inexplicable, and it is difficult to fathom why they insisted on the adoption of the 1981 Understanding. In order to be clear on this point, here is what the panel in the *Tax Legislation Cases* found:

> The Panel found that however much the practices may have been an incidental consequence of Belgian taxation principles rather than specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market . . . .
>
> In circumstances where different tax treatment in different countries resulted in a smaller total tax bill in aggregate being paid on exports than on sales in the home market, the Panel concluded that there was a partial exemption from direct taxes ... .

Income Tax Practices Maintained by Belgium, L/4424, BISD 23S/127, paras. 35, 37. The panel made similar findings in *Income Tax Practices Maintained by France*, L/4423, BISD 23S/114, paras. 48, 50, and in *Income Tax Practices Maintained by the Netherlands*, L/4425, BISD 23S/137, paras. 35, 37.

The EC's observation in paragraph 57 that the *Tax Legislation Cases* involved different legal obligations and different dispute settlement arrangements is irrelevant to the nature of what the panel found as a matter of fact. The GATT Council adopted those factual findings, and the only alteration the Council made was to adopt the 1981 Understanding, which changed the legal conclusions that flowed from the panel's factual findings.

avoid double taxation of foreign-source income, rather than forcing them to adopt strict arm's length transfer pricing into their source rules.

Q24. Would a measure that exempted foreign-source income from taxation (i.e., a pure territorial system) be a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59?

Reply

27. The United States submits that territorial tax systems should be viewed in the same way as the Act in the context of footnote 59.[23] They should pass muster or fail for the same reasons.

28. The EC, however, attempts to distinguish the systems of its member states from the Act in a way that simply has no basis in reality. The EC states that the "prevailing benchmark" in a territorial tax system is to tax income generated within the territory of the taxing authority. However, this benchmark only exists because the EC says it exists. The EC's response is simply inconsistent with the way EC "territorial" systems actually operate. The EC explained to the *FSC* Panel that its member states generally apply taxes on business income on a worldwide basis, but then provide an exemption for foreign-source income.[24] The United States previously has explained how five European tax systems make an exception for foreign-source income in relation to their otherwise applicable tax rules.[25]

29. As discussed above in the US comments on the EC's answer to Question 23, so-called territorial systems tax income from export transactions more favourably than comparable domestic transactions because exporters can exempt part of their income from tax. Where exporters in a country providing a territorial exemption run their transactions through a lower-tax jurisdiction, they net an overall tax savings. According to the EC's argument in this dispute, this constitutes a subsidy contingent upon export performance.

30. The Panel's question raises the further interesting question, which the EC has consistently refused to answer:[26] whether a country that taxes some persons on an exemption basis and other persons on a worldwide basis (at their election) confers subsidies within the meaning of Article 1.1.[27] Under the EC's argument, it would appear that the answer to this question is "yes."

31. The United States also notes the EC's assertion that the territorial exemption "is however undeniably a measure to avoid the double taxation of foreign-source income." Given that countries that rely on the exemption method typically do not require that the exempted income actually be taxed, the United States considers this assertion irreconcilable with the position that the EC has taken with respect to the Act.

Q25. The EC argues that "the fact that the extension of the FSC replacement scheme to foreign produced goods is subject to a foreign content requirement creates in many cases a requirement for exports to be made from the US. This renders the extended FSC Replacement subsidy also export contingent and thus prohibited."[28] Is it the EC's view that the measure is contingent *de jure* on export performance? Or *de facto*? Is it export-contingent only in those cases where compliance requires the export of US goods, or does the fact that the export of US

[23] Again, the United States notes that there are no such things as "pure" territorial tax systems.
[24] Annex EC-2 (U-5), para. 2; *see also First US 21.5 Submission*, para. 41.
[25] *First US 21.5 Submission*, paras. 42 and 96.
[26] *EC Answers to Questions from the United States*, para. 1.
[27] As the United States has noted previously, France is an example of such a country. *US Answers to Questions from the Panel*, para. 52.
[28] EC first submission, para. 119.

goods may sometimes be required render the "extended FSC replacement scheme" export-contingent in its totality?

32. The United States disputes the EC's assertion in paragraph 60 of the answer to this question that "[i]t was clear from evident facts known to all at the time the law was adopted that respecting the foreign content limitation would require the use of US articles in many cases." The EC cites nothing to support this assertion, and the United States does not believe that there is anything in the record of this case that would substantiate the assertion. The EC does not even identify what the "evident facts" were or the identity of the "all concerned" to which it refers. The EC essentially is asking the Panel to take "judicial notice" of a key fact which, under established WTO jurisprudence, the EC has the burden of proving, and for which it has failed to satisfy that burden.

33. The United States also disputes the EC's assertion in paragraph 62 of its answer to this question that "the fact that export of US goods may sometimes be required renders the 'extended FSC replacement scheme' export-contingent in its totality". The United States does not agree that it is ever a necessity for a taxpayer to use US, as opposed to imported, articles in order to qualify for the Act's exclusion. The United States also does not believe that, because some taxpayers choose to use US goods to satisfy the 50 per cent rule, this renders the Act export contingent. There are a host of reasons underlying private decisions to use domestic goods – or to export – in order to satisfy certain requirements, but these decisions do not create an export contingency *per se*. If that were the case, then every broadly applicable production subsidy would be export contingent if one manufacturer decided that it "needed" to export in order to obtain the subsidy.

Q26. The EC states that the basic FSC subsidy is contingent upon the use of domestic over imported goods because domestic US articles will "often" be necessary to ensure that the foreign content limitation is not exceeded.[29] Is it the EC's view that the frequency with which this will be the case is relevant to whether the 50% foreign content rule is inconsistent with Article 3.1(b)? Would the rule be inconsistent with Article 3.1(b) if domestic US goods were "sometimes" necessary? Occasionally? Rarely?

Reply

34. With respect to paragraph 63 of the EC's answer to this question, the United States is not sure what to make of the EC's assertion that the Act is inconsistent with Article 3.1(b) "by the reason [*sic*] of the fact that it give [*sic*] rise to a requirement to use US article [*sic*] in *any* case." (Emphasis in original). The United States assumes that this statement is merely the product of hasty drafting, and that the EC argument remains that the Act would violate Article 3.1(b) if in a single, actual case the use of US articles was required. If this remains the EC argument, the EC has not presented any evidence that this is the case, but simply has offered hypotheticals allegedly based on "actual" data to which only the EC has had access.

35. On the other hand, if the EC statement reflects a shift in the EC argument to the effect that the Act requires the use of US articles in all cases, the EC has not presented any evidence to support this assertion either.

Q28. Is it possible to establish on the basis of the *Act* itself, and without reference to external facts relating to the manufacture of particular products, that the 50 per cent foreign content rules require a beneficiary in some cases to use domestic over imported goods? If not, and taking into account the view of the Appellate Body in *Canada – Certain Measures Affecting the Automotive Industry*[30] that contingency in law is demonstrated "on the basis of the *words* of the

[29] EC first submission, para. 174.
[30] Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, para. 123.

relevant legislation, regulation or other legal instrument", please explain how the Act could be contingent *in law* on the use of domestic over imported goods.

Reply

36. The EC's answer to this question ignores the key portion of the Appellate Body report in *Canada Autos*, which runs from paragraphs 126-131 of the report. There, the Appellate Body found that the mere existence of a content requirement is not enough to violate Article 3.1(b). Instead, given the "multiplicity of *possibilities*", one must examine how such requires "operate for individual manufacturers." The United States does not believe that the EC has met its burden of proof with respect to the standard articulated in *Canada Autos*.

Q32. What is the relationship, if any, between the scope of Article III:4 of the GATT and Article 3.1(b) of the SCM Agreement -- is one necessarily broader than the other-- could a measure fall within the scope of one of these provisions, but not within the scope of the other? Please substantiate your response with reference to past GATT/WTO dispute settlement reports and other materials.

Reply

37. The United States is pleased to note that the EC agrees with the United States that the scope of Article III:4 is broader than that of Article 3.1(b).

38. In addition, with respect to paragraph 84 of the EC's answer to this question, the United States also is pleased to see the EC finally refer to a relevant portion of the Appellate Body report in *Canada Autos*, which states that the standard of contingency under Article 3.1(b) is that a measure must "*require* the use of domestic goods over imported goods." (Emphasis added). Of course, the EC has failed to demonstrate that the Act *requires* the use of domestic over imported goods, but instead, relying on an incorrect legal standard, has alleged that the Act violates Article 3.1(b) because it allegedly "favours" or "gives preference to" domestic over imported goods.

Q33. The EC states that "the US review of its subpart F legislation is yet to be completed".[31] Please explain whether and how this statement is relevant to the current proceeding.

Reply

39. The EC asserts that the Treasury Department study of subpart F refutes the US statement that the Act represented, in part, the results of a review by the US Senate of the international provisions of the US Internal Revenue Code.[32]

40. The EC assertion proves nothing of the sort, and in making the assertion, the EC appears to be projecting on to the United States the relative powers of European Union institutions. However, in the United States, the Congress and the Executive are separate and co-equal branches of government (along with the Judiciary), and the fact that the bureaucracy may have been studying subpart F does not negate the fact that the US Senate was conducting its own, independent review of the international provisions of the Internal Revenue Code. The Senate stated that the Act was, in part, a product of its review, [33] and the EC's assertion to the contrary is presumptuous, as well as unsubstantiated.

[31] EC rebuttal submission, para. 29.

[32] This statement was made in the *First US 21.5 Submission*, para. 24, citing to *Senate Report*, page 5 (US 2).

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

Q34. Is the Panel to understand from Section 4.3.2 of the EC's rebuttal submission that the EC is not relying on the language "whether sole or as one of several other conditions" as a basis for its argument that the existence of "alternatives" to exportation as a means to gain entitlement to the alleged subsidy provided under the Act does not eliminate the alleged export contingency?

<u>Reply</u>

41. The EC's answer that its "argument does not depend on these words" is reflective of the fact that the EC has ignored these words. In the view of the United States, however, these words cannot be ignored, and the US explanation of what these words mean and their significance to this case is set forth in the *First US 21.5 Submission*, paras. 133-136. For the reasons set forth in prior US submissions, the United States believes that these words confirm the US – not the EC's – position, and the EC never has rebutted the US arguments regarding the meaning of these words.

42. Furthermore, the United States understands the EC's answer to mean that its Article 3.1(a) claim is *not* based on the notion that the Act is export contingent for one category of transactions but not others. The EC's answer indicates that its argument is premised on the theory that the Act is export contingent in its entirety. That is, there is one export contingency in the Act that applies equally in all circumstances. As a practical matter, this means that the EC is *not* arguing that the Act violates Article 3.1(a) because it requires exporting *or* some other type of activity. Rather, the EC is arguing that the Act requires exporting in all cases. As the United States has demonstrated, however, the Act does not require exporting at all, let alone in all cases. The EC has failed to prove otherwise.

Q35. Please comment on paragraphs 91, 108, 159 and 170-171 of the US Oral Statement.

Paragraph 91

<u>Reply</u>

43. The United States respectfully refers the Panel to the US comments on the EC's answer to Question 23.

44. The United States would add to those comments that it does not see how the EC's discussion regarding what it terms "capital-export" and "capital-import" neutrality is relevant to the present dispute. Nevertheless, with respect to the EC's statement in paragraph 93 regarding capital-import neutrality – in which the EC said that such neutrality pertains to not influencing whether a taxpayer establishes operations at home or abroad – the United States notes that the Act applies equally to foreign transactions irrespective of whether goods are produced in the United States or abroad.

45. In its answer, the EC continues to maintain that the tax systems of its member states are not export contingent under Article 3.1(a) because export income is not treated better than domestic income. The United States again notes, as it did in its comments regarding question 23, that domestic manufacturers can benefit from a territorial exemption only by exporting. The EC's attempts to distinguish between export sales made by domestic manufacturers to their subsidiaries on the one hand, and income earned by these subsidiaries in selling exported products on the other, ignores the reality of such transactions and the reasoning of the Panel and the Appellate Body in *FSC*. There, the Panel and the Appellate Body found that the US partial exemption of income earned by foreign sales subsidiaries – and the tax-free repatriation of dividends from such income – constituted prohibited export subsidies. The fact that foreign subsidiary income was involved was irrelevant.

Paragraph 108

46. With respect to the EC's answer regarding paragraph 108, in footnote 37 the EC states that the definition of "qualifying foreign trade property" in the Act is "identical" to the definition of "export property" in the former FSC provisions. In doing so, the EC conveniently ignores the fact that the FSC definition required that covered products must be made, produced, or extracted in the United States. In contrast, the most significant aspect of the definition of "qualifying foreign trade property" is that the term means, *inter alia*, "property . . . manufactured, produced, grown, or extracted within *or outside the United States*." The Act § 3, amending IRC § 943(a)(1)(A) (US-1) (emphasis added).

47. In paragraph 97, the EC asserts that "specifically", as used in paragraph (e) of Annex I, means "having a special, precise or clearly defined relationship or connection to exports." Assuming *arguendo* that the EC's interpretation is correct, the United States is at a loss to understand how an exclusion applicable to income earned from goods that can be manufactured and sold outside of the United States, and without incorporating any US articles, can have a "special, precise or clearly defined relationship or connection to exports.".

48. With regard to the EC's statement in paragraph 98 that the "extended subsidy" is export contingent "because in many cases it will be necessary for US goods to be exported as components and raw materials in order to respect the foreign content limitation", the United States notes that: (1) the EC has failed to prove that US goods will be used over imported goods in any instance, let alone "in many cases", and (2) the fact that private actors may *choose* to use US goods does not amount to the type of condition that renders the so-called "extended subsidy" export contingent under Article 3.1(a).

Paragraph 159

Reply

49. In paragraph 101 of its answers, the EC appears to have introduced yet another standard for Article 3.1(b) that deviates from the actual language of that provision. The EC now argues that Article 3.1(b) is violated if a contingency on the use of domestic over imported goods "is not precluded." Because the United States is not even sure what the EC means by this phrase, our comments necessarily are limited to the observation that this new standard is not supported by the text of Article 3.1(b) itself or applicable panel and Appellate Body jurisprudence regarding the meaning of the term "contingent".

Q36. In regard to the "extended" FSC Replacement subsidy scheme, is there "revenue forgone" that is "otherwise due"? What is the US legal rule that would apply to the foreign beneficiary of the extended scheme in the absence of the "extended" scheme? What is the "some other situation" for foreign beneficiaries of the "extended" regime, in which their income would be subject to the US taxation? If, in the EC's view, it is different from the legal rule -- normative benchmark -- applicable to the "basic" subsidy scheme, , please specify.

Reply

50. The United States is pleased to note that the EC now agrees that the normative benchmark in the United States is determined by the definition of "gross income" contained in section 61 of the IRC.[34] This answer, however, disproves the EC's own position because the Act, in section 114, excludes a category of income from the section 61 definition of gross income. The EC, therefore, seems to be arguing either (1) that section 114, despite its plain language, somehow is ineffective in amending section 61, or (2) that any amendment to section 61 automatically confers a subsidy.

[34] *EC Answers to Questions from the Panel*, paras. 116, 126, 127.

51. Section 61 can be understood only in light of the other provisions of the IRC that define its terms and application. Section 114 is an integral part of section 61. The EC would disconnect section 114 from section 61. It in effect is asking the Panel to assume that the United States normative benchmark is to tax all income earned by parties that may be subject to US tax. However, in the US system, "gross income" is a term with a special meaning. It does not apply to all income. It applies only as defined by the IRC.

52. In any event, despite the EC's rhetoric, the EC's answer to the Panel's question shows how much this case differs from the *FSC* case. In that case, the Panel found that the FSC provisions conferred exceptions to three specific, otherwise applicable tax measures: subpart F (sections 951(e) and 954(d)), the tax on effectively connected earnings (section 921(a)), and the limitation on the dividends received deduction for foreign corporations (section 245(c)).[35] The EC points to no such exceptions in this case. Rather, the EC declares that the income would be taxable under section 61 if the Act had not amended section 61. However, Article 1.1 is not so broad as to sanction such circular reasoning.

Q37. What is the US "norm" which can constitute a "normative benchmark" for the purpose of Article 1 of the SCM Agreement? Can the EC specifically identify any US tax rules in addition to the new Section 941(a)(1) of the IRC which defines the term "qualifying foreign trade income"? In other words, what is the statutory basis for the EC's argument that the US is still maintaining its "worldwide" tax system?

Reply

53. The EC's answer to this question contains an assortment of misleading and irrelevant citations and quotations.

54. First, the EC cites certain historical documents to suggest that US Constitution requires the United States to maintain a "worldwide" tax system. This suggestion is false. The Sixteenth Amendment to the US Constitution gives the US Congress the *power* to levy an income tax "without apportionment among the several States, and without regard to any census or enumeration."[36] The Sixteenth Amendment does not *require* Congress to levy an income tax at all, much less an income tax on extraterritorial or foreign-source income. The same can be said about the EC's citation of *Cook v. Tait*, 265 US 47 (1924), and *Commissioner v. Glenshaw Glass Co*., 348 US 426 (1955). Neither case states that the United States is bound to tax extraterritorial or foreign-source income.

55. Second, the EC cites two treatises for the false proposition that the United States still taxes its citizens and residents on a worldwide basis despite the extraterritorial income exclusion. However, both treatises pre-date the Act, and therefore fail to reflect the Act's change to the normative benchmark for taxation in the United States.[37]

56. The EC next quotes the Treasury Department's Subpart F Study for the same, false proposition that the United States still adheres to a "worldwide" tax system. The EC, however, omits the statement, contained in the Study, that "[t]he United States also has elements of a territorial regime. For example, section 911 modifies US worldwide taxation by allowing US individuals working overseas to exclude from their US income certain amounts of foreign earned income and

[35] *FSC (Panel)*, para. 7.100.

[36] The Sixteenth Amendment was adopted to override the rule, in Article III of the US Constitution, that "[n]o Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." US Const., art. III, § 9.

[37] The EC's citation to the Isenbergh treatise, "*International Taxation: US Taxation of Foreign Persons and Foreign Income*, vol. 1, at p. 2:32 (2nd ed. 2000)," appears to date from after the effective date of the Act. In fact, the quotation comes from a November 1997 insert to the treatise.

housing costs. Similarly, section 114 excludes from gross income extraterritorial income of a taxpayer."[38] The EC's selective citation of the Study undermines both its argument and its credibility.

57. Fourth, the EC cites two cases, *Interstate Transit Lines v. Commissioner*, 319 US 590 (1943), and *Jones v. Kyle*, 190 F.2d 353 (10th Cir. 1951), for the proposition that "provisions granting deductions or exclusions of items from gross income are 'matters of legislative grace' and are therefore to be 'strictly construed.'" Regardless of whether the Act is construed strictly or expansively, excluded extraterritorial income is no longer part of the US tax base. Moreover, the cited cases do not support the proposition advanced by the EC. *Interstate Transit Lines* only discussed deductions, not exemptions or exclusions, and *Jones v. Kyle* merely reiterated the rule in *Cook v. Tait* that the United States may tax foreign-source income if it so decides. The United States has decided not to tax foreign-source income that is excluded extraterritorial income.

58. Thus, the only true statement in paragraph 132 of the EC's answers is the statement that section 114 is one of several, specific exclusions from the section 61 definition of gross income. However, the EC still refuses to acknowledge the legal effect of this stubborn fact.

59. Fifth and finally, the EC cites the section 911 earned-income exclusion as support for its self-created "general rule" that the United States continues to tax on a purely worldwide basis. To the contrary, as noted above in connection with the Subpart F Study, section 911 represents another aspect of territoriality adopted by the United States. Thus, the EC's citation of section 911 disproves the EC's "general rule".

60. More generally, it is unclear to the United States how the foregoing use of misleading and irrelevant citations and quotations will assist the Panel in resolving this case.

Q39. In the EC's view, would the Act be consistent with the SCM Agreement if the United States eliminated the requirements that the property be held for use "outside the United States" and the "foreign content limitation"?

Reply

61. The United States is pleased to finally learn the specific provisions of the Act to which the EC actually objects – sections 942(a)(2)(A)(i) and 943(a)(1)(B) and (C) . The EC's answer confirms that the EC's lengthy critique of other provisions of the Act is irrelevant.

62. Given the significance the EC attaches to these provisions, the United States believes that it is essential for the Panel to explain the relative importance of each of these provisions in its decision. For example, if the Panel were to find the "foreign content limitation" to be problematic, the Panel should clarify whether the requirement that property be held for use "outside the United States" is problematic only because of the existence of the "foreign content limitation" or is inherently problematic on its own. The United States has explained that it believes that neither is improper under WTO rules.

63. Furthermore, the United States submits that the EC's answer to question 39 highlights the superficial approach it has taken in this case. The EC, for example, does not address the fact that there are at least two types of income under the Act that would appear to satisfy even the EC's erroneous interpretation of the fifth sentence of footnote 59. First, with respect to wholly foreign transactions – that is, transactions taking place entirely outside the United States[39] – *none* of the income arising from such transactions can be said to be US or domestic income. *All* of the income

[38] Subpart F Study, at p. xi, n.18.

[39] This includes circumstances in which no US goods are included the products at issue.

earned in such transactions occurs outside the United States and can thus be subject to tax in another jurisdiction.

64. Moreover, with respect to transactions originating in the United States, new IRC section 941(a)(1)(A), as added by the Act, provides that 30 per cent of "foreign sales and leasing income" is excluded from taxation. According to new section 941(c), ‘‘foreign sale and leasing income’’ is the amount of the taxpayer's foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes [under the Act's "foreign economic processes requirements"]. Under the Act, these are activities that must be performed outside the United States and, as a result, comport fully with the EC's unduly narrow "foreign economic activities" definition of "foreign source income".

65. One of the legislative reports accompanying the Act gives the following example of "foreign sales and leasing income": "For example, a distribution company's profit from the sale of qualifying foreign trade property that is associated with sales activities, such as solicitation or negotiation of the sale, advertising, processing customer orders and arranging for delivery, transportation outside of the United States, and other enumerated activities, would constitute foreign sale and leasing income."[40] That report goes on to say that, where related parties are involved,

> foreign sale and leasing income may not exceed the amount of foreign sale and leasing income that would have resulted if the taxpayer had acquired the leased property in a hypothetical arm's-length purchase and then engaged in the actual sale or lease of such property. For example, if a manufacturer leases qualifying foreign trade property that it manufactured, the foreign sale and leasing income derived from that lease may not exceed the amount of foreign sale and leasing income that the manufacturer would have earned with respect to that lease had it purchased the property for an arm's-length price on the day that the manufacturer entered into the lease.[41]

66. This means that section 941(a)(1)(A) of the Act provides an exclusion for 30 per cent of income directly attributable to a defined class of foreign economic activities based on arm's-length values. Such income appears to be precisely the type of income that would fall within the fifth sentence of footnote 59 even under the EC's interpretation. Indeed, it is the type of income that the EC claims its member states exempt through their "territorial" systems.

67. The United States, of course, does not agree with the tests and standards the EC has advanced regarding footnote 59. However, assuming *arguendo* that such tests and standards apply, the EC should at the very least explain why provisions of the Act that appear to be fully consistent with standards advocated by the EC are improper. The EC has ignored wholly foreign transactions and section 941(a)(1)(A) completely.

68. Therefore, the United States respectfully requests that, should the Panel adopt the EC's interpretation of footnote 59, the Panel should make findings as to whether the Act's treatment of income derived from wholly foreign transactions and "foreign sales and leasing income" are measures to avoid double taxation of foreign-source income under that interpretation. An abstract discussion of the "foreign content limitation" and the "foreign destination test", without more, would not promote resolution of this particular dispute or the aims of the multilateral system more generally.

[40] *Senate Report* (US-2), pages 10-11.
[41] *Id.*

Q43. Can a measure of a Member provided in respect of the production of a good outside the territory of that Member be a subsidy within the meaning of Article 1 of the SCM Agreement? Please explain your answer, taking into account any relevant provisions of the SCM Agreement.

Reply

69. With respect to paragraph 157 of the EC's answer to this question, the United States merely recalls that the policy reflected in section 351.527 of the US Department of Commerce countervailing duty regulations is subject to certain exceptions.[42]

Q45. Is export income foreign source income? Some may take the view that the "foreign-source income" referred to in footnote 59 should include export income since the footnote is accompanying item (e) that is dealing with a type of subsidy specifically related to export. Please comment.

Reply

70. In its answer to this question, the EC appears to take the position that the fifth sentence of footnote 59 does not qualify paragraph (e) of Annex I. As noted above in connection with the US comments on the EC's answer to Question 3, the EC position is contradicted by the fact that footnote 59 is attached to paragraph (e) rather than Article 1. In addition, the EC position is inconsistent with prior EC statements regarding the meaning of the fifth sentence.

71. The EC position appears to be based on the use of the phrase "is not intended to" in the fifth sentence. According to the EC, if the drafters had intended that the fifth sentence qualify paragraph (e), they would have used different language. However, there are many, many ways to draft effective treaty provisions, and the universe of the WTO agreements provides numerous examples of different drafting styles. In the view of the United States, the phrase "is not intended to" constitutes a perfectly acceptable (and conventional) way of expressing the drafters' intent as to the scope of paragraph (e).

72. In this regard, the phrase "is not intended to" also appears in footnote 56 of the SCM Agreement, a footnote attached to Article 32.1. Article 32.1 provides as follows:

> No specific action against a subsidy of another Member can be taken except in accordance with the provisions of GATT 1994, as interpreted by this Agreement.

On its face, Article 32.1 arguably might limit action against a subsidy to action under the SCM Agreement or GATT Articles VI and XVI to which the SCM Agreement relates.

73. However, footnote 56 provides as follows:

> This paragraph is not intended to preclude action under other relevant provisions of GATT 1994, where appropriate.

The meaning of this footnote was at issue in the *Indonesia Autos* case in connection with Indonesia's argument that the SCM Agreement provided the exclusive remedy against measures that could be characterized as subsidies. In rejecting Indonesia's argument, the panel gave meaning to footnote 56, and cited it for the proposition that actions against subsidies remain possible under GATT 1994.[43]

[42] *US Answers to Questions from the Panel*, para. 110.

[43] *Indonesia - Certain Measures Affecting the Automobile Industry*, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, Report of the Panel adopted 23 July 1998, para. 14.36, note 659.

74. Finally, other portions of footnote 59 belie the EC's claim that the fifth sentence is merely "declaratory" of principles that the drafters articulated elsewhere. In the second sentence of footnote 59, Members "reaffirm the principle" regarding arm's length pricing between related parties. Given the use of this language in the second sentence, if the fifth sentence was merely "declaratory" of a principle articulated in Article 1, as claimed by the EC, the drafters would have written the fifth sentence as follows:

> Members reaffirm the principle in Article 1 that a measure taken by a Member to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member is not a subsidy.

ANNEX F-7

COMMENTS OF THE UNITED STATES ON EC'S ANSWERS TO US QUESTIONS

Q1. What is the "prevailing standard" or "general rule" of taxation in a country which taxes some persons on a worldwide basis and some persons on an exemption basis, in some cases at their election (and subject in such cases to the discretion of the government)? Please explain the basis for your answer.

Reply

1. The EC's inability to respond to this question is rather peculiar. The EC has had little reluctance in characterizing what it perceives to be the "prevailing standard" or "general rule" of the US tax system. Indeed, the EC has even gone so far as to reject US descriptions of its own tax system, including descriptions made by the US Congress contemporaneous with passage of the Act.

2. It is difficult to escape the conclusion that the EC wants to avoid answering a rather difficult question. In particular, the EC does not want to acknowledge the fact that certain countries, including France, allow taxpayers to choose between a territorial/ exemption system and a worldwide/credits system. More generally, the EC appears reluctant to acknowledge the fundamental similarities between the US tax system after adoption of the Act and the tax systems of its own member states.

Q2. Is the tax exemption by a country of "foreign-source income" (for purposes of footnote 59) permissible under the SCM Agreement only if *all* "foreign-source income" is exempt from tax? Please explain the basis for your answer.

Reply

3. The EC's answer is incomplete and difficult to understand. In response to the US question of whether an exemption of foreign-source income under footnote 59 must be for all such income, the EC merely says "no," and then says that the problem with the Act in this regard is that it offers a choice to a limited number of privileged taxpayers. This makes no sense for two reasons.

4. First, the EC's answer of "no" to the question is directly contradictory to many of its arguments in this case – in particular, that the Act's exclusion is improper because it is conditioned on a number of factors and does not apply to products imported into the United States. The EC's arguments regarding Article 1 of the SCM Agreement are predicated on the contention that the Act's exclusion, unlike EC territorial exemptions, allegedly does not adhere to a neat and clean formula or principle but is subject to numerous exceptions and requirements. The EC's arguments regarding Article 3 of the SCM Agreement similarly are based on the notion that the exclusion, in the EC's view, applies to exports, a near empty set of wholly foreign transactions, and no imports. It would appear to be impossible to reconcile these EC's arguments with its answer of "no" to the question.

5. Second, as the United States has explained, the Act does not apply solely to "privileged taxpayers", and it does not provide such taxpayers with "a more advantageous means of avoiding double taxation". The Act applies to all US taxpayers that engage in transactions giving rise to extraterritorial income. These taxpayers can be individuals or businesses, corporations or partnerships, and subsidiaries or branches. In fact, these taxpayers need not even be American, since the Act applies equally to non-US enterprises.

6. Moreover, the Act does not provide more generous relief than US tax credits, but rather an alternative means of relief. For some taxpayers, the Act may be more advantageous. For others, tax credits would be better. This outcome might change for taxpayers from transaction to transaction. In providing alternative options, the United States is doing precisely what many other countries do (including France, as noted in our comments on the EC's answer to U.S Question 1). As evidence of this fact, the Commentary to Article 23 of the OECD Convention notes that countries may use credits, exemptions, or both.

Q4. Are the EC member States prepared to relinquish all source-based taxation with respect to business profits in the absence of a "permanent establishment," as that term is defined in Article 5 of the OECD Model Income Tax Convention?

Reply

7. The EC's response fails to acknowledge four fundamental facts relevant to this dispute. First, countries draw their taxing boundaries differently, and many impose taxes on non-residents in the absence of a permanent establishment. Second, one reason countries enter into tax treaties is to avoid double taxation that can arise when other countries tax income earned within their borders even if no permanent establishments are involved. Third, no country has tax treaties with all other countries with which its citizens and businesses do business. And fourth, many if not most countries have domestic double taxation avoidance measures that operate in conjunction with, or in addition to, tax treaties.

8. Thus, it is difficult to understand how the EC can argue, as it does by implication in response to US Question 4, that a measure to avoid double taxation under footnote 59 can only apply to permanent establishments. The EC appears to be arguing that footnote 59 encompasses only tax treaties based on the OECD Convention or domestic double taxation avoidance measures that follow OECD principles. The OECD Convention is evidence of certain ways a number of countries have agreed to avoid double taxation in limited circumstances. However, it cannot be correct that the fifth sentence of footnote 59 applies only in instances where the OECD Convention calls for the use of the exemption or credit methods.

9. Because the EC seems to consider the concept of a permanent establishment to be so central not only to the right of a country to avoid double taxation, but also to the right of a country to tax income in the first place, the United States asked if the EC was taking the position that countries should not or cannot impose tax on non-residents in the absence of a permanent establishment. The first paragraph of the EC's answer – stating that countries are generally free to tax whatever income they wish – indicates that the EC recognizes that taxes may be levied even where there is no permanent establishment. Given this reality, countries may need flexible approaches to protect against double taxation. The EC's seemingly rigid adherence to the concept of a permanent establishment does not coincide with the more far-reaching approaches of many tax systems and would not allow for double taxation avoidance where these more far-reaching approaches are employed.

10. The United States respectfully refers the Panel to its answer to Panel Question 12, in which the United States provides examples of a number of countries that do not rely on the concept of a permanent establishment in establishing taxing jurisdiction.

Q6. Does the OECD Model Income Tax Convention contain a definition of the term "foreign-source income"? If so, please identify the provision containing such definition.

Reply

11. It is noteworthy that the EC has conceded that the OECD Convention does not use, let alone define, the term "foreign source income". The EC, however, continues to cling to the baseless notion that the Convention somehow can supply a definition to this term by implication.

12. The passage from Article 4 of the Convention quoted by the EC merely reflects that two bases on which countries may claim the right to tax income are residency and source. Residency refers to whether a taxpayer resides in a country and thus can be subjected to tax on that basis. Source reflects whether income has a nexus to a country and thus can be subjected to tax. The former focuses on the location of the taxpayer; the latter focuses on the "location" of the income.

13. The EC does not explain how the quoted passage "expresses the same concept" as "foreign source income" in "a different way". The passage merely refers to taxing jurisdiction based on "sources" in a particular country. What those "sources" are or may be is not defined.

14. The United States respectfully refers the Panel to paragraphs 132-36 of its *Oral Statement*, in which it explained "that the provisions of the OECD Convention the EC cites do not support the EC's narrow construction [of the term "foreign source income"], but rather confirm the US position.".