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UNITED STATES - TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS"

Recourse to Article 21.5 of the DSU by the European Communities

Report of the Panel

The report of the Panel on *United States - Tax Treatment for "Foreign Sales Corporations"- Recourse to Article 21.5 of the DSU by the European Communities* is being circulated to all Members, pursuant to the *DSU*. The report is being circulated as an unrestricted document from 20 August 2001 pursuant to the Procedures for the Circulation and Derestriction of WTO Documents (WT/L/160/Rev.1). Members are reminded that in accordance with the *DSU* only parties to the dispute may appeal a panel report. An appeal shall be limited to issues of law covered in the Panel report and legal interpretations developed by the Panel. There shall be no *ex parte* communications with the Panel or Appellate Body concerning matters under consideration by the Panel or Appellate Body.

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I. PROCEDURAL BACKGROUND

1.1 On 20 March 2000, the Dispute Settlement Body (the "DSB") adopted the Appellate Body Report in WT/DS108/AB/R and the Panel Report in WT/DS108/R as modified by the Appellate Body Report in the *United States - Tax Treatment for "Foreign Sales Corporations"* dispute. In its recommendations and rulings, the DSB requested the United States to bring the FSC measure that was found, in the Appellate Body Report and in the Panel Report as modified by that Report, to be inconsistent with its obligations under Articles 3.1(a) and 3.2 of the *Agreement on Subsidies and Countervailing Measures* (the "*SCM Agreement*") and under Articles 10.1 and 8 of the *Agreement on Agriculture*, into conformity with its obligations under those Agreements.[1] The DSB specified that the FSC subsidies had to be withdrawn "at the latest with effect from 1 October 2000".[2]

1.2 In its Report, the Appellate Body, *inter alia*, upheld the Panel's finding, in paragraph 7.130 of the original Panel Report, that the FSC measure constitutes a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*; reversed the Panel's finding, in paragraph 7.159 of the original Panel Report, that the FSC measure involves "the provision of subsidies to reduce the costs of marketing exports" of agricultural products under Article 9.1(d) of the *Agreement on Agriculture* and, in consequence, reversed the Panel's findings, in paragraphs 7.165 and 7.176 of the original Panel Report, that the United States has acted inconsistently with its obligations under Article 3.3 of the *Agreement on Agriculture*; and found that the United States acts inconsistently with its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture* by applying export subsidies, through the FSC measure, in a manner which results in, or which threatens to lead to, circumvention of its export subsidy commitments with respect to both scheduled and unscheduled agricultural products.[3]

1.3 On 29 September 2000, the Chairman of the DSB received a communication from the United States in which the United States "propose[d] that the DSB modify the time-period in this dispute so as to expire on 1 November 2000".[4] The United States asked "that the DSB approve this proposal and, to that end, request[ed] a meeting of the DSB on 12 October 2000 to consider this matter."[5] On 12 October 2000, the DSB, given that there was no opposition to the US request, agreed to accede to the request of the United States as formulated in its letter of 29 September 2000 and circulated in document WT/DS108/11.[6]

1.4 On 2 October 2000, the parties informed the DSB of their Understanding on "Agreed procedures under Articles 21 and 22 of the Dispute Settlement Understanding and Article 4 of the *SCM Agreement* applicable in the follow-up to the 'United States - Tax Treatment for "Foreign Sales Corporations' dispute", concluded between the parties on 29 September 2000.[7]

1.5 On 15 November 2000, the President of the United States signed into law an Act of the United States Congress entitled the "*FSC Repeal and Extraterritorial Income Exclusion Act of 2000*"[8] (the "Act"). With the enactment of this legislation, the United States considered that it had implemented the DSB's recommendations and rulings in the dispute and that the legislation was consistent with the United States' WTO obligations.[9]

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[1] Original Appellate Body Report, WT/DS108/AB/R, adopted 20 March 2000, para. 178.
[2] Original Panel Report, WT/DS108/R, adopted 20 March 2000 as modified by the original Appellate Body Report, WT/DS108/AB/R, para. 8.8.
[3] Original Appellate Body Report, *supra*, note 1, para. 177 (a), (b) and (d).
[4] WT/DS108/11, 2 October 2000.
[5] *Ibid.*
[6] See Minutes of the DSB meeting held on 12 October 2000, WT/DSB/M/90, paras. 6-7.
[7] Circulated as document WT/DS108/12, 5 October 2000.
[8] United States Public Law 106-519, 114 Stat. 2423 (2000), Exhibit EC-5; Exhibit US-1.
[9] Minutes of the DSB meeting held on 17 November 2000, WT/DSB/M/92, para. 143.

1.6 On 17 November 2000, the European Communities requested the United States to enter into consultations under Articles 4 and 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "*DSU*"), Article 4 of the *SCM Agreement*, Article 19 of the *Agreement on Agriculture* and Article XXIII:1 of the *GATT 1994* with respect to the Act. The European Communities considered that the United States had failed to comply with the DSB recommendations and rulings by 1 November 2000. Furthermore, the European Communities alleged that the Act "appears to replicate the violations of the WTO Agreement found in the original dispute rather than remove them."[10]

1.7 Consultations were held between the parties on 4 December 2000 in Geneva, but the consultations failed to settle the dispute.

1.8 On 7 December 2000, the European Communities requested the establishment of a panel as "there is a disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings" of the DSB. The European Communities made the request pursuant to Article 6 and Article 21.5 of the *DSU*, Article 4 of the *SCM Agreement*, Article 19 of the *Agreement on Agriculture* and Article XXIII of the *GATT 1994*, and as envisaged in the "Agreed procedures under Articles 21 and 22 of the Dispute Settlement Understanding and Article 4 of the SCM Agreement applicable in the follow-up to the *United States - Tax Treatment for 'Foreign Sales Corporations*' WTO dispute" between the European Communities and the United States of 29 September 2000".[11]

1.9 At its meeting on 20 December 2000, the DSB decided, in accordance with Article 21.5 of the *DSU*, to refer to the original Panel the matter raised by the European Communities in document WT/DS108/16. At that DSB meeting, it also was agreed that the Panel should have standard terms of reference as follows:[12]

> "To examine, in the light of the relevant provisions of the covered agreements cited by the European Communities in document WT/DS108/16, the matter referred to the DSB by the European Communities in that document and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements."

1.10 The Panel was composed as follows:[13]

Chairman: Mr. Crawford Falconer

Members: Mr. Didier Chambovey
Professor Seung Wha Chang

1.11 Australia, Canada, India, Jamaica and Japan reserved their rights to participate in the Panel proceedings as third parties.

1.12 The Panel met with the parties on 13-16 March 2001 and with third parties on 14 March 2001.

1.13 The Panel submitted its interim report to the parties on 22 June 2001. On 2 July 2001, both parties submitted written requests that the Panel review precise aspects of the interim report. On

[10] WT/DS108/14 and Corr. 1., 21 November 2000.
[11] WT/DS108/16, 8 December 2000.
[12] See document WT/DS108/19, 5 January 2001.
[13] *Ibid.*

9 July 2001, each party submitted written comments on the other party's written request. The Panel submitted its final report to the parties on 23 July 2001.

II. FACTUAL ASPECTS

2.1 On 15 November 2000, the United States enacted the Act[14], which repeals the provisions in the United States Internal Revenue Code ("IRC") relating to taxation of foreign sales corporations[15], subject to certain transitional provisions. In particular, the Act specifies that, in general, the amendments made by the Act "shall apply to transactions after September 30, 2000".[16] In addition, no new FSCs may be created after that date.[17] However, in the case of a FSC in existence on 30 September 2000, the amendments made by the Act shall not apply to any transaction in the ordinary course of trade or business involving a FSC which occurs: (A) before 1 January 2002; or (B) after 31 December 2001, pursuant to a binding contract between the FSC (or any related person) and any unrelated person that is in effect on 30 September 2000.[18] The original FSC scheme is described in paras. 2.1-2.8 of our original Panel Report.[19]

2.2 The Act amends the IRC by, *inter alia*, inserting a new section 114, entitled "extraterritorial income". Under the heading "exclusion", the Act[20] provides that "gross income does not include extraterritorial income". Under the heading "exception", the Act[21] provides that this exclusion "shall not apply to extraterritorial income which is not qualifying foreign trade income…".

2.3 Under the Act, certain income of a United States "taxpayer"[22] may be excluded from taxation. Such income -- "extraterritorial income" that is "qualifying foreign trade income" -- may be earned with respect to goods only in transactions involving qualifying foreign trade property.[23]

2.4 The Act defines "extraterritorial income" as the gross income of a taxpayer attributable to foreign trading gross receipts, i.e. gross receipts generated by certain qualifying transactions involving the sale or lease of "qualifying foreign trade property" not for use in the United States.[24]

2.5 "Qualifying foreign trade income" means, with respect to any transaction, the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest of:

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[14] *FSC Repeal and Extraterritorial Exclusion Act of 2000*, United States Public Law 106-519, 114 Stat. 2423 (2000), Exhibit EC-5; Exhibit US-1.

[15] See section 2 of the Act, repealing subpart C of part III of subchapter N of chapter 1 of the IRC.

[16] Act, section 5(a).

[17] Act, section 5(b)(1).

[18] Act, section 5(c)(1).

[19] See *supra*, note 2.

[20] Act, section 3; section 114(a) IRC.

[21] Act, section 3; section 114(b) IRC.

[22] Including a foreign corporation that has elected to be treated as a US corporation for the purposes of the Act. See Act, section 3; section 943(e) IRC.

[23] And, outside the goods area, such income may be earned in relation to services which are: related and subsidiary to (i) any sale, exchange, or other disposition of qualifying foreign trade property, or (ii) any lease or rental of certain qualifying foreign trade property; for engineering or architectural services for construction projects located (or proposed for location) outside the United States; or for the performance of managerial services for a person other than a related person in furtherance of the production of certain foreign trading gross receipts. Act, section 3; section 942 IRC. The only way to earn qualifying foreign trade income that does not involve qualifying foreign trade property is through certain engineering or architectural services.

[24] Act, section 3; sections 114(e) and 942 IRC. We note that the term foreign trading gross receipts also includes the gross receipts of the taxpayer which are for certain services, some of which must involve qualifying foreign trade property, as indicated *supra*, note 23. Section 942(a)(2)(A)(i) IRC, relating to the definition of "foreign trading gross receipts", states that such receipts shall not include receipts from a transaction if the qualifying foreign trade property or services are for ultimate use in the United States.

- 30 per cent of the foreign sale and leasing income[25] derived by the taxpayer from such transaction,
- 1.2 per cent of the foreign trading gross receipts[26] derived by the taxpayer from the transaction, or
- 15 per cent of the foreign trade income[27] derived by the taxpayer from the transaction.[28]

2.6 Qualifying foreign trade property means property –

> "(A) manufactured, produced, grown or extracted within or outside the United States,
>
> (B) held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and
>
> (C) not more than 50 per cent of the fair market value of which is attributable to -
>
> > (i) articles manufactured, produced, grown, or extracted outside the United States, and
> >
> > (ii) direct costs for labour (determined under the principles of Section 263A) performed outside the United States."[29] […]

Certain property is excluded from "qualifying foreign trade property", including oil or gas (or any primary product thereof)[30], any unprocessed timber that is a softwood[31] and any property the President may designate as in "short supply".[32]

2.7 The Act's definitions of qualifying foreign trade property and foreign trading gross receipts -- which determine income that qualifies as extraterritorial income, foreign trade income and qualifying foreign trade income -- thus contain at least two requirements that must be satisfied in order for a taxpayer to qualify for the exclusion from taxation: (i) a requirement that a good produced within or outside the United States must be held primarily for sale, lease or rental, in the ordinary course of

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[25] The Act defines "foreign sale and leasing income" as foreign trade income properly allocable to certain foreign economic processes performed outside the United States or derived in connection with the lease or rental of qualifying foreign trade property outside the United States. Act, section 3; section 941(c)(1) IRC. The term "foreign sale and leasing income" includes "any foreign trade income derived by the taxpayer from the sale of property described in paragraph (1)(B)". Act, section 3, section 941(c)(2) IRC, dealing with "special rules for leased property", also contains certain "limitations" in sub-paragraph (B), and section 941(c)(3) IRC contains certain "special rules".

[26] I.e. with respect to goods, gross receipts generated by certain qualifying transactions involving the sale or lease of "qualifying foreign trade property" not for use in the United States. Act, section 3; section 942 IRC. The term "foreign trading gross receipts" also includes certain gross receipts for certain services, some of which must involve qualifying foreign trade property. See *supra*, note 23.

[27] The Act defines "foreign trade income" as the taxable income attributable to foreign trading gross receipts (Act, section 3; Act, section 941(b)(1) IRC).

[28] Act, section 3; section 941(a)(1) IRC. Under section 941(a)(2) IRC, a taxpayer may compute its qualifying foreign trade income under one of these three methods other than the one that results in the greatest amount of such income.

[29] Act, section 3; section 943(a)(1) IRC.

[30] Act, section 3; section 943(a)(3)(C) IRC.

[31] Act, section 3; section 943(a)(3)(E) IRC.

[32] Act, section 3; section 943(a)(4) IRC.

trade or business for direct use, consumption, or disposition outside the United States[33] (referred to in this Report as the requirement of "use outside the United States"); and (ii) a requirement that no more than 50 per cent of the fair market value of such property can be attributable to articles manufactured, produced, grown, or extracted outside the United States, and direct costs for labour performed outside the United States (referred to in this Report as the "foreign articles/labour limitation").

2.8 Foreign trading gross receipts arise from any transaction only if certain foreign economic process requirements are fulfilled in respect of a transaction.[34] This requirement is met if the taxpayer (or any person acting under contract with such taxpayer) has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction, and the foreign direct costs (i.e. attributable to specified activities performed outside the United States) incurred meet a certain proportion of the total direct costs[35] (i.e. attributable to specified activities performed anywhere). The specified activities relating to qualifying foreign trade property are:

- advertising and sales promotion;
- processing of customer orders and arranging for delivery;
- transportation outside the United States in connection with delivery to the customer;
- determination and transmittal of final invoice or statement of account or the receipt of payment; and
- assumption of credit risk.[36]

III. FINDINGS REQUESTED BY THE PARTIES

3.1 The European Communities requests the Panel to find that[37]:

(a) The FSC Replacement scheme created by the FSC Replacement Act gives rise to subsidies within the meaning of the *SCM Agreement* and the *Agreement on Agriculture*.

(b) The FSC Replacement scheme provides subsidies contingent upon export performance contrary to Article 3.1(a) of the *SCM Agreement.* This prohibition is supported and confirmed by the fact that these subsidies are specifically related to exports within the meaning of item (e) to the Illustrative List in Annex I to the *SCM Agreement*.

(c) The foreign content limitation in the FSC Replacement scheme renders the basic FSC Replacement subsidy (and the extended FSC Replacement subsidy, if this is not contrary to Article 3.1(a)) contingent upon the use of US over imported goods contrary to Article 3.1(b) of the *SCM Agreement*.

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[33] See *supra*, para. 2.6.

[34] Act, section 3; section 942(b) IRC, except where a taxpayer's foreign trading gross receipts do not exceed US$5 million, see section 942(c) IRC.

[35] The foreign direct costs attributable to the transaction generally must exceed 50 per cent of the total direct costs attributable to the transaction, but the requirement will also be satisfied if, with respect to at least two categories of direct costs, the foreign direct costs equal or exceed 85 per cent of the total direct costs attributable to each category (Act, section 3; section 942(b)(2)(A)(ii) and (B)).

[36] Act, section 3; section 942(b)(3) IRC. Section 942(b)(4) states that a taxpayer "shall be treated as meeting the requirements of this subsection with respect to any sales transaction involving any property if any related person has met such requirements in such transaction or any other sales transaction involving such property".

[37] EC first written submission, Annex A-1, paras. 29 and 259.

(d) Consequently, the FSC Replacement scheme grants and maintains subsidies contrary to Article 3.2 of the *SCM Agreement*.

(e) The FSC Replacement scheme accords more favourable treatment to US than to like imported products in relation to the use of such products for the production of goods for export under the scheme, contrary to Article III:4 of *GATT 1994.*

(f) The FSC Replacement scheme is inconsistent with Articles 10.1 and 8 of the *Agreement on Agriculture* or, in the alternative, with Articles 3.3 and 8 of the *Agreement on Agriculture* in conjunction with Article 9.1 of the *Agreement on Agriculture*.

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

(h) By failing to withdraw the FSC subsidies and to comply with the rulings and recommendations of the DSB by the end of the period of time allowed by the DSB, the US has also failed to comply with its obligations under Article 21 *DSU.*

3.2 In addition, the European Communities "requests the Panel to make a preliminary ruling to the effect that third parties are entitled to receive all written submissions of the parties submitted prior to the meeting of the Panel and to make this preliminary ruling and communicate it to the parties and the third parties as soon as possible after receipt of the US first written submission and before the date for the presentation of the second written submissions."[38]

3.3 The United States requests that the Panel find that[39]:

(a) The Act's exclusion of extraterritorial income from US taxation does not constitute a prohibited subsidy contingent upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement.*

(b) The Act's exclusion of extraterritorial income from US taxation does not constitute a prohibited subsidy contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the *SCM Agreement.*

(c) The Act does not result in less favourable treatment being provided to imported goods in comparison to the treatment afforded to like domestic goods within the meaning of Article III:4 of *GATT 1994.*

(d) The Act's exclusion of extraterritorial income from US taxation is not inconsistent with US obligations under Articles 10.1 and 8, or Article 3.3 and 8, of the *Agreement on Agriculture*.

(e) The United States complied with the DSB's recommendations and rulings in the original FSC dispute.

(f) The third parties in this proceeding do not have a right to the parties' rebuttal submissions.

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[38] EC first written submission, Annex A-1, para. 260.
[39] US first written submission, Annex A-2, para. 239.

IV. ARGUMENTS OF THE PARTIES

4.1 The arguments of the parties are set out in their submissions to the Panel. The parties' submissions are attached to this Report as Annexes (see List of Annexes, page iii).

V. ARGUMENTS OF THE THIRD PARTIES

5.1 The arguments of the third parties, Australia, Canada, India and Japan, are set out in their submissions to the Panel and are attached to this Report as Annexes (see List of Annexes, page iii). One third party, Jamaica, made no written or oral submissions to the Panel.

VI. PROCEDURAL MATTERS

A. THIRD PARTY ACCESS TO REBUTTAL SUBMISSIONS

6.1 In its first written submission, the European Communities requested "the Panel to make a preliminary ruling to the effect that third parties are entitled to receive all written submissions of the parties submitted prior to the meeting of the Panel and to make this preliminary ruling and communicate it to the parties and the third parties as soon as possible after receipt of the US first written submission and before the date for the presentation of the second written submissions."[40]

6.2 In response, the United States requested that we find that the third parties in this proceeding do not have a right to the parties' rebuttal submissions.[41]

6.3 On 21 February 2001, the Panel issued the following decision to the parties:[42]

> Panel decision concerning the request by the European Communities relating to third party access to parties' rebuttal submissions
>
> 1. The working procedures adopted by the Panel provide that third parties "shall receive copies of the parties' first written submissions" and that "[a]ny party may decide to provide the third parties with a copy of its rebuttal or other submissions." The European Communities contends that the working procedures conflict with Article 10.3 *DSU* as they do not require that third parties receive *all* of the parties' submissions preceding the one substantive Panel meeting in an accelerated panel process under Article 21.5 *DSU*. The European Communities requests that the Panel rule that third parties be allowed to receive all the main parties' submissions preceding the single Panel meeting.[1] The United States asks us to deny this request.[2]
>
> 2. For the reasons stated below, we do not consider that Article 10.3 *DSU* requires that third parties receive all pre-meeting submissions of the parties (including rebuttal submissions) in the context of an accelerated proceeding under Article 21.5 *DSU* that involves only one meeting of the parties and third parties with the panel. Accordingly, we deny the EC request.
>
> 3. The EC argument is based upon Article 10.3 *DSU*, which provides: "Third parties shall receive the submissions of the parties to the dispute to the first meeting of the panel."

[40] EC first written submission, Annex A-1, para. 260. See paras. 247-258 for EC arguments in support of this request.

[41] US first written submission, Annex A-2, para. 239(f). See paras. 234-238 for US arguments in response to the EC request.

[42] We have made certain technical changes to the text of the decision.

4. In reaching our decision, we took note of the weight placed by the EC argument on the text of Article 10.3 *DSU*[3], as well as on certain perceived considerations in the *DSU*.[4] We were mindful also of the *Vienna Convention* rules on treaty interpretation, including the need to avoid isolating the words of a treaty from their context.[5]

5. We note, to begin with, the express reference in Article 10.3 to the "first" meeting of the panel. In our view, this reference in Article 10.3 to "submissions … to the *first* meeting of the panel" (emphasis added) cannot be interpreted in such a way as to render the word "first" devoid of meaning. Its use clearly presupposes a context where there is more than one meeting of a Panel. This reflects the fact that the reference at issue is made in the context of standard panel procedures.

6. Under such procedures, a panel ordinarily holds two meetings. Documentation is submitted prior to each of these meetings.[6] Third parties ordinarily do not have a right to hear the oral statements of the parties at any panel meeting (including the first meeting). Rather, they attend a single special third party session set aside for this purpose and held subsequent to the first panel meeting with the parties.[7] In that context, it should be emphasized, the manifest effect of Article 10.3 *DSU* is to limit third party rights to receive only the parties' first written submissions (submitted to the first meeting); not the parties' written rebuttals (presented to the second meeting).

7. A panel under Article 21.5 must follow *DSU* panel procedures. But it must do so in a particular context, namely in the context of a much stricter timeframe. As a result, this Panel decided to hold only one meeting, rather than two, as would usually be the case (i.e. in the context of a proceeding with a lengthier timeframe). Our working procedures maintained the practice of obtaining from the parties two sets of documentation in the form of first written submissions and written rebuttals (both, however, prior to the single Panel meeting). We note, further, that such arrangements received the concurrence of the parties. It was, indeed, their declared preference.

8. In our view, the plain language of Article 10.3 *DSU* does not expressly address the extent of third party access to submissions in a situation where there is only one meeting pursuant to the constraints imposed by Article 21.5 *DSU*. This is manifest from the plain language which, as noted above in paragraph 5, refers to a "first" meeting. However, it is incumbent upon us to construe Article 10.3 *DSU* "…in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".[8]

9. In this regard, the Panel is of the view that in order to give effect to Article 10.3 *DSU*, this provision must be understood as limiting third party rights in these proceedings to access to the first written submissions only, and as not including access to the written rebuttals. In the absence of any explicit or express provision to the contrary in an Article 21.5 proceeding involving only one panel meeting, we can find no basis to warrant a contrary approach. The drafters of the *DSU* restricted third party rights. It is not this Panel's task to extend them in Article 21.5 procedures.[9]

10. Nor, for that matter, can we see that there is any other reason why such an approach could be construed to be anything other than most consonant with Article 10.3 *DSU*. In our view, it is an arrangement that ensures that the situation of all parties is most consistently applied. As noted, had the Panel decided to hold two meetings with the parties -- the more frequent situation envisioned in Article 10 and Appendix 3 *DSU* -- third parties would have received the written submissions made

prior to the first meeting, but not rebuttals or other subsequent submissions. Thus, in a more frequent procedure, third parties would be in precisely the same position as they are here with respect to their ability to present views to the Panel. Therefore, in our view, the procedures we have adopted more closely parallel the degree of access foreseen by Article 10.3 *DSU* than if they *required* that third parties receive the rebuttals. They are thus, in our view, in keeping with Article 10.3 *DSU* in a proceeding involving only one substantive meeting.

11. Moreover, we gave the parties an opportunity to comment on draft working procedures and timetable, and at no time did either party make any comment with respect to any modification of this aspect of the working procedures.

12. Finally, while we recognize that an extension of third party rights would not be precluded were special circumstances to arise, we note that no third party has requested any third party rights other than those referred to in our working procedures and see no special reason why any third party to this case would need extended third party rights.

13. While we decline the EC request to rule that third parties be allowed to receive all the main parties' submissions preceding the single Panel meeting, we recall that pursuant to our working procedures, "[a]ny party may decide to provide the third parties with a copy of its rebuttal or other submissions."

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[1]EC first written submission, Annex A-1, paras. 247 *ff*.

[2]US first written submission, Annex A-2, para. 237.

[3]e.g. EC first written submission, Annex A-1, paras. 251-252.

[4]*Ibid*., paras. 253-254.

[5]Pursuant to Article 31 of the *Vienna Convention on the Law of Treaties* (23 May 1969, 1155 U.N.T.S. 331; 8 I.L.M. 679) to the extent it reflects customary international law, the Panel is required to interpret Article 10.3 *DSU* "in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".

[6]Appendix 3 to the *DSU*, paras. 4-7.

[7]*Ibid*., paras. 5 and 6.

[8]See *supra*, note 5.

[9] We note that at least two other Article 21.5 panels were of a similar view. See Article 21.5 Panel Report, *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather, Recourse to Article 21.5 of the DSU by the United States*, WT/DS126/RW, adopted 11 February 2000, para. 3.9. See Article 21.5 Panel Report, *Australia - Measures Affecting Importation of Salmon, Recourse to Article 21.5 by Canada;* WT/DS18/RW, adopted 20 March 2000, para. 7.5.

B. TIMING OF REBUTTAL SUBMISSIONS

6.4 On 12 February 2001, the United States sent a written communication to the Panel requesting that we revise the schedule for this proceeding in order to provide for consecutive, rather than simultaneous, filing of the second written submissions by the parties. The United States stated that the existing schedule meant that any response by the United States to the EC second submission would have to be presented by the United States in its oral statement at the Panel meeting. The United States was of the view that consecutive filing would be of more assistance to the Panel in its work. The United States asserted that while the European Communities had new material from the United States to rebut in its rebuttal submission, the United States did not. The United States further argued that the European Communities has the opportunity to file two written submission, while the United States was limited to one.

6.5 On 14 February 2001, the European Communities sent a written communication to the Panel, asking that we "reject this request" and expressing surprise that the United States was trying to reopen this matter at this late stage in the proceeding, after the deadline for requesting preliminary rulings. The European Communities asserted that "[s]imultaneous rebuttals are required by Article 12.6 DSU" and that this rule had also been followed in previous panel proceedings under Article 21.5 *DSU*. The European Communities stated that these considerations had presumably led the Panel to reject the United States request at the organizational meeting with the parties in December 2000.

6.6 On 21 February 2001, the Panel issued the following decision to the parties:

> Panel decision concerning the request by the United States relating to the timing of rebuttal submissions
>
> 1. We have carefully considered the request by the United States of 12 February 2001 that the Panel provide for consecutive, rather than simultaneous, filing of the parties' second written submissions, as well as the responding communication of the European Communities dated 14 February 2001.
>
> 2. We recall that we adopted our working procedures after having heard the views of the parties, including their views on the issue of the timing of the filing of their rebuttal submissions. We do not believe that any development or consideration has since arisen that would require us to reconsider this aspect of our working procedures, particularly given the current advanced stage of the proceedings and the difficulties inherent in adjusting other aspects of the Panel's schedule that such a change would necessitate.
>
> 3. We therefore deny this request by the United States to change the Panel's schedule with respect to the timing for filing the parties' second written submissions. We note that the United States, as well as the European Communities, if they wish, would be able to respond to, or comment on, the other party's rebuttals in their oral statements at the substantive meeting.

VII. INTERIM REVIEW

7.1 The Panel submitted its interim report to the parties on 22 June 2001. On 2 July 2001, both parties submitted written requests that the Panel review precise aspects of the interim report. On 9 July 2001, each party submitted written comments on the other party's written request.

A. ORIGINAL COMMENTS BY THE EUROPEAN COMMUNITIES

7.2 The **European Communities** suggests that we insert references to the panel report in *Canada-Autos*[43] in footnotes relating to paras. 8.148 and 8.157. The **Panel** has inserted such a reference in footnote 262 and clarified our reasoning in paragraph 8.157.

7.3 The **European Communities** asserts that we inaccurately reflected its argument concerning the treatment afforded by the Act to imported goods *vis-à-vis* domestic goods in paragraph 8.151 (and footnote 264). The **Panel** has adjusted the drafting in this paragraph (and footnote 264).

[43] *Infra*, para. 231.

7.4 The **European Communities** further argues that the formulation that originally appeared in paragraph 8.164 suggested that the DSB had changed an adopted panel report, by referring to a date contained in the our original Report and then stating that the DSB had subsequently extended that date. In the EC view, the DSB agreed to accede to the request of the United States as formulated in document WT/DS108/11, which referred to a time-period set (implicitly) by the DSB for the "necessary measures" to be *adopted* by the United States; the DSB did not affect the explicit recommendation that the FSC subsidies "must be withdrawn at the latest with effect from 1 October 2000." The European Communities submits that paragraph 8.171 was also inaccurate as to the DSB specification in this dispute. The **United States** disagrees with the EC's "mischaracterization of the US request that was granted" at the 12 October 2000 meeting of the DSB. According to the United States, at that meeting, the United States requested, and was granted, an extension of the time-period within which the United States was to withdraw the measure. The **Panel** has made changes to paragraphs 8.164 and 8.171 in order to reflect more clearly our understanding of the US request acceded to by the DSB. We have, as well, made changes to paragraph 8.169 in order to maintain consistency.

7.5 The **European Communities** submits that it is not appropriate for us to make a recommendation in this case, as our mandate under Article 21.5 *DSU* is to decide a disagreement. In the EC view, this replaces the normal rule in Articles 7 and 11 *DSU* that a panel makes findings so as to assist the DSB in making recommendations and rulings. The European Communities argues that we have already made the recommendation referred to in Article 19 *DSU* in our original Report. The **Panel**, noting that the United States did not respond to this EC comment and that practice in this area has not been entirely consistent in Article 21.5 *DSU* proceedings[44], is of the view that the original recommendation adopted by the DSB on 20 March 2000 remains operative. We have therefore deleted what was originally paragraph 9.3 of the interim report (and made a consequential change in the title of Section IX of the Report).

B. ORIGINAL COMMENTS BY THE UNITED STATES

7.6 The **United States** argues that we had omitted a reference in Section II to the fact that foreign tax credits are not allowed in respect of excluded extraterritorial income, as well as an indication that the "legislative history" of the Act "makes clear that because the Act's exclusion was intended to avoid double taxation, tax credits are not allowed on excluded income in order to avoid double relief of double taxation." The United States requests the insertion of a new paragraph to this effect. The **European Communities** considers that the new paragraph proposed by the United States is misleading and unnecessary, but that if we consider including a reference to the Act, section 3; section 114(d) IRC, we should also include a reference to the Act, section 3, section 943(d) IRC. The **Panel** notes that we refer to and elaborate upon certain of these elements in our examination under footnote 59 of the *SCM Agreement*, *infra*, paragraphs 8.76-8.108. We have therefore made modifications to footnote 197 to ensure that the text of the Senate and House Reports referred to by the United States are appropriately reflected in the substantive part of our analysis.

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[44] Certain Article 21.5 *DSU* panels have made recommendations (e.g. Article 21.5 Panel Report, *European Communities - Regime for the Importation, Sale And Distribution of Bananas - Recourse To Article 21.5 By Ecuador*, WT/DS27/RW/ECU, adopted 6 May 1999; Article 21.5 Panel Report, *Australia – Measures Affecting Importation of Salmon - Recourse to Article 21.5 by Canada*, WT/DS18/RW, adopted 20 March 2000; Article 21.5 Panel Report, *Mexico-Anti-Dumping Investigation of High Fructose Corn Syrup (HFCS) from the United States*, WT/DS132/RW, circulated 22 June 2001), while others have not (e.g. Article 21.5 Panel Report, *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather - Recourse to Article 21.5 of the DSU by the United States*, WT/DS126/RW, adopted 20 March 2000; Article 21.5 Panel Report, *Brazil – Export Financing Programme for Aircraft - Recourse By Canada To Article 21.5 of the DSU*, WT/DS46/RW, adopted 4 August 2000; Article 21.5 Panel Report, *Canada – Measures Affecting the Export of Civilian Aircraft, Recourse by Brazil to Article 21.5 of the DSU*, adopted 4 August 2000, WT/DS70/RW).

7.7 The **United States** submits that paragraph 2.3 is inaccurate as it states that certain income "may be" rather than "is" excluded from taxation, and that paragraph 2.7 was inaccurate as it stated that the definitions of qualifying foreign trade property and foreign trading gross receipts determine income that "may" qualify as extraterritorial income (rather than "income that qualifies as extraterritorial income"). The **European Communities** understands us to have used the word "may" in paragraph 2.3 because, pursuant to the Act[45], a taxpayer may elect to exclude certain receipts from foreign trading gross receipts so that the corresponding income will not be qualifying foreign trade income. The European Communities has no objection to the proposed change in paragraph 2.7. The **Panel** has maintained the term "may be" in paragraph 2.3. In our view, this term more accurately characterizes the situation, not least because, pursuant to the Act[46], the term "foreign trading gross receipts" shall not include receipts of a taxpayer from a transaction if the taxpayer elects not to have such receipts taken into account. Noting that the European Communities does not object to the change proposed by the United States in paragraph 2.7, and recalling the fact that income that "qualifies" as qualifying foreign trade income need not necessarily be excluded from taxation, we have made the requested change in paragraph 2.7.

7.8 The **United States** argues that our Report inaccurately indicated **--** in paragraphs 2.3, 2.4 and 2.5 (footnote 26) **--** that qualifying foreign trade income could be generated only by the sale or lease of qualifying foreign trade property, and submits that such income may also be generated by certain services, including engineering or architectural services without regard to qualifying foreign trade property. The **European Communities** agrees that qualifying foreign trade income may be earned from architectural or engineering services performed outside the United States. The European Communities submits that this is the only case in which foreign trading gross receipts may be earned that does not involve qualifying foreign trade property, but that this has not been considered relevant for the debate and is nowhere discussed in the Report. The **Panel** has made certain insertions in footnotes 23, 24, and 26, to clarify that foreign trading gross receipts may be generated in certain transactions relating to services involving qualifying foreign trade property, as well as engineering or architectural services for construction projects located (or proposed for location) outside the United States and not involving qualifying foreign trade property. We note that, with respect to goods, qualifying foreign trade income may be generated only in certain transactions involving qualifying foreign trade property and that we had originally been referring to the Act only in respect of goods, and had not originally elaborated upon the Act in respect of services.

7.9 The **United States** further submits that we had inaccurately omitted an element of the definition of "foreign sale and leasing income" in paragraph 2.5, footnote 25. The **European Communities** submits that a complete definition of foreign sale and leasing income would have to take into account all of the provisions of section 941(c) IRC. The **Panel** has inserted the additional element set out in the Act (section 3; section 941(c)(2) IRC), as identified by the United States, as well as referring to the remaining paragraphs of the provision concerned.

7.10 The **United States** suggests that we incorporate the precise wording of the Act in our description of the requirement of use outside the United States in paragraph 2.7. The **European Communities** does not object to this suggestion. The **Panel** has reflected the full wording of the text of the Act[47] in our description of the requirement in paragraph 2.7.

7.11 The **United States** submits that the list of findings it had requested was incomplete in paragraph 3.3, as it omitted the requested finding that third parties in this proceeding did not have a right to parties' rebuttal submissions. The **European Communities** submits that we deal with this US request in paragraph 6.2. The **Panel**, while noting that we deal with such procedural matters in Section VI of our Report, and that we already specifically refer to this US request in paragraph 6.2,

[45] Act, section 3; section 942(a)(3).
[46] Act, section 3; section 942(a)(3).
[47] Act, section 3; section 943(a)(1)(B) IRC:

has inserted the finding requested by the United States in paragraph 3.3. In order to maintain consistency, we have also inserted, in paragraph 3.2, the procedural finding requested by the European Communities.

7.12 The **United States** objects to our citation, in paragraph 8.38, of section 941(a)(1) IRC as support for our conclusion that the text of the Act is inconclusive on the question of whether extraterritorial income is excluded from gross income. In the US view, this citation is inaccurate and, as the United States submits it had explained during the proceedings[48], the rule set forth in this provision functions as a computational mechanism for determining the amount of the gross income exclusion. The **European Communities** considers that no change need be made to this paragraph, and that even if section 941(a)(1) IRC includes a "computational mechanism", the presence of such mechanism confirms that it is not the "extraterritorial income" as such that is excluded, but only a portion of it (and then only upon fulfilment of certain conditions). The European Communities submits that the reference to section 941(a)(1) IRC merely confirms the conclusion already drawn by referring to section 114 IRC, a provision making clear that only a fraction of the "category" "extraterritorial income" -- qualifying foreign trade income -- can actually be "excluded" (if the relevant conditions are met). The **Panel** takes note of these comments and has maintained the reference to the provision in question. It is the structure of the provision, read in conjunction with the other relevant provisions of the Act, that provides the basis for our analysis in paragraph 8.38.

7.13 The **United States** contends that in paragraph 8.40 (and elsewhere), we appear to attach significance to the fact that the exclusion of extraterritorial income is (according to the Panel) based on “highly selective qualitative conditions and quantitative requirements.” We repeat this phrase several times, so, presumably, the US argues, we must consider this fact significant. In the view of the United States, however, the relevance of this fact is not readily apparent, and is not clarified by our analysis. Indeed, the United States submits that there is an inherent contradiction between our "repudiation of the relevance of the concept of specificity" in footnote 108, and our "repeated invocation of the “highly selective qualitative conditions and quantitative requirements” as a reason for finding the Act’s exclusion to constitute the foregoing of revenue that is otherwise due". It seems to the United States that we are saying one of two things: (1) the exclusion for extraterritorial income constitutes foregone revenue that is otherwise due because the exclusion is “highly selective”; or (2) any exclusion from gross income, regardless of how broad it might be, constitutes foregone revenue that is otherwise due. In the view of the United States, it is essential that we clarify our analysis on this point. The **European Communities** submits that our reference to the “highly selective conditions” for obtaining the tax benefit is not contradictory with our "rejecting the relevance of the notion of “specificity”". According to the European Communities, our view on the specificity notion is clearly explained in footnote 108. For the European Communities, excluding the relevance, in interpreting Article 1 of the *SCM Agreement*, of a notion which becomes relevant under Article 2 of the Agreement (that is, once it is established that a subsidy exists), by no means takes away our duty to evaluate the structure of a measure in order to assess whether there is revenue foregone which is “otherwise due” in the sense of Article 1.1. The European Communities sees no reason to change this paragraph and notes that the United States makes no precise proposal. The **Panel** perceives no contradiction in our analytical approach. As we state *infra*, paragraph 8.26, "[b]y treating as "non-taxable" certain income on the basis of highly selective qualitative conditions and quantitative requirements, the Act effectively carves such income out from another situation….". This selective "carve-out" under the Act that we address in our Article 1.1(a) analysis is conceptually distinct from the notion of specificity within the meaning of Articles 1.2 and 2 of the *SCM Agreement*. We have, however, made certain clarifications of our reasoning in the text of Section VIII(B)(1)(b)(i) of our Report, including in footnote 108.

7.14 The **United States** argues that, in paragraphs 8.67 and 8.72, we state that a differentiation in treatment – *i.e.*, that domestically sold products may not be given less favorable treatment than export

[48] The United States refers here to US response to Panel Question 7, Annex F-3, paras. 10-13.

products – constitutes export contingency within the meaning of Article 3.1(a) of the *SCM Agreement*. In the view of the United States, our discussion of this point fails to connect the rule we articulate to the actual text of Article 3.1(a). In the view of the United States, we should fill in this gap in our analysis in order to add clarity to our resolution of a critical issue in this dispute. In the **European Communities'** view, the reference to "differentiation in treatment" is easily "connected" to the actual text of Article 3.1(a), contrary to the US suggestion. According to the European Communities, we make this perfectly clear in paragraph 8.72. The European Communities submits that if we wish to make the text of paragraph 8.67 even clearer for the United States, we could insert language clarifying that the differentiation in treatment is as regards eligibility or non-eligibility for the tax exemption. The **Panel** does not concur with the US view that we fail to connect the rule we articulate to the text of Article 3.1(a) of the *SCM Agreement*. In this context, we recall that an examination of *de jure* contingency under Article 3.1(a) calls for an examination of whether export contingency is apparent from the words of the Act, or can be derived by necessary implication (*infra*, paras.8.55-8.56). We then find that the words of the Act make clear that the subsidy is not available in relation to goods produced within the United States sold for use within the United States (*infra*, para. 8.60). It is the differential treatment provided for in the Act -- that is, if US-produced goods are exported, the subsidy is available, while if they are sold in the domestic market, it is not -- that renders the Act contingent upon export performance within the meaning of Article 3.1(a).

7.15 With respect to paragraphs 8.76-8.108, the **United States** submits that the parties disagreed during the proceedings as to which party bore the burden of proof with respect to footnote 59. However, the United States submits, in our discussion of footnote 59 and the status of the Act as a "double taxation avoidance measure", nowhere do we articulate which party bore the burden of proof.[49] In the view of the United States, our analysis of the footnote 59 issue is inadequate and incomplete without an explanation as to how we allocated the burden of proof. The **European Communities** does not agree that we are required to "articulate which party bore the burden of proof" as requested by the United States, and that the Appellate Body has confirmed on several occasions that this is not necessary.[50] The European Communities reads the interim report as indicating that we did not need to consider the issue of burden of proof because we had all the information we needed to come to the conclusions we did. In the EC view, a detailed consideration of the issue of burden of proof is only really necessary when the evidence is incomplete or is in equipoise. According to the European Communities, the absence of a specific consideration of the burden of proof is also consistent with the Panel's approach of not considering, and therefore not prejudicing, the question of whether the last sentence of footnote 59 is an exception to Article 3.1(a) or not. The European Communities submits that we could explain in response to the United States request that, even if the European Communities were to have the burden of proof that the conditions of the last sentence of footnote 59 were not met, we consider that the European Communities had satisfied this burden. The **Panel** agrees with the United States that it is appropriate for us to identify who bears the burden of proof on this issue.[51] Accordingly, we have clarified *infra*, paragraph 8.90,

[49] The United States notes that we also refrained from addressing the burden of proof with respect to other issues, as well. However, the United States note, with respect to these other issues there was no serious disagreement that the EC, as the complainant, bore the burden of proof.

[50] The European Communities cites Appellate Body Report, *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products ("Korea – Dairy Safeguards")*, WT/DS98/AB/R, adopted 12 January 2000, para. 145; Appellate Body Report, *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, adopted 16 January 1998, para. 74; and, more recently, Appellate Body Report, *Thailand – Anti-Dumping Duties on Angles, Shapes and Sections of Iron or Non-Alloy Steel and H-Beams from Poland ("Thailand – H-Beams")*, WT/DS122/AB/R, adopted 5 April 2001, para. 134.

[51] By contrast, we understand that a panel is not required to make an explicit ruling on whether a *prima facie* case has been established before proceeding to examine the evidence submitted with a view to rebuttal. See, for example, Appellate Body Report, *Korea- Dairy Safeguards*, *supra*, note 50, para. 145: "We find no provision in the DSU … that requires a panel to make an explicit ruling on whether the complainant has established a *prima facie* case of violation before a panel may proceed to examine the respondent's defence and evidence." See also Appellate Body Report, *Thailand - H-Beams, supra*, note 50, para. 134: "…a panel is not

that, in our view the United States bears the burden of proof in this context. In any event, we consider that the evidence and argumentation adduced by both parties was sufficient to enable us properly to weigh this evidence and argumentation in reaching our finding. Moreover, even if the European Communities bore the burden of proving that the Act was not within the scope of the last sentence of footnote 59, we consider that the European Communities discharged this burden.

7.16 The **United States** submits that the last sentence in paragraph 8.102 appeared to have disregarded the first element of the "foreign sales and leasing income" prong of the Act, which excludes income attributable to foreign economic processes.[52] In the view of the United States, the last sentence of paragraph 8.102, as well as our analysis related thereto, was inaccurate and incomplete to the extent that it failed to take this element of the "foreign sales and leasing income " prong into account. According to the **European Communities**, these US comments appear to be a rather artificial attempt to have us include in the Report consideration of an argument that the United States raised for the first time in its comments on the European Communities' answers to the Panel's questions (and that did not appear to bear any real connection therewith) and which had not been debated during the proceeding. The European Communities submits that the United States appears to argue that there may be a relationship between the extent of "foreign economic processes" conducted and the amount of the excluded income where qualifying foreign trade income is calculated on the basis of foreign sale and leasing income in accordance with Act, section 3; section 941(c)(1)(A) IRC. While the European Communities is of the view that it cannot be expected to deal with this complex issue at this stage of the proceedings, it made several brief points to demonstrate that the arguments are unmeritorious. The European Communities asserts that Act, section 3; section 941(c)(1)(A) IRC constitutes only one of two ways of calculating "foreign sales and leasing income" which in turn is only one out of three ways of calculating "qualifying foreign trade income". The alternative way of calculating "foreign sales and leasing income" is set out in Act, section 3; section 941(c)(1)(B) IRC, from which the "attributable" or "properly allocable" language on which the United States appears to rely is absent. According to the European Communities, the method for calculating qualifying foreign trade income based on "foreign sale and leasing income" in Act, section 3; section 941(a)(1) IRC in fact corresponds to the calculation of FSC income based on arm's length pricing under the original FSC scheme (which is why the exclusion is 30 per cent). Just as in the case of the FSC scheme, this provision cannot serve to justify the FSC Replacement scheme since taxpayers are always able to use the most favourable basis for calculating the exemption. In this connection, the European Communities observes that the definition of foreign trading gross receipts also covers lease income (Act, section 3; section 942(a)(1)(B) and (C)(ii) IRC). According to the European Communities, by raising this argument, the United States is effectively asking us to rule on a hypothetical scheme that does not at present exist by asking us to imagine a system where the amount of qualifying foreign trade income (that is "foreign sales and leasing income" calculated under Act, section 3; section 941(c)(1)(A) IRC) may arguably bear some relationship to the amount of the foreign activity. There are many reasons why such a hypothetical scheme based on Act, section 3; section 941(c)(1)(A) IRC would also not be a "measure to avoid the double taxation of foreign-source income." However, the European Communities submits, we may simply refuse to rule on such a hypothetical scheme, just as we refused to rule on a hypothetical scheme involving only wholly foreign transactions in paragraph 8.163 of the Report (even though, the EC submits, we had the benefit of a proper debate between the parties on the issue of wholly foreign transactions). The European Communities made certain drafting suggestions if we did wish to make changes to our Report. In light of the comments of the parties, the **Panel** has made certain clarifications in the text of paragraph 8.102 and inserted footnote 204.

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required to make a separate and specific finding, in each and every instance, that a party has met its burden of proof in respect of a particular claim, or that a party has rebutted a *prima facie* case."

[52] The United States refers to Act, section 3, section 941(c)(1)(A) IRC; US first written submission, Annex A-2, para. 33, note 39; and US comments on EC Answers to Questions from the Panel, Annex F-6, paras. 64-68.

7.17 The **United States** argues that the thrust of paragraph 8.104 appears to be that a measure to avoid double taxation within the meaning of footnote 59 must be general in nature. In the view of the United States, nothing in the text of footnote 59 suggests that a broad measure is necessary. Likewise, nothing in the text of footnote 59 suggests that a Member is precluded from using tax credits as a double taxation avoidance measure with respect to some products or some types of transactions and the exemption method with respect to other products or other types of transactions. Similarly, the United States submits, there is nothing in the text of footnote 59 which suggests that a Member is precluded from using a combination of tax credits and the exemption method with respect to a single transaction. It is an undisputed fact in this case that the exemption method results in more favorable tax treatment for exports. Therefore, a "reasonable legislature" – the role, the United States argues, that "the Panel has assigned to itself" – might very well decide to "draft legislation, such as the Act", which uses a combination of methods to avoid double taxation. Accordingly, in the view of the United States, we should clarify our discussion of footnote 59 by explaining why a measure to avoid double taxation, within the meaning of the footnote, must be of a general nature. Alternatively, if the United States has misunderstood our position, we should explain why we find the Act's perceived lack of uniformity relevant, or, to use our term, "striking." The **European Communities** does not understand us to be saying that measures relevant under footnote 59 must be general in nature, or that they must be "broad". If we are minded to further develop our reasoning to respond to the United States request, the European Communities submits that we may wish to consider the following comments. In the European Communities' view, we correctly weighed the "overall structure and design" of the specific measure before it and, based on its specific features, decided on the issue of whether it was a measure "to avoid" double taxation. As regards specifically the reference to legislative history, the European Communities submits, as observed by the Appellate Body in *Japan – Alcoholic Beverages*, and reiterated in *Chile – Alcoholic Beverages* (to which, the European Communities argues, we could also usefully refer), one has to proceed to "an examination of the design, architecture and structure of a tax measure precisely to permit identification of a measure's objectives or purposes *as revealed or objectified in the measure itself*" (emphasis added by EC).[53] For the record and in order to avoid any possible misunderstanding, the European Communities reiterates that it does not accept the United States' contention that the exemption method results in a more favourable tax treatment for exports – which is not, therefore, an undisputed fact – and refers us to the EC explanation of its position.[54] The **Panel** has taken note of these comments of the parties. We disagree with the US characterization of our finding as requiring that a measure be "broad" or "general" to fall within the scope of the fifth sentence of footnote 59. We recall our statements *infra*, paragraph 8.97, that the Act is unusually broad for a measure whose purpose is to avoid double taxation, and at the same time, the Act is unusually narrow for a measure whose asserted purpose is to avoid double taxation. Further, we note there "that the Act overlaps with an extensive system of bilateral agreements designed to avoid double taxation through foreign tax credits, and its application is not designed to cover situations where such agreements did not exist." In particular, we reiterate that no single one of these elements, taken separately, would necessarily lead us to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income; taken together, however, they lead us to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income within the meaning of footnote 59. As to the alternative US argument that we should explain why we find the Act's perceived lack of uniformity relevant, or "striking", we recall our statement *infra*, paragraph 8.95, that "we consider that the relationship between the measure and its asserted purpose -- i.e. "to avoid the double taxation of foreign-source income …" -- must be reasonably discernable". As indicated there, we seek to ascertain whether the Act is a measure "to avoid" the double taxation of foreign-source income by concentrating our examination on a review of the overall structure, design and operation of the Act in the context of the broader United States tax system. Taken together, the Act's breadth -- in certain respects -- and its

[53] Appellate Body Report, *Chile – Taxes on Alcoholic Beverages ("Chile – Alcoholic Beverages")*, WT/DS87/AB/R, WT/DS110/AB/R, adopted 12 January 2000, para. 71.

[54] The European Communities refers to EC Responses to Panel Questions, Annex F-1, paras. 54 to 57, and, in particular, para. 56.

narrowness -- in other respects, in conjunction with the other aspects of the Act's structure and design that we examine lead us to find that the relationship between the measure and its asserted purpose is not reasonably discernable. We have therefore maintained our original language while making an insertion in footnote 197.

7.18 We have also made certain technical revisions and clarifications in paragraphs 1.13, 8.60, 8.66, 8.80, 8.91, 8.94, 8.95, 8.97, 8.104, 8.105, 8.107, 8.108, 8.163 and 9.1, including in certain footnotes linked to those paragraphs.

VIII. FINDINGS

A. PANEL'S APPROACH TO EXAMINATION OF EC CLAIMS IN THIS DISPUTE

8.1 We note that the European Communities has confirmed that, in its view, "there would no longer be a prohibited subsidy within the meaning of Article 3 of the *SCM Agreement*" if the United States eliminated the requirements that the property be held for use outside the United States and the 50 per cent "foreign content limitation".[55] Therefore, we will focus our examination of the European Communities' claims on these two aspects of the Act.

B. REQUIREMENT OF "USE OUTSIDE THE UNITED STATES"

1. Claims under Article 3.1(a) of the *SCM Agreement*

(a) analytical approach

8.2 In examining the European Communities' Article 3.1(a) claims in the original dispute, we first considered issues arising under Articles 1 and 3 of the *SCM Agreement*, rather than issues arising under footnote 59 attached to item (e) of the Illustrative List of Export Subsidies in Annex I to the *SCM Agreement*. The Appellate Body found that there was no "legal error" in this analytical approach.[56] The parties also do not expressly contest this approach in these Article 21.5 proceedings. Accordingly, we will adopt the same analytical approach in this Article 21.5 proceeding.

(b) whether a subsidy exists within the meaning of Article 1 of the *SCM Agreement*

(i) financial contribution

8.3 The first issue we address in this dispute is whether the Act's "exclusion" from "gross income" of certain "extraterritorial income" gives rise to a "financial contribution" in the form of a foregoing of "government revenue that is otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.

8.4 The European Communities submits that the Act gives rise to a "financial contribution" in the form of a foregoing of "government revenue that is otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*. In the EC view, there is no general US taxation rule excluding extraterritorial income from taxation. The majority of extraterritorial income -- that is, the part that is not qualifying foreign trade income -- is subject to the normal rate of tax.[57] The European Communities argues that the Act does not qualitatively define a class or category of income that is excluded from the tax base, but rather lays down conditions for the non-taxation of a part of extraterritorial income (i.e. qualifying foreign trade income) that would otherwise be taxed.[58]

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[55] EC response to Panel Question 39, Annex F-1, para. 148.
[56] Original Appellate Body Report, *supra*, note 1, para. 89.
[57] EC first written submission, Annex A-1, para. 51.
[58] EC first written submission, Annex A-1, paras. 57, 61.

8.5 In the EC view, section 114(a) of the IRC is a "limited exclusion or exemption" that confirms the general rule of world-wide taxation of income of US natural or legal persons.[59] With respect to "corporate income from a commercial activity"[60], the European Communities asserts that the US "prevailing domestic standard" is that such income may be taxed, if it is earned by a US corporation, under section 11, in conjunction with section 61, IRC. If such income is earned by a foreign corporation, it may be taxed under section 881 IRC if it is US-source income; or under section 882 IRC if it is "effectively connected" with a US trade or business.[61] The European Communities also argues that the "benchmark" for assessing the "extended"[62] FSC Replacement scheme under Article 1.1(a)(1)(ii) would be the situation prevailing if the conditions (notably sale "not for use within the United States" and the "foreign content limitation") were not fulfilled. Except in the case of a foreign corporation that is not a subsidiary of a US corporation[63], the Act, therefore, in the EC view, gives rise to a foregoing of revenue that is "otherwise due" and thus to a financial contribution within the meaning of Article 1.1(a)(1)(ii) *SCM Agreement*.

8.6 The United States asserts that the new measure is not a "financial contribution" within the ordinary meaning of the language of Article 1.1(a)(1)(ii) of the *SCM Agreement*. The United States submits that, taking the ordinary meaning of the terms in Article 1.1(a)(1)(ii) together, "the foregoing of revenue otherwise due means that a government has refrained from collecting income that in another circumstance would be legally owed to the government".[64] The United States asserts that the Act redefines the concept of gross income and that the revised definition of gross income is the "prevailing domestic standard" for US taxation. As the United States lacks the statutory authority to tax outside the definition of "gross income", there is no general rule of taxation that would apply "but for" the definition of gross income.[65] Taxes on extraterritorial income are thus not "foregone" or "otherwise due".[66] The United States submits that absent the Act, income defined as extraterritorial income may not be subject to tax at all, or taxed to a lesser extent.[67] The "exception" concerning

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[59] EC response to Panel Question 37, Annex F-1, para. 135.

[60] EC second written submission, Annex C-1, para. 68.

[61] EC second written submission, Annex C-1, para. 68; EC response to Panel Question 37, Annex F-1, para. 124 *ff*. In response to Panel Question 36, Annex F-1, paras. 118-121 *ff*, the European Communities submits that "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. 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. 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)".

[62] The European Communities contends that there are two distinguishable subsidies in the Act. In its first written submission, the European Communities explains that it "will refer to the subsidy granted in respect of the export of US produced goods as the "basic FSC Replacement subsidy" and that accorded to transactions involving foreign produced goods as the "extended FSC Replacement subsidy" in order to distinguish them. When there is no need to distinguish the two cases, the EC will refer to them generally as the "FSC Replacement subsidy" or the "FSC Replacement subsidies"." See EC first written submission, Annex A-1, para. 64. We use these terms in describing the EC argument, but do not ourselves adopt this terminology.

[63] EC response to Panel Question 36, Annex F-1, para. 122. The EC submits: "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." Subsequently, however, the European Communities states: "…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." EC response to Panel Question 36, Annex F-1, para. 123.

[64] US first written submission, Annex A-2, para. 61.

[65] US first written submission, Annex A-2, para. 77.

[66] US first written submission, Annex A-2, para. 79.

[67] US first written submission, Annex A-2, paras. 101-105.

extraterritorial income that is not qualifying foreign trade income is a revenue-raising exception, i.e. without it, all extraterritorial income would be excluded from gross income and revenues would be less.[68] The United States contends that the exclusion of extraterritorial income from US taxation represents a shift in US taxing jurisdiction and the "normative benchmark" for US taxation of "foreign income".[69]

8.7 The United States submits that section 61 IRC can be understood only in light of the other provisions of the IRC that define its terms and application and that section 114 IRC is an integral part of section 61 IRC. The US submits that the European Communities is, in effect, 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" applies only as defined by the IRC and does not apply to all income.[70] According to the United States, the approach in the Act "is one that is faithful to the text of the Agreement and to the findings of the Panel and the Appellate Body [in the original dispute]".[71]

8.8 In commencing our analysis as to whether the Act involves a financial contribution, we first recall that Article 1.1 of the *SCM Agreement* provides, in relevant part:

> "For the purpose of this Agreement, a subsidy shall be deemed to exist if:
>
> (a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:
>
> …
>
> (ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)[footnote omitted]; ….

8.9 As indicated above, the issue before us is whether the Act gives rise to "revenue forgone that is otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.

8.10 We recall that, in the original dispute, the Appellate Body largely agreed with our analytical approach under Article 1.1 of the *SCM Agreement*. The Appellate Body stated,

> "…the "*foregoing*" of revenue "*otherwise* due" implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, "otherwise". Moreover, the word "foregone" suggests that the government has given up an entitlement to raise revenue that it could "otherwise" have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues. There must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised "otherwise". We, therefore, agree with the Panel that the term "otherwise due" implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question. To accept the argument of the United States that the comparator in determining what is "otherwise due" should be something other than the prevailing domestic standard of the Member in question would be to imply that WTO obligations somehow compel Members to

[68] US first written submission, Annex A-2, para. 81.
[69] US first written submission, Annex A-2, paras. 71-72.
[70] US comments on EC response to Panel Question 36, Annex F-6, para. 51.
[71] US closing oral statement, Annex D-4, para. 8.

> choose a particular kind of tax system; this is not so. A Member, in principle, has the sovereign authority to tax any particular categories of revenue it wishes. It is also free *not* to tax any particular categories of revenues. But, in both instances, the Member must respect its WTO obligations. What is "otherwise due", therefore, depends on the rules of taxation that each Member, by its own choice, establishes for itself.[72]

8.11 We further recall that the Appellate Body upheld our use of a "but for" analysis as to whether there was revenue foregone that was "otherwise due" in the original dispute. In the Appellate Body's view, that legal standard provided a "sound basis for comparison" as it was not difficult in that dispute to establish in what way the foreign-source income of a FSC would otherwise be taxed ("but for" the contested measure).[73] The Appellate Body opined, however, that it had,

> "… certain abiding reservations about applying any legal standard, such as this "but for" test, in the place of the actual treaty language. Moreover, we would have particular misgivings about using a "but for" test if its application were limited to situations where there actually existed an alternative measure, under which the revenues in question would be taxed, absent the contested measure. It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be *no* general rule that applied formally to the revenues in question, absent the contested measures…"[74]

8.12 As both parties used certain of the terminology referred to in the original Appellate Body Report in their argumentation before us, and as the United States asserts that its approach under the Act "is one that is faithful to the text of the Agreement and to the findings of the Panel and the Appellate Body…[in the original dispute]",[75] we consider the text of Article 1.1 of the *SCM Agreement*, coupled with the above citations from the Appellate Body decision, is a useful -- although not necessarily the only possible -- starting-point for our analysis of the measure before us.

8.13 In particular, we continue to be of the view that the basis of comparison in an analysis under Article 1.1(a)(1)(ii) *SCM Agreement* as to whether revenue "otherwise due" is foregone must be the tax rules applied by the Member in question.

8.14 In so approaching the matter, we emphasize our view that in order to discern whether revenue is "otherwise due", we are not assuming that this can only be ascertainable where a purely mechanical exercise of inspection is feasible. Clearly, a defendant Member would have an incentive to argue that what is argued by a complainant to be the foregoing of revenue otherwise due was never due in the first place. Indeed, one might reasonably surmise that any Member applying such a contested regime could have every reason to ensure that there was no automatic or explicit link to the situation of what would be otherwise due. The Appellate Body itself has been mindful of this circumstance when it observed, *a propos* of the concept of a "but for" test that:

> "It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be *no* general rule that applied formally to the revenues in question, absent the contested measures.[76]"

8.15 Indeed, it is worth underlining that the same may be said of the actual terms of the *SCM Agreement* when it comes to the term "otherwise due" itself. Were this term to be construed in an

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[72] Original Appellate Body Report, *supra*, note 1, para. 90.
[73] Original Appellate Body Report, *supra*, note 1, para. 91.
[74] Original Appellate Body Report, *supra*, note 1, para. 91.
[75] US closing oral statement, Annex D-4, para. 8.
[76] Original Appellate Body Report, *supra*, note 1, para. 91.

equivalent narrow and formalistic manner, the practical consequence would be precisely the same. It would effectively ensure that any Member that was careful enough to sever any self-evident formal link between a measure at issue and its default regime would thereby insulate itself from effective discipline under the *SCM Agreement*. The Member would be in a position to assert that what was claimed to be foregoing of revenue otherwise due was simply never due in the first place. Asserted compliance by a defendant Member would be tantamount to a definitive defence. This is manifestly absurd and would render the provisions of the *SCM Agreement* operationally ineffective.

8.16 Of course, this does not mean that one can run to the other extreme. As the Appellate Body has also observed:

> "…the word "foregone" suggests that the government has given up an entitlement to raise revenue that it could "otherwise" have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues...."[77]

8.17 Thus, one cannot simply assert that revenue is otherwise due in the abstract. It cannot be presumed. The key is to apply critical judgement to the facts of the matter. In so doing, we follow the reasoning of the Appellate Body *viz* that the comparison to be made involves revenues due under the contested measure and those that would be due in some other situation and that the basis of the comparison must be the tax rules applied by the Member in question.[78]

8.18 In following this reasoning, we underline that while the inquiry cannot be inherently presumptive or speculative, neither can it be so exacting or confining that it is necessary to attain the level of establishing a mathematical deductive relationship between the contested measure and the default situation. To interpret the *SCM Agreement* in the latter manner would expose a panel to precisely the manifestly absurd consequence referred to in paragraph 8.15 above. The key point is that the tax rules applied by the Member in question are the *basis* for the comparison. Thus, any finding that revenue has been foregone must be securely grounded on that foundation.

8.19 That, in our view, provides a sound basis for exercising reasonable judgement as to whether or not a defending Member's assertion that no revenue was due in the first place is, in fact, valid or whether the contested measure in effect masks the substance of what is actually the foregoing of revenue that is otherwise due.

8.20 Against that background, we therefore turn to the tax rules of the Member in question, in this case, the United States, in order to identify a basis for comparison for the purposes of our inquiry as to whether a "financial contribution" exists within the meaning of Article 1.1(a) of the *SCM Agreement*. In so doing, we look first to the Act.

8.21 Under the Act, certain income is "excluded" from taxation. In order to qualify as such "excluded" "extraterritorial income"[79], income must satisfy several stringently selective qualitative conditions and quantitative requirements.[80] The qualitative conditions include, first and foremost, the

[77] Original Appellate Body Report, *supra*, note 1, para. 90.

[78] Original Appellate Body Report, *supra*, note 1, para. 90.

[79] The Act defines "extraterritorial income" as the gross income attributable to foreign trading gross receipts, i.e. derived from the sale of "qualifying foreign trade property" for ultimate use outside the United States. Act, section 3; sections 114(e) and 942 IRC. The Act defines "foreign trade income" as the taxable income attributable to foreign trading gross receipts. Act, section 3; sections 941(b)(1) and 942 IRC. *Supra*, paras. 2.4-2.6.

[80] The Act defines qualifying foreign trade income as the amount of gross income which, if excluded, will result in a reduction of taxable income by certain amounts defined in the Act. See Act, section 3; section 941(a)(1) IRC, described *supra*, para. 2.5.

requirements relating to use outside the United States[81] and the foreign articles/labour limitation.[82] In addition, the Act stipulates, for example, that certain property is "excluded property"[83], and not included in the term "qualifying foreign trade property". Such property includes, *inter alia*, "oil and gas (or any primary product thereof)" and "any unprocessed timber which is a softwood".[84] Furthermore, the Act provides that the President may designate property that might otherwise constitute qualified foreign trade property as property in "short supply".[85] During the period that it is so designated, the property shall not be treated as "qualifying foreign trade property" and income derived in transactions relating to such property is therefore not eligible for the tax treatment available under the Act.

8.22 As we discuss further below, where income fails to qualify as excluded extraterritorial income within the meaning of the Act it remains subject to taxation.

8.23 Consistent with the approach outlined in paragraph 8.17 above, our task is to assess whether, in essence, this "exclusion" of "extraterritorial income" can properly be characterized as a situation in which no revenue is inherently due, or whether it is a situation in which revenue otherwise due is foregone. In doing so, we look at the overall situation as an integrated whole.

8.24 In this regard, we take note of the US assertion that the concept of "gross income" in section 61 IRC can be understood only in light of the other provisions of the IRC that define its terms and application and that section 114 ("excluding" from gross income extraterritorial income with the "exception" of non-qualifying foreign trade income) "is "an integral part" of section 61 IRC".[86] However, we consider significant the EC statement endorsed by the United States -- that section 114 IRC is one of several, specific exclusions from the section 61 definition of gross income.[87]

8.25 On this basis, it is clear to us that where income does not qualify for the "exclusion" from "gross income" upon the fulfilment of the Act's stringently selective conditions, it is not shielded from taxation. It is part of gross income and is subject to taxation[88] under otherwise applicable US taxation rules. Reaching this view is not a matter of speculation or invention of an entitlement to tax where it is manifestly absent. This is not a matter of mere presumption or assertion of a hypothetical possibility in the abstract severed from the context of applicable US tax rules. On the contrary, it is grounded in the actual way in which the US tax regime functions. Based on this, it is clear to us that there is a "prevailing" domestic standard[89] and that the measure at issue functions, indeed, as an effective departure from it. In this respect, we understand, for example, that the income earned by a

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[81] See Act, section 3; section 943(a)(1)(B) IRC relating to the definition of "qualifying foreign trade property", as well as, for example, section 942(a)(2)(A)(i) IRC relating to the definition of "foreign trading gross receipts".

[82] Act, section 3; section 943(a)(1)(C) IRC relating to the definition of "qualifying foreign trade property".

[83] Act, section 3; section 943(a)(3)(C) IRC.

[84] See Act, section 3; section 943(a)(3)(E) IRC.

[85] See Act, section 3; section 943(a)(4) IRC.

[86] US comments on EC response to Panel Question 36, Annex F-6, para. 51.

[87] US comments on EC response to Panel Question 37, Annex F-6, para. 58, referring to EC response to Panel Question 37, Annex F-1, para. 132.

[88] We note that, in order to avail itself of the tax "exclusion", a foreign corporation must make domestication election, while a foreign branch of a US corporation need not make a domestication election (see US first written submission, Annex A-2, para. 139 ("…the Act applies to foreign branches of US businesses manufacturing outside the United States without the need for an election. This is because, under US law, a foreign branch of a US business is not treated as a separate entity for tax purposes"). We further note the European Communities' assertion that in the case where 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, and the Act "would not give rise to a subsidy because no revenue would be forgone" (EC response to Panel Question 36, Annex F-1, para. 122).

[89] See original Appellate Body Report, *supra*, note 1, para. 90.

US corporate taxpayer in transactions not involving foreign trading gross receipts or qualifying foreign trade property would ordinarily be subject to taxation, under section 11 of the IRC, in conjunction with sections 61 and 63 of the IRC. [90] Foreign corporations pay tax in the United States on income "from sources within the United States" under section 881 of the IRC and on income "effectively connected with a United States trade or business" under section 882 of the IRC**.**

8.26 By treating as "non-taxable" certain income on the basis of highly selective qualitative conditions and quantitative requirements, the Act effectively carves such income out from another situation. The Act's demarcation -- in a negative manner through a number of qualitative (and quantitative) conditions -- of income that may be eligible for "exclusion" from "gross income" cannot be rationally understood as a self-standing autonomous construct, but rather only by comparison with another situation to which the Act itself explicitly refers. This other situation is the one that prevails where the Act's conditions for obtaining the "exclusion" are *not* fulfilled, most particularly, for example, where goods are for use *within* the United States or where they do not satisfy the foreign articles/labour limitation. That leads us to the conclusion that this is to be rightly characterized as the foregoing of revenue otherwise due.

8.27 Moreover, we do not see any other, countervailing, features that could reasonably lead us to conclude otherwise. Even if one seeks to discern some kind of overall rationale and coherence to the “extraterritorial income” “exclusion” that might even hypothetically (and we make no presumption that it would) lead one to modify the view that this is revenue that is “otherwise due”, no such rationale is apparent here.

8.28 For instance – and without prejudice to what the status of such a measure might be under the *SCM Agreement* – the Act manifestly does not represent a coherent approach to corporate earnings derived from offshore activities only. The conditionality is such that the eligibility is, in fact, circumscribed carefully to render it only effective, for example, with respect to goods, only with respect to *certain* goods -- i.e. *certain* "qualifying foreign trade property" -- produced within or outside the United States, where those goods are for "use outside the United States" and where those goods fulfil the foreign articles/labour limitation included in the definition of qualifying foreign trade property. In short, one is left with the perspective simply of certain carve-outs being provided for in relation to what would otherwise be the prevailing regime of revenue liability in respect of the income concerned.

8.29 We add that while, in our view, the terms of the *SCM Agreement* are clear enough, their application to the facts of the multiplicity of Members’ regimes will not necessarily be self-evident. Indeed, discerning what might be described as “the prevailing domestic standard” for a particular tax regime may be a particularly exacting exercise. In more common usage, it might be rather difficult to discern what is the exception, as it were, and what is the rule. But the terms of the *SCM Agreement* are clearly of general application: there is nothing which states that they are only to be applied when the results are self-evident. Be that as it may, we are not, in this dispute, presented with a situation of such complexity. This dispute does not involve a debatable call as to whether the glass is half-full or half-empty. As outlined above, we have looked at the essential shape and the rationale that is exhibited. In examining that, we have weighed such considerations as the degree of conditionality, the range of limitations and the manner in which the measure at issue relates to the overall regime. Taken together, they enable us to assess the nature of the relationship of the measure at issue and the overall regime. That is precisely how one is in a position to arrive at the judgement required by the terms of the *SCM Agreement*.

[90] Exhibit EC-21 and Exhibit US-4. Section 11 IRC states: "a tax is hereby imposed for each taxable year on the taxable income of every corporation". Section 61 states in pertinent part that: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived... ". Section 63 IRC provides in general that "taxable income means gross income minus the deductions allowed by this chapter."

8.30 In light of these considerations, we are of the view that, through the tax "exclusion" provided by the Act, the United States government foregoes revenue that is otherwise due within the meaning of Article 1.1(a)(1)(ii). In our view, a "financial contribution" thereby arises within the meaning of Article 1.1 *SCM Agreement*.

8.31 We recall that in its Report in the original dispute, the Appellate Body referred on several occasions to the concept of "categories" of revenue and indicated that a Member is "free *not* to tax any particular categories of revenues".[91] Before us, the parties had divergent views on the utility and meaning of the term "categories" of revenue used by the Appellate Body. The parties disagreed on the nature of "categories" that could be excluded in a WTO-consistent manner from taxation, and on whether extraterritorial income (or foreign trade income or qualifying foreign trade income) constitutes such a “category”.

8.32 We turn now to whether utilization of the term "category" would in any way alter the nature of our analysis to this point. However, before considering these issues, we first observe that the concept of "categories" of revenue to which the Appellate Body referred is not actual treaty language. We further note that the Appellate Body also emphasized that, regardless of any "category" of revenue that may be under consideration, a Member is bound at all times to respect its WTO obligations.[92]

8.33 According to the United States, the rationale for the Act's exclusion is "to treat all foreign transactions alike regardless of where goods are manufactured".[93] The United States asserts that the Act excludes extraterritorial income from gross income and that this constitutes a defined, normative benchmark for taxing income earned on foreign transactions.[94] The United States contends that the exclusion of extraterritorial income from gross income was an exercise of the United States sovereign right not to tax a particular category of revenue and that extraterritorial income is a "category" that may be excluded from taxation in a WTO consistent manner.[95] The European Communities contends that while foreign-source income may be a general "category" that WTO Members are free not to tax, "extraterritorial income" is not foreign-source income.[96] For the European Communities, "extraterritorial income" (and even less qualifying foreign trade income) is not a general category of income that a Member may choose not to tax in conformity with the *SCM Agreement*.[97] According to the European Communities, the Act does not qualitatively define a class or category of income that is excluded from taxation. Rather, it lays down conditions for the partial non-taxation of a quantity of income that would otherwise be taxed.[98]

8.34 Based on the facts of the situation, we understand the United States to be arguing in effect that it can simply exclude certain income from gross income and that, when it does so, the "excluded income" is, by definition, not "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.[99] It follows from this US argument that the United States may exclude *any* "category" of income[100] from "gross income" in this manner, and that there would *never* be a foregoing of revenue otherwise due within the meaning of Article 1.1 of the *SCM Agreement*. We further understand the United States to argue that, in any event, the exclusion of "extraterritorial income" excludes a "category" of income (income derived from "foreign transactions") that may be excluded consistently with the United States' WTO obligations.

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[91] Original Appellate Body Report, *supra*, note 1, e.g. paras. 90, 98-99, 120.
[92] See original Appellate Body Report, *supra*, note 1, para. 90.
[93] US first written submission, Annex A-2, para. 116.
[94] US first written submission, Annex A-2, para. 79.
[95] US first written submission, Annex A-2, para. 83.
[96] EC first written submission, Annex A-1, para. 59.
[97] EC first written submission, Annex A-1, para. 60.
[98] EC first written submission, Annex A-1, paras. 57, 61.
[99] We refer also to our summary of US arguments *supra*, paras. 8.6-8.7.
[100] US oral statement, Annex D-3, para. 77.

8.35 In our view, although the terminology of “categories” is particular, we see no reason why the analysis utilized above is not just as applicable, even if one views the nexus of tax measures under this particular descriptor.

8.36 In this way, we turn first to the US argument that it can simply exclude certain income from gross income and that, when it does so, the "excluded income" is, by definition, not "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.[101] This is, in substance, just as subject to the reasoning we applied above.[102] The situation is linguistically different, but the underlying substance remains the same. Here again, this effectively amounts to no more than the assertion that what is claimed to be otherwise due was never due in the first place, albeit that this is clothed in language which presents it as a “category”.

8.37 In this context, we consider the US argument that the Act's revised definition of gross income is the "prevailing domestic standard" for US taxation and that once income is "excluded" from "gross income", there is no general rule of taxation that would apply "but for" the definition of gross income -- and therefore no foregoing of revenue that is "otherwise due" under Article 1.1 *SCM Agreement* -- to be a highly formalistic construct that is difficult to reconcile with the text and context of Article 1.1(a)(1)(ii) in light of the object and purpose of the *SCM Agreement*. To give due meaning and effect to Article 1.1 of the *SCM Agreement*, our examination as to whether there is revenue foregone that is "otherwise due" must be based on actual substantive realities and not be restricted to pure formalism.

8.38 That said, we observe that even under the highly formalistic approach advocated by the United States before us, the Act is inconclusive on its face. Looking to section 114(a) of the Act, we read that "gross income does not include extraterritorial income". In section 114(b), we read that this "exclusion" does not apply to certain extraterritorial income. Looking then to section 114(e), we see that "extraterritorial income" is defined as "…the *gross income* of the taxpayer attributable to foreign trading gross receipts" (emphasis added). In addition, the Act defines the term ‘qualifying foreign trade income’ as "the amount of *gross income* which, *if excluded*, will result in a reduction of the taxable income of the taxpayer…".[103](emphasis added) Thus, the text of the Act itself appears to indicate variously that extraterritorial income is excluded from gross income, while it also forms part of gross income that may or may not be excluded. We do not consider that it is discernable from the text of the Act itself whether extraterritorial income is actually "excluded" from gross income or is rather "gross income" that may become "excluded" upon fulfilment of certain conditions.[104]

8.39 More importantly, we point out the perilous systemic implications inherent in the approach advocated by the United States in these proceedings and the corrosive effect such an approach would have upon the legal foundations of the *SCM Agreement*. Particularly revealing in this regard was the US response to Panel questioning as to whether the United States believed that there would be revenue foregone that was "otherwise due" within the meaning of Article 1.1 of the *SCM Agreement* if the US legislation provided that "gross income does not include income generated from export activities". The United States was of the view that "…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), as 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".[105] Taken

[101] *Supra*, paras. 8.33-8.34.
[102] *Supra*, para. 8.23 *ff*.
[103] Act, section 3; section 941(a)(1).
[104] Furthermore, "foreign trade income" -- which the Act defines as "taxable income" derived from foreign trading gross receipts (Act, section 3; section 941(b)(1)) -- may be, in part, "excluded" as "qualifying foreign trade income". See Act, section 3; section 941(a)(1)(C). We also see in the Act (section 3, section 943(b)(4) IRC) that "Section 114 shall not be taken into account in determining the amount of gross income or foreign trade income from any transaction".
[105] US response to Panel Question 20, Annex F-3, para. 62.

to its logical extreme, this US argument would be that a government could opt to bestow financial contributions in the form of fiscal incentives simply by modulating the "outer boundary" of its "tax jurisdiction" or by manipulating the definition of the tax base to accommodate any "exclusion" or "exemption" or "exception" it desired, so that there could *never* be a foregoing of revenue "otherwise due". This would have the effect of reducing paragraph (ii) of Article 1.1(a)(1) of the *SCM Agreement* to "redundancy and inutility"[106] and cannot be the appropriate implication to draw from the stipulation as to what constitutes one of the enumerated forms of "financial contribution" under Article 1.1 of the *SCM Agreement*. Furthermore, the consequences of this reasoning would also entirely undermine Article 3.1(a) of the *SCM Agreement*, as there could never be, in this situation, a subsidy contingent upon export in the form of a financial contribution involving of a foregoing of revenue that is otherwise due. As such, it is inherently contradictory to what may be viewed as the object and purpose of the *SCM Agreement* in terms of disciplining trade-distorting subsidies in a way that provides legally binding security of expectations to Members. In this regard, it is evident that the interpretation advanced by the United States would be irreconcilable with that object and purpose, given that it would offer governments "*carte-blanche*" to evade any effective disciplines, thereby creating fundamental uncertainty and unpredictability.[107] In short, such an approach would eviscerate the subsidies disciplines in the *SCM Agreement*.[108]

8.40 We turn next to the argument of the United States that, in any event, the exclusion of "extraterritorial income" excludes a "category" of income (income derived from "foreign transactions") that may be excluded consistently with the United States' WTO obligations.[109] Even assuming that income attributable to "foreign transactions" might be a "category" of income that might be excluded in a WTO-consistent manner (an issue which we need not and do not decide here), the United States is not in fact excluding -- or giving up an entitlement to raise revenue that it could "otherwise" have raised with respect to -- all of the income attributable to "foreign transactions", but rather only a portion of certain income defined by highly selective qualitative conditions and

[106] It is well-established that an interpreter is not free to adopt a reading that would reduce whole clauses of a treaty to redundancy or inutility. See, for example, Appellate Body Report, *Brazil - Export Financing Programme for Aircraft*, WT/DS46/AB/R, adopted 20 August 1999, para. 179 and note 110.

[107] In this respect, the panel in *Canada – Measures Affecting the Export of Civilian Aircraft* noted that "…the object and purpose of the SCM Agreement could more appropriately be summarised as the establishment of multilateral disciplines "on the premise that some forms of government intervention distort international trade, [or] have the potential to distort [international] trade." WT/DS70/R, adopted 20 August 1999, para. 9.119. We also find support for our view of the object and purpose of the *SCM Agreement* in the Appellate Body Report in *Canada - Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R, adopted 20 August 1999, para. 157, where the Appellate Body referred to "the trade-distorting potential of a "financial contribution"".

[108] In response to the same Panel Question 20, the United States also submitted that, "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 …. 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" (US response to Panel Question 20, Annex F-3, para. 60). We also do not consider this approach -- which amounts to determining whether there is a financial contribution for the purposes of Article 1.1 on the basis of whether or not there is export-contingency under Article 3.1 of the *SCM Agreement* -- to be an acceptable interpretation of the relationship between these provisions. We note, however, that even on the basis of its own theory, the United States' argument would fail. As we note in our examination below under Article 3.1(a) of the *SCM Agreement* (*infra*, para. 8.64 *ff*), we consider that the fact that the subsidy is available only in respect of transactions involving goods for use outside the US renders the subsidy export-contingent within the meaning of Article 3.1(a). We recall that, pursuant to Article 2.3 of the *SCM Agreement*, any subsidy falling under the provisions of Article 3 "shall be deemed to be specific". Thus, following the US logic, this would be specific within the meaning of Article 2 and, as such, would constitute a financial contribution within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*. However, we certainly do not endorse the US approach.

[109] *Supra*, para. 8.33.

quantitative requirements and attributable only to certain *qualifying* "foreign" transactions (as it itself characterizes the Act).[110] For example, we note that income derived from "foreign" transactions not involving qualifying foreign trade property or foreign trading gross receipts would not qualify for the Act's exclusion. Thus, income derived from transactions involving property for ultimate use *within* the United States (regardless of where it is manufactured or produced) and property not satisfying the foreign articles/labour limitation would not qualify. The Act contains additional restrictions with respect to the types of property and transaction that would give rise to income qualifying for the exclusion.[111]

8.41 Thus, even if one applies the term of “category” to the measure at issue, this linguistic or formal distinction in no way alters the underlying substance of the actual relationship between the measure at issue and the default tax regime as outlined above. Employment of the terminology in no way substantively modifies that relationship. Nor does it introduce any new elements or rationale to the measure at issue that change its essential character.

8.42 Irrespective of whether one simply denies that revenue is otherwise due, or describes what is "excluded" as a “category”, in both guises, this amounts to an asserted view that ignores, almost by definition, the actual context in which the measure occurs. Both arguments are effectively flawed, in our view, for the same reasons.

8.43 We therefore conclude that the exclusion from taxation by the United States of certain income on the basis of the Act's highly selective qualitative conditions and quantitative requirements relating to the definitions of "qualifying foreign trade property" and "foreign trading gross receipts" -- which define what income may become "extraterritorial income", "foreign trade income" and "qualifying foreign trade income" -- results in the foregoing of revenue which is "otherwise due" and thus gives rise to a financial contribution with the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.[112]

(ii) benefit

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[110] US first written submission, Annex A-2, para. 114. In its oral statement, Annex D-3, para. 48, the United States similarly states that the exclusion of extraterritorial income applies to income earned in "*a wide range of* foreign transactions" (emphasis added).

[111] See *supra*, paras. 2.6-2.7.

[112] We wish to emphasize that we do not base our finding on whether or not the United States Constitution or the IRC may or may not require or permit the establishment or maintenance by the United States of a world-wide taxation system, nor do we make any pronouncement as to the US view that the scheme created by the Act introduces "territorial" aspects into its system of taxation. See *e.g.* US comments on EC responses to Panel Questions, Annex F-6, para. 56. Indeed, we do not believe it is necessary to presume in the abstract that, or opine on whether or to what extent, the United States "taxes *all* income" (see e.g. US oral statement, Annex D-3, para. 12) or is required or permitted to do so by its domestic law, to reach this finding. With respect to the issue whether or not the United States maintains a "world-wide" tax system, we recall that the European Communities cites several treatises on US taxation and a study prepared by the United States Treasury in December 2000 for the proposition that the United States itself has recognized the maintenance of the world-wide taxation system, even following the enactment of the Act (EC response to Panel Question 37, para. 131, referring to Exhibit EC-22). The United States challenges this evidence and alleges that it either predates the Act or contains citations not mentioned by the European Communities that serve to refute the EC arguments US comments on EC responses to Panel Questions, Annex F-6, paras. 53-60.

We also do not rely on the evidence cited by the European Communities concerning a US Congressional budget report (EC first submission, Annex A-1, para. 21; EC rebuttal submission, Annex C-1, paras. 88-95) indicating that the measure will result in lost tax revenues, while noting the US response that the EC's reference to the Congressional budget report is misleading as it compares revenues under the Act versus the FSC and the former worldwide tax system (US first submission, Annex A-2, para. 106), and that "…the estimated revenue loss for the Act is independent of and greater than the revenue loss for the former FSC regime." (US response to EC question 2, Annex F-4).

8.44 Having found that the tax "exclusion" under the Act gives rise to a financial contribution within the meaning of Article 1.1(a) of the *SCM Agreement*, we must also examine whether a benefit is thereby conferred within the meaning of Article 1.1(b) of the *SCM Agreement*.

8.45 We recall that the term "benefit" has been found to imply "some kind of comparison", and that:

> "This must be so, for there can be no "benefit" to the recipient unless the "financial contribution" makes the recipient "better off" than it would otherwise have been, absent that contribution."[113]

8.46 Under the Act, a taxpayer involved in a qualifying transaction may exclude qualifying foreign trade income from its gross income and therefore need not pay a certain amount of tax that it would otherwise have to pay to the United States government. It is therefore "better off" than it would have been absent the contribution, that is, if it had been in another situation, where the conditions for obtaining the tax treatment under the Act were not fulfilled and it was therefore subject to otherwise applicable US taxation rules. We are of the view that the tax treatment in the Act confers a benefit.

8.47 Furthermore, the United States' arguments regarding the existence of a subsidy are limited to the contention that there is no foregoing of revenue that is "otherwise due". The United States does not specifically contest that, in the event that there is a foregoing of revenue "otherwise due", a benefit would be conferred by these rules of taxation.

8.48 We therefore find that there exists a financial contribution conferring a benefit, and that a subsidy therefore exists within the meaning of Article 1.1 of the *SCM Agreement*.[114]

(c) whether the subsidy is contingent upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*

8.49 Having determined that a subsidy exists within the meaning of Article 1 of the *SCM Agreement*, we next consider whether the subsidy is contingent upon export, that is, whether the "exclusion" from taxation is "contingent… upon export performance" under Article 3.1(a) of the *SCM Agreement*.[115]

8.50 The European Communities asserts that the "basic"[116] subsidy, relating to US-produced goods, is prohibited under Article 3.1(a) of the *SCM Agreement* because it is only applicable to profits arising from export transactions. In the EC view, the fact that there are other ways to earn the exclusion – e.g., by manufacturing and selling abroad, or by selling services abroad -- does not vitiate the export-contingency of the subsidy in respect of US-produced goods.[117]

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[113] Appellate Body Report, *Canada-Measures Affecting the Export of Civilian Aircraft* ("*Canada-Aircraft*"), WT/DS70/AB/R, adopted 20 August 1999, para. 157.

[114] A subsidy is subject to the provisions of the *SCM Agreement* only if it is specific within the meaning of Article 2. Article 2.3 provides, however, that "[a]ny subsidy falling under the provisions of Article 3 shall be deemed to be specific". Thus, we proceed directly to our analysis of whether the Act is contingent upon export performance and upon the use of domestic over imported goods within the meaning of Article 3 of the *SCM Agreement*.

[115] We recall the rationale underlying the sequence of our analysis under Article 3.1(a), *supra*, para. 8.2, that is, commencing with Articles 1 and 3 of the *SCM Agreement*, rather than with the issues arising under footnote 59 attached to item (e) of the Illustrative List of Export Subsidies in Annex I to the *SCM Agreement.*

[116] See *supra*, note 62, for the EC arguments as to the "basic" and "extended" subsidies under the Act.

[117] E.g. EC written rebuttal submission, Annex C-1, paras. 101-102.

8.51 The United States argues that, in order to be inconsistent with Article 3.1(a) of the *SCM Agreement*, export performance must be a condition that must be satisfied in order to obtain the subsidy.[118] The Act's exclusion of extraterritorial income is therefore, in the US view, not export-contingent, either on its face[119], or in operation.[120] The United States contends that under the Act, there is a single exclusion that applies to different types of foreign transactions, and that covers different situations.[121] The rationale for the exclusion was to treat all foreign transactions alike, regardless of where goods are manufactured.[122] According to the United States, the exclusion of extraterritorial income is not export-contingent because it applies to income earned in a broad range of foreign transactions wholly unrelated to exporting US goods.[123] In particular, US taxpayers may earn such income by manufacturing and selling abroad.[124] The United States asserts that there are even certain domestic transactions (e.g. domestic sales of products that are to be used outside of the United States) for which the exclusion is available.[125] Thus, the United States contends, while exporters are plainly among those taxpayers who can utilize the exclusion, the exclusion does not meet the ordinary meaning of the contingency test set out in the text of Article 3.1(a).[126]

8.52 The heart of the disagreement between the parties is, therefore, that the United States contends that the exclusion of "extraterritorial" income is not export-contingent because such income can be earned in many ways besides exporting US goods, while the European Communities asserts that the subsidy is export-contingent in respect of US-produced goods because it is conditioned upon exportation.

8.53 We must therefore consider whether the Act involves subsidies contingent upon export performance within the meaning of Article 3.1(a) *SCM Agreement* by reason of the requirement contained in the definition of "qualifying foreign trade property" and of "foreign trading gross receipts" that goods be held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition *outside* the United States. The precise issue that confronts us here is whether the export of US goods is a “condition” for satisfying the requirement of “use outside the United States”, and therefore, for receiving the subsidy. As always, the starting-point of our analysis is the text of the *SCM Agreement*. Article 3.1(a) provides, in relevant part, that:

> "Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:
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> (a) subsidies contingent, in law or in fact[4,] whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I[5];
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> [4] This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is

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[118] US first written submission, Annex A-2, para. 109, 135. The United States cites Appellate Body Report, *Canada - Certain Measures Affecting the Automotive Industry* ("*Canada-Autos*"), WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, para. 100.
[119] US first written submission, Annex A-2, paras. 112-114.
[120] US first written submission, Annex A-2, paras. 115-127.
[121] US comments on EC responses to Panel Questions, Annex F-6, para. 1.
[122] US first written submission, Annex A-2, para. 116.
[123] US first written submission, Annex A-2, paras. 118-120.
[124] US oral statement, Annex D-3, paras. 88-89.
[125] US closing oral statement, Annex D-4, para. 9.
[126] US closing oral statement, Annex D-4, para. 9.

> granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.
>
> [5] Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement."

8.54 In examining whether the exclusion of qualifying foreign trade income from gross income is "contingent … upon export performance" within the meaning of Article 3.1(a), we recall that the meaning of "contingent" in that provision is "conditional" or "dependent for its existence upon".[127] We further recall that the legal standard expressed by the word 'contingent' is the same for both *de jure* or *de facto* contingency.[128] There is a difference, however, in what evidence may be employed to establish that a subsidy is export-contingent.[129] We understand the European Communities to be making a claim of *de jure* contingency, challenging the legislation "as such".[130] We will conduct our examination accordingly.

8.55 We recall the Appellate Body's statement that "*de jure* export contingency" is demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument[131], as opposed to the "total configuration of the facts constituting and surrounding the grant of the subsidy."[132] The Appellate Body has also recently stated,

> "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."[133]

8.56 Applying these principles to the case at hand, we will examine whether export-contingency is apparent from the words of the Act, or can be derived by necessary implication from the words actually used in the Act.

8.57 We first turn to the text of the Act. We note that under the Act, "extraterritorial income" means "the gross income of the taxpayer attributable to the foreign trading gross receipts … of the taxpayer."[134] "Foreign trade income" is the taxpayer's taxable income attributable to foreign trading gross receipts.[135] "Foreign trading gross receipts" means generally: "the gross receipts of the taxpayer which are -- (A) from the sale, exchange, or other disposition of qualifying foreign trade property, [or] (B) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States, …".[136] The term "foreign trading gross receipts" does not include receipts of the

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[127] Appellate Body Report, *Canada-Aircraft, supra*, note 113, para. 166.
[128] Appellate Body Report, *Canada-Aircraft, supra*, note 113, para. 167.
[129] Appellate Body Report, *Canada-Aircraft, supra*, note 113, para. 167.
[130] EC response to Panel Question 2, Annex F-1, para. 6. We note the EC statement that "[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." See EC response to Panel Question 2, Annex F-1, para. 10.
[131] Appellate Body Report, *Canada-Aircraft, supra*, note 113, para. 167.
[132] *Ibid.*
[133] Appellate Body Report, *Canada-Autos, supra*, note 118.
[134] Act, section 3; section 114(e) IRC.
[135] Act, section 3; section 941(b) IRC.
[136] Act, section 3; section 942(a)(1) IRC.

taxpayer from a transaction if the qualifying foreign trade property (or services) are for ultimate use in the United States.[137] The Act defines the term 'qualifying foreign trade property' to mean property:

> "(A) manufactured, produced, grown or extracted within or outside the United States,
>
> (B) held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and
>
> (C) not more than 50 per cent of the fair market value of which is attributable to -
>
> > (i) articles manufactured, produced, grown, or extracted outside the United States, and
> >
> > (ii) direct costs for labour (determined under the principles of Section 263A) performed outside the United States."[138]

8.58 We observe that the text of the Act limits the definitions of "foreign trading gross receipts" and "qualifying foreign trade property" -- which determine what income will qualify as "extraterritorial income", "foreign trade income" and "qualifying foreign trade income" -- to property that is for ultimate use *outside the United States*. The subsidy is therefore only available in respect of income derived from transactions relating to such property.

8.59 The definition of qualifying foreign trade property applies to goods manufactured, produced, grown or extracted *within* or *outside* the United States. The fact that the definition of the term "qualifying foreign trade property" refers to property manufactured, produced, grown or extracted within *or outside the United States* is, according to the United States "the most significant aspect of the definition of "qualifying foreign trade property"".[139] In the United States' view, this reference shows that the Act applies equally to all foreign transactions irrespective of whether goods are produced in the United States or abroad[140] and, we understand the United States to argue, essentially means that tax treatment under the Act is not export-contingent under Article 3.1(a).

8.60 We disagree. We consider that the words of the Act make clear that the subsidy is not available in relation to goods produced *within* the United States sold for use *within* the United States and that the following can be derived by necessary implication from the words actually used in the Act:

- goods produced outside the United States are eligible for the tax exclusion under the Act only if they are, *inter alia*, for use outside the United States.

- goods produced within the United States are eligible for the tax exclusion under the Act only if they are, *inter alia*, for use outside the United States.

Thus, in relation to US-produced goods, the words of the statute itself make it clear that exporting is a necessary precondition to qualify for the subsidy. In respect of US-produced goods, the existence and amount of the subsidy depends upon the existence of income arising from the exportation of such

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[137] Act, section 3; section 942(a)(2)(A)(i) IRC.
[138] Act, section 3; section 943(a)(1) IRC.
[139] US comments on EC response to Panel Question 35, Annex F-6, para. 46.
[140] US comments on EC response to Panel Question 35, Annex F-6, para. 44.

goods. In relation to US-produced goods, the existence of such income is clearly conditional, or dependent upon, the exportation of such goods from the United States. We are therefore of the view that by necessary implication the scheme is *de jure* dependent or contingent upon export in relation to US-produced goods.

8.61 We take note of the US argument that US manufacturers may earn extraterritorial income without exporting, as they have the option to produce and sell outside the United States.[141] That entities effecting transactions relating to goods in the United States could opt to source their goods from outside the United States and to engage in wholly non-US transactions does not, in our view, alter the fundamental reality that for US-produced goods, export is a necessary precondition for benefitting from the subsidy under the Act due to the requirement of "use outside the United States".

8.62 The United States emphasizes that the subsidy is also available under the scheme with respect to goods produced outside the United States, provided the transactions involve qualifying foreign trade property, and asserts that the subsidy is not export-contingent because it is available to other than exporters. By contrast, the European Communities argues that it is not necessary to show that all subsidies under the Act are export-dependent[142], and that a subsidy that is export-contingent in some situations does not cease to be so if it can also be obtained in other situations which do not require export.

8.63 For the purpose of our analysis, and consistent with the stated view of both parties[143], we assume for the sake of argument that there may be a subsidy within the meaning of Article 1 of the *SCM Agreement* even in the case where a financial contribution confers a benefit exclusively in respect of production outside the territory of the Member providing the financial contribution. Given that a resolution of this question is not necessary to resolve this dispute, we need not decide this issue.[144]

8.64 We do not believe that it is necessary that the Act involves exclusively subsidies that are export-dependent in order to make a finding that the Act involves a defined segment of subsidies – i.e. in respect of US-produced goods -- that are prohibited export subsidies because, in respect of this defined segment, the Act is inevitably and invariably conditioned on exportation.[145] The fact that the Act also involves subsidies with respect to goods produced outside the United States -- that need not be exported from the United States by reason of the foreign use requirement alone in order to qualify for the subsidy -- does not, in our view, vitiate the export-contingency of the Act that we find in respect of US-produced goods. We find support for our view that export-contingent subsidies may

[141] US oral statement, Annex D-3, paras. 88-89.

[142] EC first written submission, Annex A-1, para. 96.

[143] See EC response to Panel Question 43, Annex F-1, paras. 149 *ff*; US response to Panel Question 43, Annex F-3, paras. 101 *ff*.

[144] If, however, a subsidy within the meaning of Article 1 *were* limited to a financial contribution provided by a Member only in respect of production inside its territory, then the availability of the exclusion provided by the Act to income derived from the sale or lease of foreign-produced goods would not constitute a subsidy within the meaning of Article 1. This would invalidate the United States argument that the "subsidy" is not export-contingent by reason of the requirement of "use outside the United States" on the grounds that it is also available in respect of goods that are produced and sold outside the United States and thus are not exported from the United States.

[145] In our view, the following analogy supports our conclusion. Assume that "goods produced outside the United States" may be referred to as "good A" (for example, toasters), and that "goods produced within the United States" may be referred to as "good B" (for example, aircraft). On this basis, the Act's requirement of use outside the United States is tantamount to a stipulation that "good A" (toasters) need not be exported from the United States, while "good B" (aircraft) must be for use outside the United States (i.e. be exported from the United States) in order to become eligible for the subsidy under the Act. In our view, this amounts to a provision making exportation a condition for receiving the subsidy with respect to "good B" (e.g. aircraft), although not with respect to "good A" (e.g. toasters).

exist in the context of a broader subsidies scheme in the reasoning of the Appellate Body in *Canada-Aircraft*. There, the Appellate Body stated that,

> "the fact that some of TPC's contributions, in some industry sectors, are *not* contingent upon export performance, does not necessarily mean that the same is true for all of TPC's contributions. It is enough to show that one or some of TPC's contributions do constitute subsidies "contingent ... in fact … upon export performance".[146]

There, the export-contingency of the subsidy *vis-à-vis* regional aircraft was not vitiated by the fact that it did not depend on exports *vis-à-vis* other products/sectors.

8.65 We recall that, in response to Panel questioning, the United States drew an analogy between export contingency and specificity under the *SCM Agreement*, arguing that just as "the conventional way of making a specific subsidy non-specific is to expand the universe of users or beneficiaries"[147], "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".[148] While it may be that an expansion of the group of eligible recipients may be a way to eliminate the specificity of a subsidy, we do not consider that this logic can be extended to export contingency.

8.66 The analogy drawn by the United States with specificity does not, in our view, hold here at all. In the case of specificity, what might be loosely described in purely formal terms as an "expansion" cannot blind one to the fact that, as a matter of substance, this "expansion" of the subsidy itself thereby actually, inherently and invariably changes the nature of the subsidy at issue. A specific subsidy is, by definition, a subsidy that is only granted to a specific enterprise or industry or group of enterprises or industries.[149] In "expanding" the granting of the subsidy to a broad group of users or beneficiaries sufficient to achieve the standard of non-specificity, a Member is at the same time *necessarily* ceasing to grant it as a specific subsidy. The specificity and the non-specificity cannot in any manner objectively co-exist. The act of granting a non-specific subsidy in and of itself precludes specificity. Specificity is simply eliminated.

8.67 This is not at all the case we are dealing with here. In the case at hand, we are dealing with an "expansion" which does not inherently eliminate the objective existence of export-contingency. The fact that some other form of economic activity which relates to goods produced outside the territory of the Member concerned also obtains a subsidy does not in any way thereby eliminate the contingency of a subsidy on exports. The two can perfectly conceivably co-exist. This reflects the fundamental fact that "exports" here only have meaning in the context of sale or consumption of goods that are produced within the territory of the Member. In common usage, such goods can be either exported or sold domestically. That exhausts the alternative possibilities for their sale or consumption. As long as there is differentiation between the treatment of those domestically-produced goods depending on whether they are, respectively, either exported (subsidy provided) or sold domestically (subsidy not provided), the provision of such a subsidy is contingent on export. This is the defining contrast.

8.68 One can hardly "cure" a situation that essentially arises from -- and is essentially related to -- differential treatment of the sale of products that are domestically produced by providing subsidies in respect of economic activities that do not even involve those goods produced in the territory of a Member in the first place. Indeed, when conducting an analysis from the perspective of the Member granting the subsidy, the very concept of "exporting" does not even arise in the context of goods that

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[146] Appellate Body Report, *Canada-Aircraft*, *supra*, note 113, para. 179.
[147] US response to Panel Question 21, Annex F-3, para. 72.
[148] *Ibid*., para. 73.
[149] See *SCM Agreement*, Article 2.1.

are themselves not produced within the territory of the Member itself.[150] In effect, the United States seems to argue that a subsidy to economic activity that is entirely irrelevant to export activity -- indeed, is precluded from involving such exports -- can effectively remove export contingency. This seems to be a manifestly unreasonable interpretation. Be that as it may, it would also have the practical effect of reducing the disciplines of the *SCM Agreement* to ineffectiveness and inutility.

8.69 This can be readily seen. If the provision of such a subsidy -- that does not even relate to goods that can be, in principle, exported -- could "cure" export-contingency, where would the line be drawn demarcating the parameters of such an approach? Manifestly, there could not be any such line. One could just as readily argue that the provision of subsidies in realms entirely unrelated to the sale or consumption of domestically-produced goods would eliminate export subsidies otherwise deemed to exist in respect of such domestically-produced goods.

8.70 Thus, the application here by the United States of a subsidy to offshore economic activity is, at most, the provision of a supplemental feature or an additional subsidy. But the fundamental differentiation that existed in the first place has still not thereby been eliminated. This contrast in respect of domestically-produced goods irrevocably remains. The analogy that more readily springs to mind is that a Member does not eliminate an export subsidy on apples by also granting a subsidy on oranges that is not contingent upon export performance.

8.71 In fact, the specificity analogy, if anything, actually implies the reverse of the US argument. The only way to eliminate an export subsidy in the manner equivalent to eliminating specificity is to eliminate the essential basis of the differentiation in the first place *viz* grant the equivalent subsidy also to the goods for sale or consumption on the domestic market. It would not then be contingent on export because it would be available in respect of goods produced in the US territory *irrespective of whether or not they are exported*. THAT would be the comparable case to the conversion from specificity to general availability.

8.72 Thus, in our view, a way to cure export-contingency in this case would be to eliminate the conditionality on export by making the subsidy available irrespective of whether a product of national origin is sold in the domestic market or abroad. It is the differential treatment provided for in the Act -- that is, if US-produced goods are exported, the subsidy is available, while if they are sold in the domestic market, it is not -- that renders the Act contingent upon export performance within the meaning of Article 3.1(a).[151] The addition of other circumstances or products in respect of which the subsidy may be available -- i.e. foreign-produced goods -- does not eliminate the conditionality of the

[150] We consider that the use of the term "export" in Article 3.1(a) of the *SCM Agreement* indicates that goods must be moved from the territory of one Member to that of another Member. For the purposes of this dispute, we consider that it is sufficient for us to clarify our view that this involves movement of a good from the territory of the Member granting the subsidy to the territory of another Member. We also consider that the treatment of domestically-produced goods sold domestically in the territory of the Member granting the subsidy is a useful basis for comparison for the purposes of an Article 3.1(a) analysis. We find contextual support for this approach in, for example, the text of Article XVI of the *GATT 1994*, which refers to granting "directly or indirectly any form of subsidy which operates to increase the export of any primary product from its territory…" (para. 3) and to subsidies resulting in the sale of a product for export "at a price lower than the comparable price charged for the like product to buyers in the domestic market" (para. 4).

[151] We note that the United States argues that such an approach to contingency (i.e. for owners of US produced goods, export is a condition for obtaining the benefits under the scheme for those goods, see e.g. EC rebuttal submission, para. 102), would mean that "territorial exemptions in most European countries provide export-contingent subsidies…" (US oral statement, Annex D-3, para. 91) and that most tax systems worldwide were inconsistent with the *SCM Agreement*, which could not have been intended by the drafters of the Agreement. The EC responds that "a territorial system taxes income from economic activity -- the final destination of the product is irrelevant" (EC response to Panel Question 35, Annex F-1, para. 89).

subsidy upon export, and thus does not cure the inconsistency with Article 3.1(a) of the *SCM Agreement*.[152]

8.73 We also take note of the US argument that the tax exclusion is even available for certain domestic transactions (domestic sales of products that are to be used outside of the United States).[153] In response to questioning from the Panel, the United States submits that "[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".[154] The United States contends, further, that:

> "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."[155]

8.74 These US statements do not change our view of the nature of the scheme in relation to US-produced goods. Since, in order for a transaction involving US-produced goods to qualify for the tax exclusion under the Act, the goods must not be "for use in the United States", it follows that these goods must be sent across the US border and moved outside US territory, generally, and in the usual case not involving questions of territorial waters, into another country. In our view, this means that, in respect of US-produced goods, the subsidy is conditioned upon export. The factual situation identified by the United States in these proceedings where a good could re-enter the United States – e.g. 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"[156] – still requires that the goods leave US territory and cross the US border (entering into another country) before they re-enter upon US territory. That the requirement of "use outside the United States" may require only "*predominant* foreign use"[157] still means that some extent of foreign use is a requirement, immaterial whether this is entire or predominant.[158] In short, for US-produced goods, the subsidy is available only upon the condition of exportation.

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[152] In this respect, we do not rely upon the phrase "solely or as one of several other conditions" in Article 3.1(a) of the *SCM Agreement*. Nor would our ruling mean, as the United States argues, that the application of Article 3.1(a) extends "to essentially any measure that has any relationship to exportation or that might result in exportation" (see US first written submission, Annex A-2, para. 133). We are not dealing here with a situation where a subsidy may be earned in respect of particular goods either through export or through sale in the domestic market. Nor is this a situation where a subsidy might be earned in respect of US-produced goods if one of several alternative conditions was met (e.g. export or generation of employment). Thus, we do not address, and reserve our position on, the issue whether "one of several other conditions" in Article 3.1(a) refers to "additional" conditions beyond export-contingency or to conditions "alternative" to export contingency.

[153] US closing oral statement, Annex D-4, para. 9. US response to Panel Question 11, Annex F-3, paras. 22-26.

[154] US response to Panel Question 11, Annex F-3, para. 22.

[155] US response to Panel Question 11, Annex F-3, para. 22. In respect of these hypothetical situations it raises, the US states that "these 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" (US response to Panel Question 11, Annex F-3, para. 22).

[156] US response to Panel Question 11, Annex F-3, para. 24.

[157] US response to Panel Question 11, Annex F-3, para. 25.

[158] In this connection, we note that the requirement of "use outside the United States" can be met under the Act if, with other conditions being satisfied, property is held *primarily* for use outside the United States. Act, section 3, section 943(a)(1) IRC. Moreover, the Act, section 3, section 942(a)(2)(A)(i), relating to the

8.75 We therefore find that the Act involves subsidies "contingent … upon export performance" by reason of the requirement of "use outside the United States" and is therefore inconsistent with Article 3.1(a) of the *SCM Agreement*.[159]

2. Footnote 59

(a) analytical approach

8.76 The United States contends that, even if the Act's exclusion were an export-contingent subsidy, it would not be prohibited because the fifth sentence to footnote 59, when read in conjunction with footnote 5, provides that measures to avoid the double taxation of foreign-source income are not prohibited by the *SCM Agreement*.[160] In the view of the United States, the fifth sentence of footnote 59, which provides that "[p]aragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member", falls within the scope of footnote 5, which provides that, "[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement". The United States refers in this respect to the *Brazil – Aircraft* panel report, which opined that footnote 5 "could extend more broadly to cover cases where the Illustrative List contained some other form of affirmative statement that a measure is not subject to the Article 3.1(a) prohibition", and referred by way of example to the first and fifth sentences of footnote 59.[161]

8.77 The European Communities "sees no reason to contest that that the last sentence of footnote 59 may be an exception to Article 3.1(a)"[162], but, in response to a Panel question, asserts that it "was not stating that it considers that the last sentence of footnote 59 is an exception to Article 3.1(a)".[163] The European Communities submits that as the scheme is not a measure to avoid the double taxation of foreign-source income, the conditions of the last sentence of footnote 59 are not met. Accordingly, the European Communities asserts, the Panel need not reach the issue of whether the last sentence to footnote 59 is an exception to item (e) and thus within the scope of footnote 5.[164]

8.78 We recall that the fifth sentence of footnote 59 to item (e) of the Illustrative list of Export Subsidies in Annex I of the *SCM Agreement* states:

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

8.79 Footnote 5 of the *SCM Agreement* states:

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

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definition of "foreign trading gross receipts" states that such receipts shall not include receipts from a transaction if the qualifying foreign trade property is for *ultimate* use in the United States.

[159] Having made this finding, we do not consider that it is necessary for us to further examine whether the Act also involves the full or partial exemption, remission or deferral "specifically related to exports", of direct taxes paid or payable by industrial or commercial enterprises within the meaning of item (e) of the Illustrative List of Export Subsidies in Annex I of the *SCM Agreement*.

[160] US first written submission, Annex A-2, para. 154.

[161] US first written submission, Annex A-2, para. 175, citing Article 21.5 Panel Report, *Brazil - Export Financing Programme for Aircraft - Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW, adopted as modified by the Appellate Body, 4 August 2000.

[162] EC written rebuttal submission, Annex C-1, para. 181.

[163] EC response to Panel Question 3, Annex F-1, para. 12.

[164] *Ibid.*

8.80 In order for the United States to prevail, on the basis of footnotes 59 and 5 of the *SCM Agreement*, with respect to the claims of the European Communities under Article 3.1(a), we must determine that:

- the Act is a measure to avoid the double taxation of foreign-source income within the meaning of the fifth sentence of footnote 59 of the *SCM Agreement*, and

- the fifth sentence of footnote 59 falls within the scope of footnote 5 of the *SCM Agreement.*[165]

(b) whether the Act is a measure to avoid the double taxation of foreign-source income under footnote 59 of the *SCM Agreement*

8.81 We first turn to an examination of the United States argument that the Act is a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59 of the *SCM Agreement*.

8.82 The United States contends that the language in the fifth sentence of footnote 59 is "particularly flexible, imposing no *limit* on WTO Members in fashioning double tax relief *measures*."[166] The United States submits that the last sentence of footnote 59 suggests that WTO Members are not prevented by the *SCM Agreement* from taking "prophylactic steps to prevent their taxpayers from being subjected to taxation both at home and in a foreign jurisdiction."[167] The United States submits that the Act is a measure to avoid double taxation of foreign-source income and that the Act provides a partial exclusion from tax for foreign-source income (i.e. income derived from non-domestic sources). The United States points to legislative history that it contends indicates that the Act "was intended and designed" to serve as " a measure to avoid double taxation", and that the structure of the Act demonstrates this.[168]

8.83 The United States submits that while the terms "double taxation" and "foreign-source income" are terms widely used in the tax area, it is not clear that they have obtained universally agreed-upon "special meanings", and no such "special meanings" have been accepted by the WTO.[169] For the United States, the ordinary meaning of the terms in the fifth sentence of footnote 59 is readily ascertainable and there is no need for recourse to supplemental means of interpretation for these terms.[170]

8.84 In the US view, the term "foreign-source income", as used in footnote 59, is not limited solely to income attributable to foreign economic activities.[171] The United States argues that there is no international consensus that a permanent establishment is necessary to tax income. The United States asserts that income covered by the Act's exclusion is income that faces the legitimate possibility of

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[165] Footnote 59 of the *SCM Agreement* is linked to item (e) of the Illustrative List in Annex I of the *SCM Agreement*. Footnote 5 is linked to Article 3.1(a) of the *SCM Agreement*. As footnote 5 of the *SCM Agreement* relates to situations where a measure is referred to as *not* constituting an export subsidy in Annex I, it would thus be necessary for us to determine whether a measure found to fall within the scope of footnote 59, fifth sentence -- which provides that "[p]aragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income…" -- constitutes a measure referred to in Annex I as *not* constituting an export subsidy for the purposes of footnote 5.

[166] US oral statement, Annex D-3, para. 143.

[167] US oral statement, Annex D-3, para. 22.

[168] US oral statement, Annex D-3, paras. 138-139.

[169] US oral statement, Annex D-3, para. 111.

[170] US oral statement, Annex D-3, paras. 120-121.

[171] US first written submission, Annex A-2, para. 190-192, US written rebuttal submission, Annex C-2, paras. 56-59: US oral statement, Annex D-3, para. 133.

taxation outside the United States.[172] In the US view, the issue that arises is whether the Act does *not* constitute a measure to avoid double taxation under footnote 59 because it does not limit its exclusion to the amount of foreign taxes paid.[173]

8.85 The United States submits that the exemption (non-taxation) of foreign-source income is a widely accepted method of avoiding double taxation (along with foreign tax credits).[174] While the United States continues to use foreign tax credits, it asserts that nothing prevents it from using alternative means (tax credits and exclusions) to avoid double taxation.[175] The United States relies on the *OECD Model Tax Convention on Income and Capital* solely as an example, and does not consider it to be a substitute for the text of the relevant WTO provisions.[176] The United States refers to the OECD Commentary as relevant only in that it reflects that many countries are like the United States and offer a mix of exemptions and exclusions as well as foreign tax credits.[177] The United States asserts that there is no "double relief from double taxation" as "[f]oreign tax credits may not be used with respect to excluded extraterritorial income".[178]

8.86 For the European Communities, it is not necessary in this case to establish the exact status and meaning of footnote 59, but it is rather sufficient to note that the Act is not a measure for the avoidance of double taxation and is not limited to foreign-source income.[179] The European Communities submits that “whether one considers that this is a reference to a WTO standard or must be assessed, like revenue foregone, by a reference to the tax system of the country concerned, the Act does not satisfy this condition".[180] The European Communities contests US assertions that the legislative history shows that the purpose of the Act was to avoid double taxation.[181]

8.87 The European Communities argues that the provisions of the *OECD Model Tax Convention* apply only where income may, in accordance with its provisions, be taxed in another state, and the Convention provides evidence of the rule that business profits may only be taxed where an enterprise carries on business through a "permanent establishment".[182] The European Communities contends that under the Act, income may be excluded in respect of transactions where the taxpayer does not maintain a permanent establishment abroad and is thus not subject to taxation in another state. As the Act excludes from tax income which could not legitimately be taxed in any other country, it provides "single taxation relief".[183]

8.88 The European Communities contends that the source of income is the place in which the activities giving rise to these profits have taken place. The United States treats income as "extraterritorial" if the money or assets originate outside the United States. Thus, the income excluded by the Act is not foreign-source income. Nor is "extraterritorial income" foreign-source

[172] US closing oral statement, Annex D-4, para. 15.
[173] US oral statement, Annex D-3, para. 8.
[174] US first written submission, Annex A-2, paras. 178, 180, citing to Articles 23A and 23B of the *Model Tax Convention on Income and Capital* (“*OECD Model Tax Convention*”) (Exhibit US-7; Exhibit EC 12).
[175] US written rebuttal submission, Annex C-2, paras. 35-38.
[176] US oral statement, Annex D-3, para. 117.
[177] US oral statement, Annex D-3, para. 142, referring to the Commentary to Article 23 of the *OECD Model Tax Convention* (Exhibit US-7)
[178] US first written submission, Annex A-2, paras. 188-189; US oral statement, Annex D-3, para. 139; US comments on EC response to Panel Question 16, Annex F-6, para. 17, referring to ss. 114(c)-(d) IRC.
[179] EC closing oral statement, Annex D-2, paras. 29-30.
[180] EC closing oral statement, Annex D-2, paras. 29-30.
[181] EC written rebuttal submission, Annex C-1, paras. 41-42.
[182] Eg EC closing oral statement, Annex D-2, para. 22.
[183] EC written rebuttal submission, Annex C-1, paras. 186 – 198.

income within the meaning of US law.[184] In the EC view, the scheme allows what is claimed to be double taxation relief on both foreign-source income and domestic-source income. 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.[185]

8.89 Finally, the European Communities argues that the United States has no need of the Act to relieve double taxation, because it has a comprehensive system of foreign tax credits. Nor does the Act solve the problem of double taxation because, the amount of excluded income being limited, companies may still need to claim foreign tax credits to avoid double taxation. On the other hand, the Act in some cases permits an enterprise to take a foreign tax credit with respect to excluded income, thus providing "double relief from double taxation". Nor do the "formulaic" rules for calculating the amount of excluded income correspond to the arm's length apportionment of the profits which another country would seek to tax. Thus, the European Communities asserts, avoidance of double taxation cannot be the "real objective" of the Act.[186]

8.90 In considering this issue, we first recall that a party asserting the affirmative of a particular claim or defence bears the burden of proof with respect to that claim or defence.[187] It appears to us that the nature of the last sentence of footnote 59 is such that the party asserting that its measure falls within the scope of that sentence bears the burden of establishing that the measure fulfils the conditions set out in that sentence. We do not believe that it would be incumbent upon a party to assert that a measure was *not* a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59 before the party imposing the measure had invoked the last sentence of footnote 59 as a justification for its measure.[188]

8.91 We observe that the fifth sentence of footnote 59 contains several elements relating to the type of measure that item (e) "is not intended to limit a Member from taking". In this regard, footnote 59 refers to "measure[s] to avoid the double taxation of foreign-source income". Thus, item (e) "is not intended to limit a Member from taking measures: (i) "to avoid"; (ii) "the double taxation"; (iii) "of foreign-source income" earned by the enterprises of the Member concerned or of another Member. In order for a measure to fall within the scope of the fifth sentence of footnote 59, it must satisfy each of these three elements.

8.92 We do not understand the parties to disagree that the term "double taxation" refers to the situation where the same income is taxed in more than one jurisdiction. However, the parties have diverging views on the nature and scope of the justification provided by the fifth sentence of the footnote, on the meaning of the term "foreign-source income" as used in the footnote and on whether the Act is a measure "to avoid" double taxation. We therefore consider each of these other elements in turn.

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[184] EC written rebuttal submission, Annex C-1, paras. 199-208. The European Communities states that the United States deals with taxation of income from sources without the United States in section 862 IRC, submitted as part of Exhibit EC-21. See e.g. EC response to Panel Question 36, Annex F-1, para. 118.

[185] EC comments on US responses to Questions, Annex F-5, paras. 29-30.

[186] EC written rebuttal submission, Annex C-1, paras. 209-220.

[187] Appellate Body Report, *United States - Measure Affecting Imports of Woven Wool Shirts and Blouses form India*, WT/DS33/AB/R, adopted 23 May 1997, p. 15.

[188] We consider the original Appellate Body Report in this dispute to be instructive here. The Appellate Body stated that "… the United States did not indicate that, in its substantive arguments to the Panel, it had *justified* the FSC measure as a measure "to avoid double taxation" under footnote 59. Nor do we find any indication in the Panel Record that the United States ever *invoked this justification*. We, therefore, conclude that the United States *did not assert*, far less argue, before the Panel that the FSC measure is a measure "to avoid double taxation of foreign-source income" under footnote 59 (emphasis added)." Original Appellate Body Report, *supra*, note 1, para. 101. We consider that this supports our view that it is for the Member seeking to justify its measure under the last sentence of footnote 59 to invoke this provision and to bear the burden of proof by establishing an affirmative *prima facie* case that the conditions in that sentence of the footnote are fulfilled.

8.93 We turn first to the term “foreign-source income". We recognize that this term in footnote 59 refers to a taxation concept. However, it is not clear to us that the term has obtained a universally agreed upon special meaning. Even if such a definition or special meaning existed, no such definition or meaning has been included in the *SCM Agreement* as a common understanding among WTO Members. Therefore, in our examination of the Act under footnote 59, we do not impose a single rigid definition or interpretation of the term “foreign-source income”, as that term is used in footnote 59, nor do we import into the *WTO Agreement* any definition of the term that may exist in other international instruments or fora.[189] Nor are we of the view that the meaning of the term "foreign-source" as used in footnote 59 need necessarily be determined purely by reference to the domestic laws of the Member invoking the footnote, in this case, the United States.[190] We note, however, that footnote 59 refers to measures taken to avoid "the double taxation of foreign-source income". We understand the term "foreign-source income" as used in footnote 59 to refer to certain income susceptible to "double taxation".

8.94 We turn next to the term "to avoid" in footnote 59, fifth sentence. The term "avoid" is defined *inter alia* as "[t]o empty out; remove…to get rid of, put an end to…" and as "[t]o escape, evade; … To prevent, obviate".[191] The use of the term "to avoid", rather than, for example, measures "that avoid", indicates to us that the *purpose* of the measure (or at least one of its purposes) must be to avoid (i.e. "prevent" or "obviate") the double taxation of foreign-source income.[192] Thus, the fact that a measure may incidentally prevent certain income from being subject to double taxation in a particular set of circumstances would not, in and of itself, be sufficient to bring the measure within the scope of footnote 59. We note, in any event, that virtually *any* subsidy provided through relief from income taxation might have such an incidental effect in certain circumstances. For example, a provision that income derived from exportation was not subject to income taxes would have at least an incidental effect in avoiding the double taxation of certain foreign-source income. We observe that such a broad interpretation of the term "to avoid" in footnote 59, fifth sentence would render item (e), and possibly all of Article 3 of the *SCM Agreement*[193], devoid of all meaning and do not believe that such an interpretation could have been intended. We note that the text also does not, for example, state that item (e) is not intended to limit Members from taking measures "that happen to avoid"; "in relation to avoiding"; "in respect of avoiding"; or "in regard to avoiding" the double taxation of foreign-source income. All of these might be seen as phrasings which are more consistent with the interpretative approach posited by the United States. But the language in the fifth sentence of footnote 59 is far more targeted than that.

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[189] We note that to the extent that it might be relevant to this proceeding as an example of international tax practice, the *OECD Model Tax Convention* refers to the concept of "source" but does not, in any event, contain such a definition. See also *infra*, note 195.

[190] Section 862 of the IRC refers to and describes "Income from sources without the United States". The European Communities contests the US assertion in its response to Panel Question 15 (Annex F-3, para. 51) 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" and offers explanation as to why "foreign-source income and extraterritorial income are entirely unconnected concepts". See EC comments on US response to Panel Question 15, Annex F-5, paras. 7-8. We do not consider the US definition of foreign-source income contained in the IRC decisive here. We observe that footnote 59 does not contain any statements analogous to the statement in footnote 6 to Article XIV of the *General Agreement on Trade in Services*, which reads: "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."

[191] *The Shorter Oxford English Dictionary* , 3rd ed. (Oxford University Press, 1965).

[192] We note that this term appears in the French text of the footnote as: "en vue d'éviter" and in the Spanish text as "destinadas a evitar". We consider that these translations are consistent with our view.

[193] We note the US argument that a measure falling under the fifth sentence of footnote 59 is "not prohibited" not only in respect of item (e), but also in respect of the *SCM Agreement* as a whole (including Article 3 thereof). See e.g. US first written submission, Annex A-2, para. 154. As noted *infra*, para. 8.108, we do not decide this issue here.

8.95 We have a degree of sympathy for the US statement that "precision" in the relief of double taxation 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."[194] Indeed, we do not view footnote 59 as requiring that a measure "to avoid" the double taxation of foreign-source income must avoid double taxation entirely, exclusively or precisely.[195] However, we consider that the relationship between the measure and its asserted purpose -- i.e. "to avoid the double taxation of foreign-source income …" -- must be reasonably discernable.[196] We seek to ascertain whether the Act is a measure "to avoid" the double taxation of foreign-source income by concentrating our examination on a review of the overall structure, design and operation[197] of the Act in the context of the broader United States tax system.

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[194] US response to Panel Question 19, Annex F-3, para. 61.

[195] We recognize that the United States itself is not contending that the Act is a "narrowly-tailored, dollar-for-dollar offset of foreign taxes paid" (US oral statement, Annex D-3, para. 23), and we are not of the view that this would necessarily be the only type of measure that might qualify for justification under the footnote. To the contrary, such an interpretation would imply that only a system of foreign tax credits, and not a mechanism to exempt foreign-source income, would fall within the scope of footnote 59. Such an approach would be inconsistent with a broadly-held view, reflected in the *OECD Model Tax Convention*, that both the credit and exemption methods are appropriate means to avoid double taxation.

We want to be clear that when we refer to the *OECD Model Tax Convention* here and elsewhere in this Report, we are not suggesting that its provisions are somehow controlling of our interpretation of the *WTO Agreement*. Rather, we consider that the *OECD Model Tax Convention* can be relevant to the extent it is reflective of tax practices of certain WTO Members. We note that the United States itself has relied upon the *OECD Model Tax Convention* for this purpose (US oral statement, Annex D-3, para. 117).

[196] We note the US assertion that the language in footnote 59 is "particularly flexible, imposing no *limit* on WTO Members in fashioning double tax relief *measures*" (US oral statement, Annex D-3, para. 143). While we agree with the United States that the language of the footnote may accommodate a certain degree of flexibility, we do not view this flexibility as extending entirely beyond the words and concepts actually used in the text of the provision.

[197] We find support for our approach in previous WTO dispute settlement reports. For example, in the context of an examination under Article III:2 of the GATT 1994, the Appellate Body has stated "[a]lthough it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure." See Appellate Body Report, *Japan - Taxes on Alcoholic Beverages*, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, pp. 29-30 ("*Japan-Alcoholic Beverages*"). In its Report in *Chile-Taxes on Alcoholic Beverages*, *supra*, note 53, para. 71, the Appellate Body characterized its approach in *Japan - Alcoholic Beverages* as calling "for examination of the design, architecture and structure of a tax measure precisely to permit identification of a measure's objectives or purposes as revealed or objectified in the measure itself." As well, in the context of an examination under Article XX(g) of the GATT 1994, the Appellate Body examined "the relationship between the general structure and design of the measure" at stake "and the policy goal it purports to serve". *United States - Import Prohibition of Shrimp and Shrimp Products*, WT/DS58/AB/R, adopted 6 November 1998, para. 137. See also *infra*, note 217.

In this context, we do not place great weight in our examination on the asserted intent of the United States legislators prior to enactment of the Act. We recall that the Act (section 3; section 114(d) IRC) disallows foreign tax credits that might otherwise be allowed with respect to excluded extraterritorial income (and that the Act, section 3; section 943(d) IRC contains rules relating to the treatment of "withholding taxes" for purposes of section 114(d) IRC). We note, in this regard, the references identified by the United States in the *US House of Representatives Report on the FSC Repeal and Extraterritorial Income Exclusion Act*, H.R. Rep. No. 106-845 (2000) ("*House Report*")(Exhibit US-3), (see e.g. US first written submission, Annex A-2, paras 188-189) as demonstrating that the Act was intended and designed to avoid double taxation of foreign-source income. We further note that the Reports of the United States Senate and House of Representatives relating to the Act state that,

> "Because the exclusion of such extraterritorial income is a means of avoiding double taxation, no foreign tax credit is allowed for income taxes paid with respect to such excluded income. An exception from this general rule is provided for extraterritorial income that is not qualifying foreign trade income."

8.96 Examining the overall structure, design and operation of the Act, we consider that the parameters of the Act do not even roughly approximate the parameters of a measure to avoid the double taxation of foreign-source income. With the Act, the United States has not approximated the boundaries relating to the type of income that might be subject to tax by another tax authority, but has rather drawn a distinct line demarcating what it refers to as "extraterritorial income" (and then provided for an exclusion from "gross income" of a portion thereof, i.e., qualifying foreign trade income).

8.97 As discussed in more detail below, the Act includes as "extraterritorial income" that is excluded from taxation income which would, in our view, not necessarily be treated as taxable in other jurisdictions. In this respect, the Act is unusually broad for a measure whose purpose is *to avoid* double taxation. At the same time, the "extraterritorial income" excluded from taxation does not include a range of income which *is* potentially subject to taxation in other jurisdictions. It is thus, in certain respects, unusually narrow for a measure whose asserted purpose is *to avoid* double taxation. Finally, we note that the Act overlaps with an extensive system of bilateral agreements to avoid double taxation through foreign tax credits, and its application is not designed to cover situations where such agreements did not exist. No single one of these elements, taken separately, would necessarily lead us to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income; taken together, however, they lead us to the conclusion that the Act is not a measure taken *to avoid* the double taxation of foreign-source income within the meaning of footnote 59.

8.98 First, we note that the Act is exceedingly broad in that it excludes income which would rarely be taxable in another jurisdiction.

8.99 We recall that a defining feature of the tax exclusion provided for by the Act is that it is only available in respect of income derived from the sale or lease of goods held primarily "for direct use, consumption or disposition outside the United States".[198] We consider it clear, however, that income is not necessarily subject to taxation outside the United States merely because the money originated outside the United States.[199] Rather, many countries impose limits on the extent to which they will seek to tax business income relating to transactions on their territory. One such approach, as evidenced in Articles 5 and 7 of the *OECD Model Tax Convention,* is to tax business profits of an enterprise only where that enterprise carries on business through a permanent establishment, and only to the extent those profits are attributable to that permanent establishment.

8.100 The parties have debated at length the issue of "permanent establishment". The United States, in particular, has argued that "[a] number of nations have broader jurisdiction under their tax laws to reach income of non-residents than that prescribed by the concept of 'permanent establishment'..."[200] We do not dispute this contention. Nevertheless, we observe that many countries appear to have rules concerning the taxation of certain earnings of foreign entities that are based on the "permanent

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(*US Senate Report on the FSC Repeal and Extraterritorial Income Exclusion Act*, S. Rep. No. 106-416 (2000) ("*Senate Report*") (Exhibit US-2), page 2; and *House Report*, Exhibit US-3, page 10. Also see, for example, *House Report*, page 18.) These references are not, in our view, decisive or conclusive here. They appear primarily to explain why foreign tax credits are disallowed, that is, to avoid a situation where foreign tax credits would be granted in respect of taxes on income that was, in any event, excluded from taxation in the United States. We further note that the stated purpose of the Act was, according to the *House Report*, "to comply with decisions of a World Trade Organization dispute panel and Appellate Body". *Id.*, p. 9.

[198] Act, section 3; section 943(a) IRC.

[199] We note, in any event, the US contention that "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." (US response to Panel Question 11, Annex F-3, para. 22). Thus, even if we were to accept this US view, the Act would nevertheless be overbroad in this respect as a measure to avoid double taxation.

[200] US oral statement, Annex D-3, para. 127.

establishment" principle or on an analogous basis. In fact, we note that the bilateral tax treaties of the United States and a number of other countries largely rely on this approach.[201] Thus, in cases where the United States maintains either a bilateral tax treaty reflecting the "permanent establishment" approach or the country in question has incorporated the concept of "permanent establishment" in its legislation, there is no potential for double taxation in the absence of a permanent establishment. The Act, however, contains no requirement that excluded income be derived from a permanent establishment. It may thus be anticipated that the Act will, in a range of situations, exclude from taxation income that could not, in any event, be taxed in the foreign jurisdiction in question.

8.101 We note the United States' contention that the foreign economic processes requirement in section 942(b) IRC is an indication that extraterritorial income must involve some foreign economic activity, as well as the US statement that "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 subject to foreign taxation".[202] We further note that, while the foreign economic processes referred to and required by the Act must be performed outside the United States, the Act allows the solicitation or negotiation of a given contract to be conducted by the taxpayer or any person acting under a contract with such a taxpayer and that a taxpayer is treated as meeting the requirements with respect to activities relating to qualifying foreign trade property if any related person has met the requirements in a given transaction.[203] We take these as further indications that the Act does not require that excluded income be derived from a permanent establishment, and this indicates that the Act would exclude from taxation income that could not, in any event, be taxed in many of the foreign jurisdictions in question. Moreover, the foreign economic process requirements are not applicable to entities earning less than $5 million, thus indicating that for US taxpayers with earnings under this threshold no foreign economic processes creating any degree of "nexus" whatsoever with any foreign taxing regime need occur.

8.102 We recall our observation above that many countries impose limits on the extent to which they will seek to tax business income relating to transactions on their territory, and the *OECD Model Tax Convention* is reflective of one approach that contemplates taxation of business profits of an enterprise only where that enterprise carries on business through a permanent establishment, and only to the extent those profits are attributable to that permanent establishment. We understand the concept of profits "attributable to" a permanent establishment to refer to income bearing some relationship to the level of economic activity conducted through the permanent establishment. In this regard, we note that the costs incurred in conducting the foreign economic processes required by the Act need not bear any direct proportional relationship to the amount of "extraterritorial" income that may ultimately be excluded under the Act.[204]

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[201] See e.g. US oral statement, Annex D-3, para. 127; United States Model Tax Convention, Exhibit EC-13.

[202] eg US response to EC Question 20, Annex F-4, para. 31.

[203] Act, section 3; section 942(b)(2)(A)(i) and 942(b)(4) IRC.

[204] We note that one of the three bases for calculating qualifying foreign trade income under the Act is 30 per cent of "foreign sale and leasing income" (Act, section 3; section 941(a)(1)(A) IRC). Under the Act, "foreign sale and leasing income" is defined as foreign trade income "properly allocable" to certain enumerated foreign economic processes *or* as foreign trade income derived by the taxpayer in connection with the lease or rental of certain qualifying foreign trade property, and also includes any foreign trade income derived from the sale of such property (Act section 3; section 941(c) IRC). The other two bases for calculating qualifying foreign trade income under the Act contain no reference to any relationship between the foreign economic processes and the amount of income that may ultimately be "excluded" (that is, provided the "threshold" requirements of Act, section 3; section 942(b) IRC relating to foreign economic processes are fulfilled). We recall that a taxpayer may compute its qualifying foreign trade income on one of the three enumerated bases other than the one resulting in the greatest amount of such income (Act, section 3; section 941(A)(2) IRC). We consider that these elements support the proposition that the foreign economic processes need not bear any direct proportional relationship to the amount of income ultimately excluded. We underline that it is not this element of our

8.103 We do not mean to suggest that the absence of a permanent establishment requirement in the Act in itself means that the Act is not a measure to avoid double taxation within the meaning of footnote 59. We are conscious of the fact that "there are differing views and practices among countries as to what brings a non-resident enterprise within a country's taxing authority".[205] While we believe that the Act probably pushes close to the outer limit of the income that might be subject somewhere by some other jurisdiction to taxation, we do not preclude that the broad scope of the Act might nevertheless be justified as a "prophylactic", "preventive" measure to avoid double taxation.[206] We find it difficult, however, to reconcile the asserted desire of the United States to take such a prophylactic, preventive approach with the fact that the Act is in key respects quite narrow, excluding from "extraterritorial income" a wide range of income that could be subject to double taxation. It is to this issue that we now turn.

8.104 It is in our view striking that "extraterritorial income" does not include a range of income which is potentially subject to taxation in other jurisdictions. In this respect, we first note that the Act excludes entirely from "extraterritorial income" income related to sales *within* the United States or to sales outside the United States not meeting the foreign articles/labour limitation.[207] Furthermore, the Act makes access to the special tax treatment subject to several highly selective conditions. These are the conditions relating to ultimate use outside the United States[208] and the foreign articles/labour limitation. In addition, for example, Section 943(a)(3) of the Act stipulates that certain property is "excluded property", and not included in the term "qualifying foreign trade property". Such property includes, *inter alia*, "oil and gas (or a primary product thereof");[209] and "any unprocessed timber which is a softwood".[210] Moreover, the Act provides that the President may designate property that might otherwise constitute qualified foreign trade property as property in "short supply".[211] During the period that it is so designated, the property shall not be treated as "qualifying foreign trade property" and is therefore not eligible for the tax treatment. These additional narrowing conditions are manifestly and entirely unrelated to the source of the income or the potential for double taxation and seem to relate to other policy concerns of the United States government.[212] Indeed, the range of selective conditions in the Act is inconsistent with the US characterization of the Act as constituting a "prophylactic step[] to prevent [its] taxpayers from being subjected to taxation both at home and in a foreign jurisdiction."[213]

8.105 Finally, we observe that the United States has numerous bilateral tax treaties with other countries that rely upon the foreign tax credit approach to avoiding double taxation.[214] The scope of

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examination, in isolation, that leads us to reach our findings, but rather this element taken together with other elements of our examination, see e.g. *supra*, para. 8.97.

[205] US oral statement, Annex D-3, para. 128.

[206] US oral statement, Annex D-3, para. 22.

[207] As the European Communities argues in its response to Panel Question 5, Annex F-1, para. 21, even for foreign-produced goods, some of the income could be US-source income (i.e. a US company distributing foreign-made goods).

[208] We note that the tax exclusion is available in respect of income derived from certain transactions involving qualifying foreign trade property, as well as from certain services (see *supra*, note 23). We observe that the structure and design of the Act relating to the treatment of services is similar to that of the treatment of goods in that access to the tax exclusion is subject to highly selective conditions. For example, the Act limits the definition of "foreign trading gross receipts"-- which may give rise to excluded extraterritorial income -- so as not to include qualifying foreign trade property or services for ultimate use in the United States. See Act, section 3; section 942(a)(2)(A)(i) IRC.

[209] Act, section 3; section 943(a)(3)(C) IRC.

[210] Act, section 3; section 943(a)(3)(E) IRC.

[211] See Act, section 3; section 943(a)(4) IRC.

[212] We note that the United States submitted, in response to questions from the EC, that "[n]either the Act nor the legislative history of the Act … articulates the legislative intent behind…" these sections of the IRC. See US responses to Questions from the EC, Annex F-4, para. 8.

[213] US oral statement, Annex D-3, para. 22.

[214] US oral statement, Annex D-3, para. 127.

the Act is not designed to cover, in particular, situations where such a tax treaty is not in place.[215] We are cognizant that some countries may utilize several means to avoid double taxation simultaneously[216], and do not mean to suggest that the last sentence of footnote 59 only applies to measures that are "necessary"[217] to avoid double taxation. We do consider, however, that the existence of this extensive system of bilateral agreements addressing double taxation, combined with the fact that the Act does not target those situations where such bilateral agreements were not in place, represents an additional element relevant to our consideration as to whether the Act was "intended and designed" to serve as a measure to avoid the double taxation of foreign-source income.

8.106 Put simply, the question we have posed is whether legislators concerned with avoiding the double taxation of foreign-source income might reasonably have been expected to draft legislation such as the Act. In our view, and for the reasons set forth above, the answer is no.

8.107 In light of these considerations, we find that the Act fails to fall within the scope of the fifth sentence of footnote 59 because it is not a measure to avoid the double taxation of foreign-source income within the meaning of the fifth sentence of footnote 59.

8.108 As we have found that the Act does not fall within the scope of the fifth sentence of footnote 59, we do not believe that it is necessary to reach the issue of whether the fifth sentence of footnote 59 also falls within the scope of footnote 5 of the *SCM Agreement*.

3. Claim under Article 3.2 of the *SCM Agreement*

8.109 The European Communities alleges that the Act grants and maintains subsidies contrary to Article 3.2 of the *SCM Agreement*.[218] The United States does not specifically contest that if it were found to be in violation of its obligations under Article 3.1, it would also be in violation of its obligations under Article 3.2. That provision states:

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

8.110 The parties submitted no additional or separate argumentation on this claim relating to any independent violation of this provision. We therefore view this claim as wholly dependent upon our resolution of the claims under Article 3.1 of the *SCM Agreement*. Recalling our finding that the Act involves prohibited export subsidies in breach of Article 3.1(a) of the *SCM Agreement* by reason of the requirement of "use outside the United States", we find that by maintaining the subsidies under the

[215] We note that section 3 of the Act, section 942(a)(3) IRC, allows taxpayers the option to exclude any transaction from giving rise to foreign trading gross receipts and thus from the exclusion for extraterritorial income. We recall that the United States cites "legislative history" to the effect that: "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" (US response to EC Question 5, Annex F-4, citing *Senate Report* (Exhibit US-2), *supra*, note 197, page 8; and *House Report*, (Exhibit US-3), *supra*, note 197, page 21. We further note that tax credits are not available for excluded extraterritorial income, pursuant to Act, section 3; Article 114(d) IRC. See *supra*, note 197.

[216] The United States points to the Commentary to Article 23 of the *OECD Model Tax Convention* for the proposition that countries may "offer a mix of exemptions and exclusions as well as foreign tax credits" (US oral statement, Annex D-3, para. 122). Although it is not dispositive to our analysis, we note that the Commentary (para. 31) merely states that "Contracting States may use a combination of the two methods". It does not explicitly state that Contracting States may offer taxpayers a choice between two *alternative* methods with respect to particular income.

[217] US oral statement, Annex D-3, para. 144. We observe that the term "necessary" appears in other provisions of the *GATT 1994*, for example, paragraphs (a), (b) and (d) of Article XX. The term "necessary" does not appear in the fifth sentence of footnote 59. As we have discussed above, *supra*, paras. 8.94 *ff*., the fifth sentence of footnote 59 refers to measures taken "to avoid" the double taxation of foreign source income.

[218] EC first written submission, Annex A-1, para. 186.

Act, the United States has acted inconsistently with its obligation under Article 3.2 of the *SCM Agreement* not to maintain subsidies referred to in paragraph 1 of Article 3 of the *SCM Agreement*.

4. Claims under the *Agreement on Agriculture*

8.111 We turn to consider the claim by the European Communities that, by reason of the requirement of use outside the United States, the Act gives rise to export subsidies within the meaning of the *Agreement on Agriculture*, and that the subsidies it provides are contrary to Articles 10.1 and 8 thereof.

8.112 The European Communities submits that, as export subsidies are conferred within the meaning of the *SCM Agreement*, there is no reason that they are not also conferred within the meaning of the *Agreement on Agriculture*. The European Communities argues, on the basis of the Appellate Body's reasoning in the original dispute, that the Act involves export subsidies and also creates a legal entitlement for companies to receive these subsidies. This must “at the very least” threaten to lead to circumvention of export subsidy commitments. In the EC view, it is therefore inconsistent with Articles 10.1 and 8 of the *Agreement on Agriculture*.[219]

8.113 The United States contends that, as the Act's exclusion of extraterritorial income does not constitute an export subsidy within the meaning of Articles 1 and 3.1(a) of the *SCM Agreement*, it also does not constitute an export subsidy under Article 1(e) of the *Agreement on Agriculture*. Thus, the United States argues, there is no violation of the *Agreement on Agriculture*.

8.114 Article 1(e) of the *Agreement on Agriculture* states:

> "(e) "export subsidies" refers to subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement;"

Article 10.1 of the *Agreement on Agriculture* provides:

> "1. Export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments; nor shall non-commercial transactions be used to circumvent such commitments."

Article 8 of the *Agreement on Agriculture* reads:

> "Each Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member's Schedule."

8.115 The question for determination is thus whether, for the purposes of the anti-circumvention provisions of Article 10.1 of the *Agreement on Agriculture*, the subsidies to which the Act gives rise constitute subsidies contingent on export performance (other than those listed in Article 9.1 of the Agreement) as defined in Article 1(e) of the *Agreement on Agriculture*.

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[219] The European Communities did not assert that the Act involved subsidies listed in Article 9.1 of the *Agreement on Agriculture*. It did, however, make an alternative claim under Articles 3.3, and 8 in conjunction with Article 9.1, of the *Agreement on Agriculture*, which claim was only applicable in the event that the United States so asserted. See EC first written submission, Annex A-1, para. 231. As neither party asserts that the Act involves export subsidies listed in Article 9.1 (see also US first written submission, Annex A-2, note 210) we do not address this alternative argument.

8.116 In line with the decision of the Appellate Body in the original dispute concerning the scope and application of Article 10.1 of the *Agreement on Agriculture*[220], we consider that our reasoning and conclusions with respect to Articles 1.1 and 3.1(a) of the *SCM Agreement*[221], are also applicable as regards whether the Act gives rise to subsidies contingent upon export performance within the meaning of Article 1(e) of the *Agreement on Agriculture* for the purposes of Article 10.1 of the *Agreement on Agriculture*. Consequently, we find in the circumstances of the present case that the Act also involves subsidies contingent upon export performance within the meaning of Article 1(e) of the *Agreement on Agriculture* for the purposes of Article 10.1 of the *Agreement on Agriculture*.[222]

8.117 Turning to the issue of whether the export subsidies are "applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments" within the meaning of Article 10.1 of the *Agreement on Agriculture*, we derive guidance from the approach of the Appellate Body in the original dispute and consider the structure and other characteristics of the measure.[223] We recall that the term "export subsidy commitments", defining the obligations that are to be protected under Article 10.1 of the *Agreement on Agriculture*, "… covers commitments and obligations relating to *both* scheduled and unscheduled agricultural products".[224]

8.118 We note that the Act creates a legal entitlement for recipients to receive export subsidies, not listed in Article 9.1[225], with respect to both scheduled and unscheduled agricultural products. Upon fulfilment by the taxpayer of the conditions stipulated in the Act, the United States government must provide the tax exclusion. As there is no limitation on the amount of extraterritorial income, and thus on the amount of qualifying foreign trade income, that may be claimed in respect of eligible transactions, the amount of export subsidies is unqualified.[226]

8.119 Thus, with respect to *unscheduled* agricultural products, we believe that the Act involves the application of export subsidies, *not* listed in Article 9.1, in a manner that, at the very least, "threatens to lead to circumvention" of that "export subsidy commitment" in Article 3.3.

8.120 With respect to *scheduled* agricultural products, we observe that the measure allows for the provision of an unlimited amount of subsidies, and scheduled agricultural products may, therefore, benefit from those subsidies even after the reduction commitment levels specified in the United States' Schedule for those agricultural products have been reached. Thus, we find that the Act is applied in a manner that, at the very least, threatens to lead to circumvention of the export subsidy commitments made by the United States, under the first clause of Article 3.3, with respect to scheduled agricultural products.[227]

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[220] Original Appellate Body Report, *supra*, note 1, paras. 133-154.

[221] *Supra*, paras. 8.43, 8.75.

[222] The parties disagree as to whether the subsidy under the Act could ever in practice be available in respect of agricultural products produced abroad. While the United States contends that an agricultural product produced abroad could satisfy the 50 per cent limit on certain foreign value, and, thus, could be eligible for the Act's exclusion, the European Communities underlines the obstacles to the availability of the subsidy in respect of an agricultural product produced abroad, and argues that taxpayers will be "well advised to turn to US production if they wish to be able to rely on the benefits of the FSC Replacement scheme." EC comments on US response to EC Question 19, Annex F-5, para. 80 ff. In this context, we recall our finding *supra*, para. 8.64 that the fact that the subsidy is also available with respect to goods produced outside the United States -- that do not necessitate export -- does not, in our view, vitiate the export-contingency of the scheme that we find in respect of US-produced goods and thus does not cure the inconsistency of the Act with Article 3.1(a) of the *SCM Agreement* by reason of the requirement of "use outside the United States". Thus, we need not resolve this issue.

[223] Original Appellate Body Report, *supra*, note 1, para. 149.

[224] Original Appellate Body Report, *supra*, note 1, paras. 144-147.

[225] See *supra*, note 219.

[226] See also original Appellate Body Report, *supra*, note 1, para. 149.

[227] Original Appellate Body Report, *supra*, note 1, para. 152.

8.121 We note that, in these proceedings, the United States does not contest that, if the measure gives rise to subsidies contingent upon export performance under the *Agreement on Agriculture*, then these subsidies would violate its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture*.

8.122 We therefore conclude that the United States has acted inconsistently with its obligations under Article 10.1 of the *Agreement on Agriculture* by applying the export subsidies, with respect to both scheduled and unscheduled agricultural products, in a manner that, at the very least, threatens to circumvent its export subsidy commitments under Article 3.3 of the *Agreement on Agriculture*. Furthermore, by acting inconsistently with Article 10.1, the United States has acted inconsistently with its obligation under Article 8 of the *Agreement on Agriculture* "not to provide export subsidies otherwise than in conformity with this Agreement…".

C. FOREIGN ARTICLES/LABOUR LIMITATION

1. Claim under Article III:4 of the *GATT 1994*

8.123 We recall that, under the Act, certain extraterritorial income derived from the sale or lease of "qualifying foreign trade property" is excluded from taxation. “Qualifying foreign trade property” is property made within or outside the United States, and sold for ultimate use outside the United States, no more than 50 per cent of the fair market value of which is attributable to "articles manufactured, produced, grown or extracted outside the United States" and "direct costs for labour . . . performed outside the United States". Thus, the exclusion from taxation provided by the Act is not available in respect of income derived from the sale or lease of property more than 50 per cent of the fair market value of which is attributable to articles made, or costs of direct labour performed, outside the United States.

8.124 The European Communities submits that the foreign articles/labour limitation described above is inconsistent with Article III:4 of the *GATT 1994* as it is a requirement (contained in a law) that provides less favourable treatment to imported parts and materials than to like domestic goods with respect to their internal use in the production of goods within the United States.[228]

8.125 The United States contends, in general, that the European Communities mischaracterizes the Act, and emphasizes that the Act does not require the use of domestic rather than imported goods: goods can meet the foreign articles/labour limitation even if 100 per cent of the fair market value of their inputs is foreign.[229] The United States submits that the Act does not on its face violate Article III:4, and that the European Communities has failed to proffer adequate factual evidence in support of its claim.

8.126 Article III:4 of the *GATT 1994* provides in relevant part:

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

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[228] EC first written submission, Annex A-1, para. 188; EC response to Panel Question 30, Annex F-1, para. 75. The European Communities does not claim that the foreign articles/labour limitation is inconsistent with Article III:4 of the *GATT 1994* as it relates to the production of goods outside the United States (EC response to Panel Question 27, Annex F-1, para. 66).

[229] US first written submission, Annex A-2, paras. 213-215.

8.127 In our examination of the merits of the EC claim under Article III:4, we will examine the following issues: (a) whether the imported and domestic products at issue are "like products"; (b) whether the measure at issue is a "law, regulation, or requirement affecting their internal sale, offering for sale, purchase, transportation, distribution, or use"; and (c) whether the imported products are accorded "less favourable" treatment than that accorded to like domestic products."[230]

8.128 We recall the essence of the Article III:4 obligation that will guide our examination of the EC claim under Article III:4 of the *GATT 1994*, as follows[231]:

> "The "no less favourable treatment obligation" in Article III:4 has been consistently interpreted as a requirement to ensure effective equality of opportunities between imported products and domestic products. In this respect, it has been held that, since a fundamental objective of Article III is the protection of expectations on the competitive relationship between imported and domestic products, a measure can be found to be inconsistent with Article III:4 because of its potential discriminatory impact on imported products.[842] The requirement of Article III:4 is addressed to "relative competitive opportunities created by the government in the market, not to the actual choices made by enterprises in that market".[843] Both in relation to Article III:2 and Article III:4 it has been established that the actual trade effects of a disputed measure are not a decisive criterion in determining whether the requirements of these provisions are met in a given case.[844] Finally, as stated by the Appellate Body, a determination of whether there has been a violation of Article III:4 does not require a separate consideration of whether a measure affords protection to domestic production.[845]
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> [842] Panel Report on *US – Section 337* … paras. 5.11 and 5.13.
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> [843] Panel Report on *US – Malt Beverages*, … para. 5.31.
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> [844] See, e.g., Appellate Body Report on *Japan – Alcoholic Beverages*, … p. 16; Panel Report on *EC – Bananas III (ECU)*, … para. 7.179.
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> [845] Appellate Body Report on *EC – Bananas III*, … para. 216.

8.129 With these considerations in mind, we turn to the first element of our examination of the EC claim under Article III:4 of the *GATT 1994*.

(i) whether the imported and domestic products at issue are "like products"

8.130 The parties differ on the nature of the "like product" analysis required in this case. The European Communities asserts that the distinction operated by the foreign articles/labour limitation relates to the origin of the product and that the mere fact of having US origin is not, as such, apt to

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[230] We recall that the Appellate Body has recently held that: "For a violation of Article III:4 to be established, three elements must be satisfied: that the imported and domestic products at issue are "like products"; that the measure at issue is a "law, regulation, or requirement affecting their internal sale, offering for sale, purchase, transportation, distribution, or use"; and that the imported products are accorded "less favourable" treatment than that accorded to like domestic products." Appellate Body Report, *Korea - Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, ("*Korea -Beef*"), WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001, para. 133. We note that our approach is materially similar to that outlined by the Appellate Body.

[231] Panel Report, *Canada-Certain Measures Affecting the Automotive Industry ("Canada-Autos")*, WT/DS139/AB/R, WT/DS142/AB/R, para. 10.78, adopted 19 June 2000 as modified by Appellate Body Report, *supra*, note 118. The findings of that panel under Article III:4 of the *GATT 1994* were not appealed.

confer upon goods any quality that makes them, by definition, "unlike" any imported goods.[232] The European Communities cites the *European Communities – Parts and Components*[233] panel report for the proposition that it need not, in respect of a measure of general application, compare a certain class of domestic products with the same class of imported products.[234]

8.131 The United States contends that there must be evidence that any particular class of imported goods will be accorded less favourable treatment than a class of domestic like products, and that, as this case involves a generally applicable measure, there is a greater evidentiary burden than in the case of a measure of specific application and evidence must be introduced to establish a "meaningful nexus" between the measure and adverse effects on competitive conditions for a like class of imported goods.[235]

8.132 We view the principal purpose of the "like product" inquiry under Article III:4 of the *GATT 1994* as ascertaining whether any formal differentiation in treatment between an imported and a domestic product could be based upon the fact that the products are different -- i.e. not like -- rather than on the origin of the products involved. We find support for this view in the recent statement by the Appellate Body that under "Article III:4 of the *GATT 1994*, the term "like products" is concerned with competitive relationships between and among products."[236]

8.133 On this basis, we note that the distinction made between imported and domestic products in the Act's foreign articles/labour limitation concerning the limitation on fair market value attributable to "articles" is solely and explicitly based on origin. We do not believe that the mere fact that a good has US origin renders it "unlike" an imported good. We further note that the Act is a measure of general application. It applies horizontally to all possible products that can be used for the production of goods that might eventually be qualifying foreign trade property. Thus, in our view, there is no need to demonstrate the existence of actually traded like products in order to establish a violation of Article III:4.[237] Furthermore, where there are no like US goods, the issue of less favourable treatment of imported goods would not even arise.

8.134 Thus, we do not believe that it is necessary, as the United States argues, that there must be evidence that any particular class of imported goods will be accorded less favourable treatment than a class of like products of national origin. Nor -- as far as the "like product" analysis is concerned -- do we believe that evidence must be introduced to establish a "meaningful nexus" between the measure and adverse effects on competitive conditions for a like class of imported goods just because this case involves a generally applicable measure.[238] Nor do we endorse the US assertion that laws of general

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[232] EC first written submission, Annex A-1, paras. 196-197.

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

[234] EC written rebuttal submission, Annex C-1, paras. 240-241.

[235] US first written submission, Annex A-2, paras. 216-219; US oral statement, Annex D-3, paras. 167, 171.

[236] See Appellate Body Report, *European Communities - Measures Affecting Asbestos and Asbestos-Containing Products*, WT/DS135/AB/R, adopted 6 April 2001, para. 103.

[237] We find support, for example, in Panel Report, *Indonesia - Measures Affecting the Automotive Industry*, WT/DS54/R, WST/DS55/R, WT/DS59/R, WT/DS64/R, adopted 23 July 1998, para. 14.113 ("…an origin-based distinction in respect of internal taxes suffices in itself to violate Article III:2, without the need to demonstrate the existence of actually traded like products"). *See also* Panel Report, *Canada-Autos*, *supra*, note 231, para. 10.74. That panel stated: "It has not been contested that the distinction made between domestic products and imported products in the definition of Canadian value-added is based solely on origin and that, consequently, there are imported products which must be considered to be like the domestic products the costs of which are included in the definition of Canadian value-added."

[238] US first written submission, Annex A-2, paras. 216-219; US oral statement, Annex D-3, para. 167.

applicability have, at most, an indirect impact on imported products and thus engender a greater evidentiary burden than laws of specific application.[239]

8.135 For these reasons, we consider that the "like product" element of Article III:4 is satisfied in this case.

(ii) whether the Act is a "law, regulation or requirement affecting the internal … use" of imported and like domestic products by reason of the foreign articles/labour limitation

8.136 The parties disagree on whether or not, by reason of the foreign articles/labour limitation, the Act is a "law, regulation or requirement affecting the internal … use" of imported and like domestic products within the meaning of Article III:4 of the *GATT 1994*.

8.137 The European Communities states that its 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", and is not claiming that the "tax exemption" as such is a "requirement affecting internal sale" within the meaning of Article III:4.[240] With respect to the term "affecting", the European Communities argues that actual trade effects of the measure need not be established. Rather, according to the European Communities, it is sufficient that the limitation "affects" the competitive position of the imported product on the market.[241] The European Communities states that the Act provides an incentive to source inputs domestically because this will enhance the chances that a US producer will qualify for the tax benefit, and that this is sufficient to violate Article III:4 which guarantees equality of competitive opportunities.[242] For the European Communities, this is the case even if the measure allows for other means to obtain the advantage.[243]

8.138 For the United States, it is difficult to consider how imports could be "affected" by a generally applicable measure like the one at issue.[244] According to the United States, the Act does not affect competitive conditions between imported and like domestic products as it does not require the use of any US-origin goods for a transaction to earn excluded extraterritorial income; goods can meet this requirement even if 100 per cent of the fair market value of their inputs is foreign.[245]

8.139 In considering these issues, we first consider the *form* of the measure in question. We agree with the views expressed in previous GATT and WTO panel reports that Article III:4 applies also to measures in the form of conditions[246] that must be satisfied in order to obtain an "advantage"[247] from the government.

8.140 While we endorse the view of the European Communities that the measure at issue here falls within the scope of the phrase "laws, regulations and requirements" in Article III:4, we are inclined to

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[239] US oral statement, Annex D-3, para. 171.

[240] EC response to Panel Question 18, Annex F-1, paras. 47-48.

[241] EC first written submission, Annex A-1, paras. 198-205.

[242] EC written rebuttal submission, Annex C-1, para. 231.

[243] EC written rebuttal submission, Annex C-1, para. 237, citing Panel Report, *Canada - Autos*, *supra*, note 231, paragraph 10.82.

[244] e.g. US first written submission, Annex A-2, para. 218.

[245] US first written submission, Annex A-2, para. 214; also e.g. US oral statement, Annex D-3, para. 166 *ff*.

[246] See e.g. Panel Report, *Canada – Administration of the Foreign Investment Review Act*, BISD 30S/140, adopted 7 February 1984, paras. 5.4-5.6; Panel Report, *EC – Parts and Components*, *supra*, note 233, para. 5.21; and Panel Report, *Canada – Autos*, *supra*, note 231, para. 10.73.

[247] The term "advantage" has been used in this context in previous GATT and WTO dispute settlement reports: see Panel Report, *Canada – Autos*, *supra*, note 231, para. 10.73; Panel Report, *EC – Parts and Components*, *supra*, note 233, para. 5.21. The term "incentive" is used in the context of the Article III:4 examination by the Appellate Body in Appellate Body Report, *EC - Bananas*, *supra*, note 251, para. 213.

believe that the three separate elements identified in this phrase in Article III:4 deal with the *form* rather than the *content* of the measure under examination. We observe that the foreign articles/labour limitation is a statutory provision, that is, a requirement included in the Act, which is a generally applicable "law". At any rate, regardless of whether the measure at issue is a "law" or a "requirement", we agree with the view expressed by the European Communities that the "standard laid down in Article III:4 of GATT 1994 is the same both for "laws" and "requirements"".[248]

8.141 We recall the European Communities' statement that its 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".[249] The European Communities clarifies 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 the *GATT 1994*.[250] In this regard, we note that the measure in question in an Article III:4 examination may condition access to an advantage or incentive bestowed by the government. We consider that the nature of the "advantage" ultimately sought from (or "incentive" ultimately bestowed by) the government when a certain "requirement" is voluntarily accepted in order to obtain the "advantage" or "incentive" is not relevant for the purposes of an enquiry under Article III:4 of the GATT 1994. In particular, it is not relevant that we are dealing here with a measure that conditions access to an income tax advantage to a "firm".

8.142 In this connection, we can see no specification or limitation in the text of Article III:4 concerning the type of advantage linked to the measure under examination under Article III:4 of the *GATT 1994*. Thus, nothing in the plain language of the provision specifically excludes requirements conditioning access to income tax measures from the scope of application of Article III, which deals with "national treatment on internal taxation and regulation".

8.143 In terms of context, we note that Article XIV(d) of the *General Agreement on Trade in Services* (the "*GATS*"), entitled "General Exceptions", stipulates that nothing in that Agreement shall be construed to prevent the adoption or enforcement by any Member of measures inconsistent with the "national treatment" obligations in Article XVII, "provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members." This implies to us that a direct income tax measure would generally be covered by Article XVII of the *GATS*. We base this view on the following reasoning: unless a direct income tax measure were within the ambit of that provision, the Uruguay Round negotiators would not have deemed it necessary to create such an explicit "exception" when drafting the relevant provisions of the *GATS*. Clearly, provisions relating to national treatment under the *GATS* were modelled after Article III of the *GATT* and reflect jurisprudence developed thereunder. This contextual element, therefore, supports our view that the obligation in Article III:4 of the *GATT 1994* is not so circumscribed.

8.144 Furthermore, the terms "law, regulation or requirement affecting…" in Article III:4 are general terms that have been interpreted as having a broad scope.[251] If measures conditioning access to income tax advantages in respect of certain products were excluded from the scope of Article III:4, a wide range of trade-distortive measures with enormous economic and commercial implications would, in effect, be given a safe haven, while measures not linked to income tax advantages and perhaps associated with a lesser extent of trade distortion would be subject to the disciplines of Article III:4. It seems to us that such a interpretation runs counter to the object and purpose of the

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[248] See EC response to Panel Question 31, Annex F-1, para. 79.

[249] EC response to Panel Question 18, Annex F-1, paras. 47-48.

[250] *Ibid.*

[251] Appellate Body Report, *European Communities - Measures Affecting the Importation, Sale and Distribution of Bananas*, adopted 25 September 1997, WT/DS27/AB/R, para. 220. See also Panel Report, *Canada-Autos, supra*, note 231, para. 10.80; Panel Report, *Italian Agricultural Machinery*, BISD 7S/60, adopted 23 October 1958, para. 12.

GATT and the *WTO Agreement* (including the "elimination of discriminatory treatment" in international trade[252]) and can hardly have been what the drafters intended. On the basis of the text and context of Article III:4 in light of the object and purpose of the *GATT* and the *WTO Agreement*, we therefore consider that Article III:4 of the *GATT 1994* applies to measures conditioning access to income tax advantages in respect of certain products.

8.145 We take note of the preparatory work for the Havana Charter referred to by the United States in these proceedings. In response to Panel questioning, the United States states that "there is support in the history of the GATT that Article III:4 was never intended to apply to income taxes". According to the United States, the Reports of the Havana Convention at which Article 18 of the Havana Charter[253] 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".[254] This statement in the preparatory work of the Havana Charter does not change our view that the scope of Article III:4 of the *GATT 1994* includes measures conditioning access to income tax advantages in respect of certain products. While seemingly framed in general terms, this statement appears[255] in a section containing comments on paragraphs 1, 2 and 3 of Article 18 and thus seems to relate to what would later become Article III:2 of the GATT. It therefore would not be decisive concerning the scope of Article III:4, in any event. Moreover, the statement was made in relation to the withdrawal of a specific proposal by Peru dealing with a situation materially different than the one currently before us (not deeming as "in opposition to" Article 18 the exemption of import duties on equipment or materials and exemption from income taxes granted for a limited time to enterprises created for the establishment of "economically sound industries").[256] However, even if the statement was meant to refer more generally to what would later become Article III as a whole (including Article III:4), if taken literally, it would entirely exclude an area that was explicitly covered by Article 18 of the Havana Charter, and now Article III:4 of the GATT: i.e., internal regulation (it suffices here to recall that Article III of the GATT 1994 is entitled: "National Treatment on Internal Taxation and Regulation"), which would amount to a result that clearly runs counter to the object and purpose of Article III and of the *GATT 1994* in general. Therefore, the statement in the preparatory work of the Havana Charter does not change our view that Article III:4 of the GATT 1994 applies to measures conditioning access to income tax advantages in respect of certain products.[257]

8.146 Finally, we observe that previous panels have been of the view that the scope of Article III:4 extended to measures conditioning access to income tax advantages in respect of certain products. Indeed, one WTO panel has observed that, "subsidies granted in respect of direct taxes are generally

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[252] See preamble to the *GATT 1947* and the *Marrakesh Agreement Establishing the World Trade Organization*.

[253] *Final Act of the United Nations Conference on Trade and Employment*, March 24, 1948.

[254] In its response to Panel Question 18, the United States cites to the 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.

[255] See *ibid*.

[256] See Third Committee: Commercial Policy, Revised Annotated Agenda for Chapter IV, Proposed Amendment by Peru, E/Conf.2/C.3/6/Add. 2, 17 December 1947.

[257] Furthermore, we note that in accordance with the customary rules of interpretation of public international law as codified in Articles 31 and 32 of the *Vienna Convention on the Law of Treaties*,

> "Recourse may be had to supplementary means of interpretation, including the preparatory work of a treaty … 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."

Here, we do not consider that the ordinary meaning of the text of Article III:4, in its context and in light of the object and purpose of the *GATT 1994* and the *WTO Agreement* to be "ambiguous or obscure" or that our interpretation of that provision "leads to a result which is manifestly absurd or unreasonable". We are therefore of the view that it is not even necessary to refer at all to the preparatory work.

not covered by Article III:2, but may infringe Article III:4 to the extent that they are linked to other conditions which favour the use, purchase, etc. of domestic products."[258] We also note that provisions relating to eligibility for an import duty exemption (an area also referred to in the preparatory work cited by the United States as not falling within the scope of Article 18 of the Havana Charter) were at issue in the Article III:4 inquiry by the panel in *Canada-Autos.*[259]

8.147 We next examine whether the measure at issue is one "affecting" the internal sale or use of the products concerned. We recall here the Appellate Body's observation that the ordinary meaning of the word "affecting" implies a measure that has "an effect on" and thus indicates a broad scope of application.[260] Further, we observe that the term "affecting" in Article III:4 of the *GATT 1994* has been interpreted to cover not only laws and regulations which directly govern the conditions of sale or purchase but also any laws or regulations which might adversely modify the conditions of competition between domestic and imported products.[261]

8.148 We consider that a measure pursuant to which the use of domestic -- but not imported -- products contributes to obtaining an advantage has an impact on the conditions of competition between domestic and imported products and thus "affects" the internal "use" of imported products, *even if* the measure allows for other means to obtain the advantage, such as the use of domestic inputs other than products.[262] Under the Act, by reason of the foreign articles/labour limitation, the use of US-origin products contributes to obtaining the exclusion while the use of imported products does not. Thus, we consider that it is a measure which "affects" the internal use of imported products even if ways -- other than the use of goods -- exist to impute permissible fair market value.

8.149 For these reasons, we find that, by reason of the "foreign articles/labour limitation", the Act is a "law, regulation or requirement" that affects the internal "use" in the United States of imported goods and like domestic products for use in the production of qualifying foreign trade property.

(iii) whether the Act accords imported products "less favourable" treatment than that accorded to like domestic products by reason of the foreign articles/labour limitation

8.150 The parties disagree as to whether or not the Act accords less favourable treatment than that accorded to like domestic products by reason of the foreign articles/labour limitation.

8.151 The European Communities argues that in all cases, the "foreign articles/labour limitation" will act as an incentive to source inputs domestically because this will enhance the chances of a US producer intending to export its goods to qualify for the tax benefit.[263] According to the European Communities, this is sufficient to violate Article III:4, which guarantees equality of competitive opportunities. While the European Communities recognizes that the Act does not oblige a US producer to use US inputs, the European Communities argues that this is in many cases one of the necessary conditions for obtaining the advantage, and in all other cases the scheme encourages the use of US goods over foreign goods.[264] Thus, the Act gives "less favourable treatment" to imported goods. In any event, the European Communities considers that, under Article III:4, "[a]ny individual

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

[259] *Supra*, note 231.

[260] Appellate Body Report, *European Communities - Bananas*, *supra*, note 251 ,para. 220. See also Panel Report, *Canada-Autos*, *supra*, note 231, para. 10.80.

[261] Panel Report, *Italian Agricultural Machinery*, *supra*, note 251, para. 12; see also Panel Report, *Canada-Autos*, *supra*, note 231, para. 10.80.

[262] See Panel Report, *Canada-Autos*, *supra*, note 231, para. 10.82.

[263] EC first written submission, Annex A-1, paras. 205, 207, 208; EC written rebuttal submission, Annex C-1, para. 231.

[264] EC first written submission, Annex A-1, paras. 191-195; EC second written submission, Annex C-1 para. 231; EC oral statement, Annex D-1, para. 82; EC closing oral statement, Annex D-2, paras. 32-34.

product must be treated no less favourably than a like domestic product -- and this in all cases, for all transactions".[265]

8.152 The core of the US response to this claim hinges on its argument that no less favourable treatment is afforded to imported goods because the foreign articles/labour limitation does not change or affect the conditions of competition. According to the United States, taxpayers are under no obligation to use domestic content.[266] The United States contends that the Act does not require the use of any US-origin goods for a transaction to earn excluded extraterritorial income[267], but rather provides that up to 50 per cent of the fair market value of the goods involved in a transaction may be attributable to articles produced outside the United States and direct labour costs incurred outside the United States. The US underlines, and deems it fundamental, that goods can meet this requirement even if 100 per cent of the fair market value of their inputs is foreign.[268]

8.153 With these considerations in mind, we examine the text of the foreign articles/labour limitation in the Act to see whether it adversely affects the equality of competitive opportunities of imported products in relation to like domestic products and thus affords less favourable treatment to imported products than to like domestic products within the meaning of Article III:4 of the *GATT 1994*.

8.154 We observe that we are dealing here with a statutory requirement that is expressly and explicitly origin-based: there is an explicit reference in the Act to articles manufactured or produced "outside", as opposed to within, the United States. We are well aware, however, that any distinction that is based exclusively on criteria relating to the nationality or origin of the product will not necessarily be incompatible with Article III.[269] Article III:4 requires rather that a measure accord treatment to imported products that is “no less favourable than” that accorded to like domestic products. Therefore, we do not halt our examination here.

8.155 We further observe that the foreign articles/labour limitation explicitly places a limit on the proportion of the fair market value of a product that can be derived from imported products (and foreign labour) only, and places no similar constraint on the proportion of the fair market value of a product that can be derived from domestic products (and labour).

8.156 We note that the use of imported products by a manufacturer in the US cannot contribute to the fulfilment of the foreign articles/labour limitation -- a condition necessary to obtain the advantage in the form of the exclusion from tax of the portion of extraterritorial income that is qualifying foreign trade income available under the Act -- whereas the use of domestic products can. Thus, an advantage is conferred upon the use of domestic products that is not conferred upon the use of imported products. This constitutes a formal differentiation of treatment between imported and like domestic products which, in our view, affords less favourable treatment to imported products than to like domestic products.

8.157 At the heart of the US argument in response to this claim is its assertion that the foreign articles/labour limitation does not necessarily require the use of US-origin goods. Thus, more than

[265] EC first written submission, Annex A-1, para. 211.

[266] US oral statement, Annex D-3, para. 166.

[267] US first written submission, Annex A-2, para. 214.

[268] The United States submits that the foreign articles/labour limitation takes into account only the value of foreign articles and direct labour costs in producing a finished product, but does not limit other foreign value. Thus, the United States submits, the remaining 50 per cent of fair market value of the finished product can be attributed to non-tangible elements, including intellectual property rights, goodwill, capital, marketing, distribution and other services, which may be of either US or foreign origin. According to the United States, the articles used in manufacturing, whatever their origin, account for only part of the total value. See e.g. United States first written submission, Annex A-2, para. 201.

[269] See Appellate Body Report, *Korea-Beef*, *supra*, note 230, paras. 137-138.

50 per cent of the fair market value of "qualifying foreign trade property" could be attributable to US or foreign intellectual property, goodwill, capital, marketing, distribution or other services. However, we are of the view that the existence of other ways to impute value does not change the fundamental fact that, as far as goods are concerned, the foreign articles/labour limitation creates an incentive to use domestic rather than imported goods. That there may exist other ways to impute permissible fair market value in order to obtain qualifying foreign trade property does not vitiate the fact that this incentive inherently advantages domestic goods and that less favourable treatment is thereby accorded to imported goods than to domestic goods.

8.158 In light of these considerations, we consider that, by reason of the foreign articles/labour limitation, the Act accords less favourable treatment within the meaning of Article III:4 of the *GATT 1994* to imported products than to like products of US origin because, by conferring an advantage upon the use of products of US origin but not upon the use of imported products, it adversely affects the equality of competitive opportunities of imported products in relation to like products of United States origin.

8.159 We wish to point out that the United States argument that the European Communities has presented insufficient factual evidence in support of its claim of inconsistency of the Act, by reason of the foreign articles/labour limitation, with Article III:4 of the *GATT 1994* is not germane to our examination. In order to reach our finding of *de jure* violation of Article III:4, we take note of, but need not rely on, the evidence submitted by the European Communities indicating that in certain cases, the foreign articles/labour limitation would appear to *require* the use of a certain amount of US articles. The "less favourable treatment" we have found arises by necessary implication from the words actually used in the text of the foreign articles/labour limitation in the Act. We recall that Article III:4 of the *GATT 1994* is an obligation addressed to governments requiring that they ensure equality of competitive opportunities to domestic and like imported products. It does not require a demonstration of trade effects, nor proof that the sourcing decisions of private firms have actually been impacted by the requirement in question.[270]

2. Other claims

8.160 We note that the European Communities has also alleged that the "extended" subsidy, in respect of goods produced outside the United States, is prohibited because it will often be necessary to use US articles (and therefore exports) in order to satisfy the "foreign articles/labour limitation"[271], and that "[t]he foreign content limitation in the FSC Replacement scheme renders the basic FSC Replacement subsidy (and the extended FSC Replacement subsidy, if this is not contrary to Article 3.1(a)) contingent upon the use of US over imported goods contrary to Article 3.1(b) of the *SCM Agreement*."[272]

8.161 We recall that we need not examine all legal claims before us. Rather, we need only address those claims that must be addressed in order to resolve the matter in issue in the dispute[273], provided that we address those claims on which a finding is necessary in order to enable the DSB to make

[270] We find support for this view in Panel Report, *Canada-Autos*, *supra*, note 231, para. 10.84 and para. 10.78, Appellate Body Report, *Japan – Alcoholic Beverages, supra*, note 197, pp. 16-17.

[271] EC response to Panel Question 1, Annex F-1, paras. 1-4.

[272] EC first written submission, Annex A-1, para. 259.

[273] Appellate Body Report, *United States - Measure Affecting Imports of Woven Wool Shirts and Blouses from India*, WT/DS33/AB/R, adopted 23 May 1997, p. 19. See also e.g. Appellate Body Report, *Canada - Autos, supra*, note 118, paras. 112-117, where the Appellate Body refers to and endorses that panel's exercise of the "discretion" implicit in the principle of judicial economy.

sufficiently precise recommendations and rulings so as to allow for prompt compliance by a Member in order to ensure effective resolution of disputes to the benefit of all Members.[274]

8.162 In light of our finding that the Act is inconsistent with Article III:4 of the *GATT 1994* by reason of the "foreign articles/labour limitation" in respect of US-produced goods[275], we do not consider it necessary to also address the EC claim that the Act is inconsistent with Article 3.1(b) of the *SCM Agreement* by reason of the foreign articles/labour limitation in respect of US-produced goods.

8.163 With respect to the elements of the Act challenged by the European Communities in its claim under Article 3.1(a) of the *SCM Agreement* in respect of foreign-produced goods, we understand the European Communities to allege, in effect, that US-produced inputs that are used to produce qualifying foreign trade property outside the United States receive a subsidy contingent upon export performance. Under the current scheme, to the extent that a supplier of such inputs may be seen as receiving a "subsidy", it would be entitled to receive that subsidy irrespective of whether the inputs were used to produce qualifying foreign trade property within the United States *or* outside the United States. In order to decide the EC claim, we would be required to assume a different scheme, that is, where an input supplier might be seen as entitled to a "subsidy" *only* where the inputs were supplied for use in production of qualifying foreign trade property *outside* the United States (i.e. a scheme devoid of a foreign articles/labour limitation in respect of qualifying foreign trade property produced *within* the United States, which currently constitutes an integral part of the measure). However, such a significantly transformed measure would be manifestly different from the measure that is currently before us, and, as such, we consider that it would be neither necessary or appropriate to rule on it. With respect to the European Communities' alternative claim under Article 3.1(b) of the *SCM Agreement*, the European Communities asks us "to consider the application of the foreign content limitation in the case of non-US producers only if [we are] of the view that this limitation does not make the extended FSC Replacement subsidy contingent upon export performance contrary to Article 3.1(a)."[276] As we have not ruled on the EC claim under Article 3.1(a), it would therefore be inappropriate for us to rule on the *alternative* EC claim under Article 3.1(b) of the *SCM Agreement*.

D. TRANSITIONAL ISSUES

8.164 In our Report in the original dispute, we recommended "that the DSB request the United States to withdraw the FSC subsidies without delay"[277], and specified that "FSC subsidies must be withdrawn at the latest with effect from 1 October 2000".[278] These elements formed part of the DSB recommendations and rulings arising upon adoption, on 20 March 2000, of the original Panel and Appellate Body Reports. On 12 October 2000, the DSB acceded to the United States' request "that the DSB modify the time-period in this dispute so as to expire on 1 November 2000”.[279]

8.165 The European Communities argues that by maintaining the availability of FSC subsidies after 30 September 2000, for transactions effected by existing FSCs until 31 December 2001 (and, under certain circumstances, for an indefinite period), the United States has failed to withdraw the FSC subsidies as required by Article 4.7 *SCM Agreement* and the recommendations and rulings of the DSB and has also failed to comply with its obligations under Article 21 *DSU*.[280]

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[274] Appellate Body Report, *Australia-Measures Affecting Importation of Salmon*, WT/DS18/AB/R, adopted 6 November 1998, para. 223.

[275] *supra*, para. 8.158.

[276] EC first written submission, Annex A-1, para. 184.

[277] Original Panel Report, *supra*, note 2, para. 8.3.

[278] Original Panel Report, *supra*, note 2, para. 8.8.

[279] WT/DS108/11, 2 October 2000. See *supra*, para. 1.3 and WT/DSB/M/90, paras. 6-7.

[280] EC first written submission, Annex A-1, para. 241.

8.166 In the US view, the "limited transition relief" available under the Act provides foreign and domestic businesses with an opportunity to adjust and protect people who might have altered their conduct in reliance on the tax treatment provided by the earlier law, and is reasonable in the particular circumstances of this case. The United States contends that WTO panels have excused procedural violations in the absence of prejudice to the complaining party, essentially taking into account equitable considerations in issuing their decisions. According to the United States, a limited adjustment period is particularly appropriate given the EC's 13-year delay in challenging the FSC and the United States' reasonable reliance on the 1981 decision and understanding of the GATT 1947 Council.[281] Thus, the United States argues that the Act's limited transition rules constitute "reasonable implementation of the DSB's recommendations".[282]

8.167 We recall that the Act provides that "amendments made by this Act shall apply to transactions after 30 September 2000"[283], and that no new FSCs may be created after 30 September 2000.[284] However, in the case of a FSC in existence on 30 September 2000, the amendments made by the Act shall not apply to any transaction in the ordinary course of trade or business involving a FSC which occurs: (A) before 1 January 2002; or (B) after 31 December 2001, pursuant to a binding contract between the FSC (or any related person) and any unrelated person that is in effect on 30 September 2000.[285]

8.168 Thus, for FSCs in existence as of 30 September 2000, the FSC subsidies continue in operation for one year and, with respect to FSCs that entered into long-term, binding contracts with unrelated parties before 30 September 2000 the Act does not alter the tax treatment of those contracts for an indefinite period of time. We recall the statement of the Appellate Body in *Brazil - Export Financing Programme for Aircraft, Recourse by Canada to Article 21.5 of the DSU* that, "to continue to make payments under an export subsidy measure found to be prohibited is not consistent with the obligation to "withdraw" prohibited export subsidies, in the sense of "removing" or "taking away"."[286]

8.169 We also observe that the United States does not dispute that prohibited FSC subsidies continue to be available after the time-period set for compliance in this dispute.[287]

8.170 In light of these considerations, we find that the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies inconsistent with Article 3.1(a) of the *SCM Agreement* and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 *SCM Agreement*.

8.171 Having found that the United States has not fully withdrawn the FSC subsidies as required by the recommendations and rulings of the DSB made pursuant to Article 4.7 *SCM Agreement*, we do not believe that it is necessary to also determine whether the United States "failed to comply with the DSB recommendations and rulings within the period of time specified by the DSB and has therefore also failed to comply with Article 21 *DSU*"[288] due to its enactment of the Act repealing the FSC on 15 November 2000. We therefore exercise judicial economy with respect to this claim.

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[281] *Tax Legislation*, BISD 28S/114, 7-8 December 1981.

[282] US first written submission, Annex A-2, paras. 223-229.

[283] Act, section 5(a).

[284] Act, section 5(b)(1).

[285] Act, section 5(c)(1). The Act specifies that a binding contract shall include a purchase option, renewal option or replacement option which is included in such contract and which is enforceable against the seller or lessor.

[286] Appellate Body Article 21.5 Report, *Brazil - Export Financing Programme for Aircraft, Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/AB/RW, adopted 4 August 2000, para. 45.

[287] See US first written submission, Annex A-2, para. 224.

[288] EC first written submission, Annex A-1, paras. 242-246.

IX. CONCLUSION

9.1 In light of the findings contained in Section VIII above, we therefore conclude that:

(a) the Act is inconsistent with Article 3.1(a) of the *SCM Agreement* as it involves subsidies "contingent… upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement* by reason of the requirement of “use outside the United States” and fails to fall within the scope of the fifth sentence of footnote 59 of the *SCM Agreement* because it is not a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59 of the *SCM Agreement*;

(b) the United States has acted inconsistently with its obligation under Article 3.2 of the *SCM Agreement* not to maintain subsidies referred to in paragraph 1 of Article 3 of the *SCM Agreement*;

(c) the Act, by reason of the requirement of “use outside the United States”, involves export subsidies as defined in Article 1(e) of the *Agreement on Agriculture* for the purposes of Article 10.1 of the *Agreement on Agriculture* and the United States has acted inconsistently with its obligations under Article 10.1 of the *Agreement on Agriculture* by applying the export subsidies, with respect to both scheduled and unscheduled agricultural products, in a manner that, at the very least, threatens to circumvent its export subsidy commitments under Article 3.3 of the *Agreement on Agriculture* and, by acting inconsistently with Article 10.1, the United States has acted inconsistently with its obligation under Article 8 of the *Agreement on Agriculture*;

(d) the Act is inconsistent with Article III:4 of the *GATT 1994* by reason of the foreign articles/labour limitation as it accords less favourable treatment within the meaning of that provision to imported products than to like products of US origin; and

(e) the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies inconsistent with Article 3.1(a) of the *SCM Agreement* and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 *SCM Agreement*.

9.2 Since Article 3.8 of the *DSU* provides that "[i]n cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment", we conclude that to the extent the United States has acted inconsistently with the *SCM Agreement*, the *Agreement on Agriculture* and the *GATT 1994* it has nullified or impaired the benefits accruing to the European Communities under those agreements.