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UNITED STATES – TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS"

AB-1999-9

Report of the Appellate Body

WORLD TRADE ORGANIZATION

APPELLATE BODY

United States – Tax Treatment for "Foreign Sales Corporations"

United States, *Appellant/Appellee*

European Communities, *Appellant/Appellee*

Canada, Japan, *Third Participants*

AB-1999-9

Present:

Lacarte-Muró, Presiding Member
Bacchus, Member
Feliciano, Member

I. Introduction

1. The United States and the European Communities appeal certain issues of law and legal interpretations in the Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations"* (the "Panel Report").[1] The Panel was established to consider a complaint by the European Communities with respect to "Sections 921-927 of the Internal Revenue Code and related measures establishing special tax treatment for 'Foreign Sales Corporations' ('FSCs')".[2] Pertinent aspects of this "FSC measure"[3] are described in Section II below.[4]

2. In the Panel Report, circulated on 8 October 1999, the Panel concluded that, through the FSC measure:

> (a) the United States has, except as provided in the Agreement on Agriculture, acted inconsistently with its obligations under Article 3.1(a) of the SCM Agreement by granting or maintaining export subsidies prohibited by that provision;
>
> (b) the United States has acted inconsistently with its obligations under Article 3.3 of the Agreement on Agriculture (and consequently with its obligations under Article 8 of that Agreement):
>
> - by providing export subsidies listed in Article 9.1(d) of the Agreement on Agriculture in excess of the quantity commitment levels specified in the United States' Schedule in respect of wheat;

[1]WT/DS108/R, 8 October 1999.

[2]The Panel's terms of reference, WT/DS108/3, 11 November 1998, refer to the European Communities' request for consultations, WT/DS108/1, 28 November 1997.

[3]In paragraph 7.34 and footnote 602 thereto of the Panel Report, the Panel identified sections 245(c), 921 through 927, and 951(e) of the United States Internal Revenue Code as the "primary" legal provisions constituting the FSC measure. This finding has not been appealed.

[4]The Panel describes the FSC measure in paragraphs 2.1 to 2.8 of the Panel Report.

- by providing export subsidies listed in Article 9.1(d) of the Agreement on Agriculture in respect of all unscheduled products.[5]

3. With respect to its conclusion regarding the *Agreement on Subsidies and Countervailing Measures* (the "*SCM Agreement*"), the Panel recommended that the Dispute Settlement Body (the "DSB") request the United States "to withdraw the FSC subsidies without delay".[6] With respect to its conclusions regarding the *Agreement on Agriculture*, the Panel recommended that the DSB request the United States to bring the FSC measure into conformity with its obligations in respect of export subsidies under that Agreement.[7]

4. On 28 October 1999, the United States notified the DSB of its intention to appeal certain issues of law covered in the Panel Report and certain legal interpretations developed by the Panel, pursuant to paragraph 4 of Article 16 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), and filed a Notice of Appeal pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*"). For scheduling reasons, and pursuant to an agreement it had reached with the European Communities, on 2 November 1999 the United States notified the Chairman of the Appellate Body and the Chairman of the DSB of its decision to withdraw its 28 October 1999 notice of appeal. This withdrawal was made pursuant to Rule 30(1) of the *Working Procedures*, and was conditional upon the right of the United States to file a new notice of appeal pursuant to Rule 20 of the *Working Procedures*. On 26 November 1999, the United States once again notified the DSB of its intention to appeal certain issues of law covered in the Panel Report and certain legal interpretations developed by the Panel, pursuant to paragraph 4 of Article 16 of the DSU, and filed a Notice of Appeal pursuant to Rule 20 of the *Working Procedures*. On 2 December 1999, the United States filed its appellant's submission.[8] On 7 December 1999, the European Communities filed its own appellant's submission.[9] On 17 December 1999, the United States[10] and the European Communities[11] each filed an appellee's submission. On the same day, Canada and Japan each filed a third participant's submission.[12]

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[5]Panel Report, para. 8.1.

[6]*Ibid.*, para. 8.3.

[7]*Ibid.*, para. 8.4.

[8]Pursuant to Rule 21(1) of the *Working Procedures*.

[9]Pursuant to Rule 23(1) of the *Working Procedures*.

[10]Pursuant to Rule 23(3) of the *Working Procedures*.

[11]Pursuant to Rule 22 of the *Working Procedures*.

[12]Pursuant to Rule 24 of the *Working Procedures*.

5. The oral hearing in the appeal was held on 19-20 January 2000. The participants and third participants presented oral arguments and responded to questions put to them by the Members of the Division hearing the appeal.

II. Background

A. *Overview of Relevant United States Tax Laws*

6. For United States citizens and residents, the tax laws of the United States generally operate "on a worldwide basis".[13] This means that, generally, the United States asserts the right to tax all income earned "worldwide" by its citizens and residents. A corporation organized under the laws of one of the fifty American states or the District of Columbia is a "domestic", or United States, corporation, and is "resident" in the United States for purposes of this "worldwide" taxation system.[14] Under United States tax law, "foreign" corporations are defined as all corporations that are *not* incorporated in one of the fifty states or the District of Columbia.[15]

7. The United States generally taxes any income earned by foreign corporations within the territory of the United States. The United States generally does not tax income that is earned by foreign corporations outside the United States.[16] However, such "foreign-source" income of a foreign corporation generally will be subject to United States taxation when such income is "effectively connected with the conduct of a trade or business within the United States".[17] United States tax laws and regulations provide for the tax authorities to conduct a factual inquiry to determine whether a foreign corporation's income is "effectively connected" income.

8. Many foreign corporations are related to United States corporations. Generally, a United States parent corporation is only subject to taxation on income earned by its foreign subsidiary when such income is transferred to the United States parent in the form of a dividend.[18] The period between the earning of such income by the subsidiary and the transfer to the United States parent company of a dividend is called "deferral" under the United States tax system, because the payment of tax on that income is deferred until the income is repatriated to the United States.[19]

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[13]United States' appellant's submission, para. 21.

[14]Section 7701(a)(4) IRC; United States' appellant's submission, para. 21.

[15]Section 7701(a)(5) and (9) IRC; United States' appellant's submission, para. 22.

[16]United States' appellant's submission, para. 22. Panel Report, paras. 4.1127 and 4.1128.

[17]Section 882(a) IRC. However, the foreign corporation may be eligible for a foreign tax credit with respect to foreign income taxes that it has paid on such income.

[18]However, the United States parent may be eligible for an indirect foreign tax credit on some foreign income taxes paid by the foreign subsidiary. See United States' appellant's submission, para. 23.

[19]United States' appellant's submission, para. 23.

9. The United States has also adopted a series of "anti-deferral" regimes that depart from the principle of deferral and that, in general, respond to specific policy concerns about potential tax avoidance by United States corporations through foreign affiliates. One of these regimes is Subpart F of the United States Internal Revenue Code (the "IRC"), which limits the availability of deferral for certain types of income earned by certain controlled foreign subsidiaries of United States corporations.[20] Under Subpart F, certain income earned by a foreign subsidiary can be imputed to its United States parent corporation even though it has not yet been repatriated to the parent in the form of a dividend.[21] The effect of Subpart F is that a United States parent corporation is immediately subject to United States taxation on such imputed income even while the income remains with the foreign subsidiary.

10. These generally prevailing United States tax rules are altered for FSCs by the FSC measure.

B. *The FSC Measure*

11. FSCs are foreign corporations responsible for certain sales-related activities in connection with the sale or lease of goods produced in the United States for export outside the United States. The FSC measure essentially exempts a portion of an FSC's export-related foreign-source income from United States income tax.[22] The relevant tax regime is comprised of three separate elements, which affect the tax liability under United States law of an FSC as well as of the United States corporation that supplies goods for export. These three exemptions are described in detail below, as well as in paragraphs 7.95, 7.96 and 7.97 of the Panel Report.[23]

12. A corporation must satisfy several conditions to qualify as an FSC.[24] To qualify, a corporation must be a foreign corporation organized under the laws of a country that shares tax information with the United States, or under the laws of a United States possession other than

[20]Section 951 IRC; United States' appellant's submission, para. 24.

[21]With respect to such deferred income, the United States parent may be eligible for an indirect foreign tax credit on some foreign income taxes paid by the foreign subsidiary. See United States' appellant's submission, para. 24.

[22]This characterization of the FSC measure is not disputed by the participants. See Panel Report, para. 7.112.

[23]During the oral hearing, the United States accepted, in response to a question from the Division hearing this appeal, that paragraphs 7.95-7.97 of the Panel Report accurately describe the FSC exemptions.

[24]The description set forth here is intended to outline the main elements of the FSC measure which relate to this appeal. A comprehensive explanation of all the rules applicable to FSCs should be obtained from the text of the statutory provisions themselves or from specialized tax treatises, e.g., J. Isenbergh, *International Taxation*, 2nd ed. (Aspen Publishers Inc., 1999). We note here that special rules apply *inter alia* in the case of agricultural cooperatives, small FSCs, shared FSCs, FSCs owned by individual rather than corporate shareholders, and transactions involving military property.

Puerto Rico.[25] The corporation must satisfy additional requirements relating to its foreign presence, to the keeping of records, and to its shareholders and directors.[26] The corporation must also elect to be an FSC for a given fiscal year.[27] There is no statutory requirement that an FSC be affiliated with or controlled by a United States corporation. The FSC measure is, however, such that the benefit to both FSCs and the United States corporations that supply goods for export will, as a practical matter, often be greater if the United States supplier is related to the FSC. As a result, many FSCs are controlled foreign subsidiaries of United States corporations.

13. The foreign-source income of an FSC may be broadly divided into "foreign trade income"[28] and all other foreign-source income. "Foreign trade income" is essentially the foreign-source income attributable to an FSC from qualifying transactions involving the export of goods from the United States. An FSC's other foreign-source income may include *inter alia* "investment income", such as interest, dividends and royalties, and active business income not deriving from qualifying export transactions. This appeal raises a number of issues with respect to the taxation of an FSC's *foreign trade income*. Foreign trade income is in turn divided into *exempt* foreign trade income and *non-exempt* foreign trade income.[29] As explained below, the United States tax treatment of an FSC's *exempt* foreign trade income differs from the United States tax treatment of an FSC's *non-exempt* foreign trade income.

14. An FSC's foreign trade income is its "foreign trading gross receipts" generated in qualifying transactions.[30] Qualifying transactions involve the sale or lease of "export property" or the performance of services "related and subsidiary" to such sale or lease. "Export property" is property manufactured or produced in the United States by a person other than an FSC, sold or leased by or to an FSC for use, consumption or disposition outside the United States, and of which no more than 50 per cent of its fair market value is attributable to imports.[31] In addition, for FSC income to be foreign trade income, certain economic processes relating to qualifying transactions must take place outside the United States[32], and the FSC must be managed outside the United States.[33]

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[25]Sections 922(a)(1) and 927(d)(3) IRC. Typically an FSC is organized in a non-United States jurisdiction that does not tax, or applies a low tax rate to, corporate income.

[26]Section 922(a)(1) IRC.

[27]Section 922(a)(2) IRC.

[28]Section 923(b) IRC.

[29]Section 923(a) IRC.

[30]Section 924 IRC.

[31]Section 927(a) IRC; Panel Report, para. 2.1.

[32]Section 924(b)(1)(B) IRC.

[33]Sections 924(b)(1)(A) and 927(d)(3) IRC.

15. Under the FSC measure, an FSC may, at its option, choose to apply one of three transfer pricing rules in order to calculate its foreign trade income from qualifying transactions. These pricing rules serve two purposes. First, the transfer pricing rules allocate the income from transactions involving United States export property as between an FSC and its United States supplier. The part of this income attributable to the FSC is its foreign trade income (i.e. exempt and non-exempt foreign trade income). The second purpose of the transfer pricing rules is to determine how much of the income from transactions involving United States export property that is allocated to the FSC as foreign trade income is *exempt* foreign trade income, and how much of it is *non-exempt* foreign trade income. The transfer pricing rule applied to determine the amount of the FSC's foreign trade income must also be applied to determine the division of that foreign trade income into exempt and non-exempt foreign trade income.[34]

C. *Exemptions Provided by the FSC Measure*

16. The FSC measure establishes three main exemptions which affect the United States tax liability of the FSC, of its United States supplier and, possibly United States shareholders. The first exemption relates to the United States tax treatment of the foreign-source income of a foreign corporation.[35] Under United States law generally, the foreign-source income of a foreign corporation engaged in trade or business in the United States is taxable only to the extent that it is "effectively connected with the conduct of a trade or business within the United States".[36] This rule applies whether or not a foreign corporation is controlled by a United States corporation. To determine whether the foreign-source income of a foreign corporation is "effectively connected with the conduct of a trade or business within the United States", a factual inquiry is undertaken by the tax authorities.[37] Under the FSC measure, however, the exempt portion of an FSC's foreign trade income is "treated as foreign source income which is not effectively connected with the conduct of a trade or business

[34]Under the first transfer pricing rule, the "arm's length" rule, the allocation of income is based on the actual price paid by the FSC to its related United States supplier, subject to adjustment under Section 482 IRC. This rule may be used by any FSC. Provided that it meets certain *additional* requirements to perform distribution activities in respect of qualifying transactions; and that it is *related* to its United States supplier, an FSC may instead elect to use one of two other transfer pricing rules, known as the "administrative pricing" rules. Each administrative pricing rule allows an FSC to determine its foreign trade income by applying a formula which divides the combined total income derived from qualifying transactions between the FSC and its related United States supplier. See Section 925 IRC and paras. 2.5 – 2.8 of the Panel Report.

[35]See Panel Report, para. 7.95.

[36]Section 882(a) IRC.

[37]Section 864 IRC sets out the rules for determining whether the income of a foreign corporation is "effectively connected with the conduct of a trade or business within the United States". Under United States tax law, the "effectively connected" concept is distinct from the "source-of-income" concept. The income of a foreign corporation may be "foreign-source" income under the rules for determining source of income (Sections 861-865 IRC), but may nevertheless be "effectively connected" with a trade or business within the United States and, on this basis, subject to taxation (see J. Isenbergh, *supra*, footnote 24, Vol. I, chapters 5 and 21).

within the United States".[38] In other words, the exempt portion of the FSC's foreign trade income is not subject to a factual inquiry to determine if it is "effectively connected with the conduct of a trade or business within the United States". Thus, under this first exemption, a portion of an FSC's foreign-source income is *legislatively determined not to be* "effectively connected" and, therefore, is not taxable in the hands of the FSC – without regard to what conclusion an administrative factual inquiry might come to in the absence of the FSC measure.

17. The second exemption relates to the United States tax treatment of certain income earned by a foreign corporation that is controlled by a United States corporation. Under United States law generally, a United States shareholder in a controlled foreign corporation must include in his gross income each year a *pro rata* share of certain forms of income of the foreign controlled corporation which has not yet been distributed to its United States parent.[39] Such income is known as "Subpart F income". The United States shareholder corporation is immediately subject to United States tax on its Subpart F income, even though it has not yet received the income from its foreign affiliate. Under the FSC measure, however, the foreign trade income of an FSC is generally exempted from Subpart F.[40] Thus, under this second exemption, the parent of an FSC is *not* required to declare its *pro rata* share of the undistributed income of an FSC that is derived from the foreign trade income of the FSC, and is *not* taxed on such income.

18. The third exemption deals with the tax treatment of dividends received by United States corporations from foreign corporations.[41] Under United States law generally, dividends received by a United States corporation which are derived from the foreign-source income of a foreign corporation are taxable, unless such income has already been taxed under the Subpart F rules.[42] Under the FSC measure, however, United States corporate shareholders of an FSC generally may deduct 100 per cent

[38]Section 921(a) IRC.

[39]Section 951(a) IRC.

[40]Panel Report, para. 7.96; Section 951(e) IRC. If an FSC uses the administrative pricing rules, then this second exemption applies with respect to both the *exempt* and the *non-exempt* portions of the FSC's foreign trade income. However, if an FSC uses the Section 482 arm's length transfer pricing rules, then the United States shareholder must declare a *pro rata* share of the *non-exempt* portion of its FSC's foreign trade income and generally is subject to United States tax on that portion of the FSC's foreign trade income.

[41]See Panel Report, para. 7.97.

[42]*Ibid*.

of dividends received from distributions made out of the foreign trade income of an FSC.[43] Thus, under the third exemption, the parent of an FSC is generally not taxed on dividends received that are derived from the foreign trade income of the FSC.

III. Arguments of the Participants

A. *Claims of Error by the United States – Appellant*

19. The United States urges the Appellate Body to take account of the historical background to this appeal. According to the United States, the FSC measure and the issues raised in this appeal cannot be reviewed in a vacuum, but can be understood only in the context of basic tax principles, the application of those principles through the FSC measure, and the historical events that led to the creation of the FSC regime.

20. The United States recalls that the origins of this dispute go back to the enactment by the United States of the Domestic International Sales Corporations ("DISC") tax provisions in 1971. In 1972, the European Communities requested dispute settlement consultations regarding the DISC measure, alleging that the DISC measure constituted an export subsidy. The United States then requested consultations with France, Belgium, and the Netherlands, contending that if the DISC measure were an export subsidy, then the tax exemptions provided by those countries for foreign-source income also were export subsidies. The panel reports in these four cases, the "*Tax Legislation Cases*", were issued in 1976[44], and the panels found that both the DISC measure and the European tax systems had characteristics of an export subsidy prohibited under Article XVI:4 of the GATT 1947. Under the GATT 1947 dispute settlement system, panel reports were only adopted by consensus of the contracting parties. Since the parties to the dispute would not, initially, agree to the adoption of the panel reports in the *Tax Legislation Cases*, these reports remained unadopted for several years.

21. In 1979, a number of contracting parties, including the countries involved in the *Tax Legislation Cases*, entered into the *Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade* (the "*Tokyo Round Subsidies Code*"), which included footnote 2 to the Illustrative List of Export Subsidies. The United States points out

[43]Section 245(c) IRC. If an FSC uses the administrative pricing rules, then this third exemption applies to dividends derived from both the *exempt* and *non-exempt* portions of that FSC's foreign trade income. However, if an FSC uses the Section 482 arm's length transfer pricing rules, then the United States shareholder generally is subject to tax on dividends received from distributions derived from the *non-exempt* portion of its FSC's foreign trade income, unless such income has already been taxed under the Subpart F rules.

[44]Panel reports, *Tax Legislation - United States Tax Legislation (DISC)*, L/4422, adopted 7-8 December 1981, BISD 23S/98; *Tax Legislation - Income Tax Practices Maintained By France*, L/4423, adopted 7-8 December 1981, BISD 23S/114; *Tax Legislation - Income Tax Practices Maintained By Belgium*, L/4424, adopted 7-8 December 1981, BISD 23S/127; *Tax Legislation - Income Tax Practices Maintained By The Netherlands*, L/4425, adopted 7-8 December 1981, BISD 23S/137.

that footnote 2 addressed key elements of the *Tax Legislation Case*s. The footnote incorporated the panels' analysis in these reports with respect to the issues of deferral and arm's length pricing, but departed from the panel's reasoning with respect to double taxation. Footnote 2 expressly provided that countries may take steps to avoid the double taxation of income.

22. In 1981, the parties finally agreed to the adoption of the panel reports in the *Tax Legislation Cases* by means of a GATT 1947 Council action which adopted the reports subject to an "understanding"[45], and which was accompanied by a statement from the Chairman of the Council. According to the United States, that "understanding" effectively revised the panel reports by incorporating into them the principles of footnote 2 to the *Tokyo Round Subsidies Code's* Illustrative List. In 1984, the United States replaced the DISC provisions with the FSC provisions. According to the United States, the FSC provisions "were intended to provide a limited territorial-type system of taxation"[46] for United States exports that complied with GATT subsidy rules, in particular those laid out in footnote 2 of the *Tokyo Round Subsidies Code's* Illustrative List and the 1981 "understanding".

1. The *SCM Agreement*

23. In the view of the United States, the Panel's finding that the FSC measure constitutes an export subsidy was based on fundamental analytical errors. The Panel erred in failing to begin its analysis with footnote 59 to the Illustrative List of Export Subsidies (the "Illustrative List") in Annex I of the *SCM Agreement*, which is the "controlling legal provision" in this case. Footnote 5 to Article 3.1(a) of the *SCM Agreement* makes clear that a practice identified in the Illustrative List as *not* constituting an export subsidy is not prohibited by Article 3.1(a) or any other provision of the *SCM Agreement.* Since, according to the United States, the FSC tax exemption is permitted under footnote 59, no further analysis is needed.

24. The United States does not, as a *general proposition*, disagree with the Panel's interpretation of the term "otherwise due" in Article 1.1(a)(1)(ii) of the *SCM Agreement* as establishing a "but for" test. However, this test must yield in situations where a specific standard exists for determining whether revenue is "otherwise due". In this case, the context of Article 1.1(a)(1)(ii), in particular footnote 59 of the *SCM Agreement* and the 1981 "understanding", demonstrates that such a specific standard exists – taxation of foreign-source income is deemed not to be revenue that is "otherwise due".

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[45]The participants in this appeal have generally referred to the 1981 Council action on the basis of which the Council adopted the panel reports in the *Tax Legislation Cases* as the "1981 Understanding". *Tax Legislation*, L/5271, 7-8 December 1981, BISD 28S/114. As explained *infra* at footnote 76, we prefer the term "1981 Council action". In order faithfully to summarize the arguments of the participants, however, we use the term 1981 "understanding" within this section of our Report.

[46]United States' appellant's submission, para. 45.

25. The United States considers that footnote 59 permits tax exemptions for foreign-source income even if it is "specifically in relation to exports".[47] Item (e) of the Illustrative List identifies certain tax practices as export subsidies, and the text of footnote 59 qualifies this characterization of some of such practices. The second sentence of footnote 59, in which Members "reaffirm" the principle of arm's length pricing, imposes parameters on the prices that may be charged between related parties in export transactions. According to the United States, the second sentence of footnote 59 *assumes* that foreign-source income *may* be exempted from tax or taxed to a lesser extent than domestic-source income, and would have no meaning if foreign-source income could *not* be exempted from tax.

26. The United States submits that the FSC measure is also not an export subsidy by virtue of the fifth sentence of footnote 59, which excludes from the scope of item (e) of the Illustrative List measures to prevent foreign-source income from being subjected to double taxation. The Panel erred by failing to find that, as a tax exemption measure to avoid the double taxation of foreign-source income, the FSC measure is permitted by footnote 59. The Panel erroneously stated that the United States had not asserted that the fifth sentence of footnote 59 applied to the FSC. In its first submission to the Panel, the United States asserted that "the FSC is designed to prevent double taxation of export income earned outside the United States ... ."[48]

27. The United States argues that the Panel's interpretation of Article 1.1(a)(1)(ii), as well as of Article 3.1(a), also failed to take into account the 1981 "understanding". The "understanding" specifically states that economic processes located outside the territory of the exporting country "should not be regarded as export activities." The import of this language is to remove such processes from the ambit of Article 3.1(a) and Annex 1 of the *SCM Agreement*, both of which deal exclusively with export subsidies. If foreign economic processes do not constitute "export activities," then exempting the income from such processes from taxation *cannot* be deemed to be an export subsidy.

28. The United States contends that it is also clear that, in adopting the 1981 "understanding", the GATT 1947 Council intended to establish principles of general applicability. The opening sentence of the "understanding" states that the "understanding" applies "in general". The background to the adoption of the 1981 "understanding" supports this interpretation. Footnote 2 of the *Tokyo Round Subsidies Code's* Illustrative List recognized that countries could take steps to avoid double taxation of foreign-source income, and that foreign-source income should be determined on the basis of the arm's length principle. The impasse regarding the *Tax Legislation Cases* was resolved through the 1981

[47]United States' appellant's submission, para. 101.

[48]Panel Report, para. 4.348.

"understanding", which accepted the principles codified in footnote 2 of the *Tokyo Round Subsidies Code*.[49]

29. The United States further argues that the 1981 "understanding" satisfies all of the criteria to constitute a "decision" under paragraph 1(b)(iv) of the language in Annex 1A incorporating the GATT 1994 into the *WTO Agreement*. Accordingly, the 1981 "understanding" has the same legal force as any other provision of the GATT 1994. In finding that the 1981 "understanding" is not an "other decision" within the meaning of paragraph 1(b)(iv), the Panel wrongly imposed a requirement – that such decisions must be a "legal instrument" – that is inconsistent with paragraph 1(b)(iv). Furthermore, the Panel misapplied this standard by declaring the phrase "in general" in the 1981 "understanding" to be ambiguous, and then misinterpreted the circumstances surrounding the adoption of the "understanding" to override the text itself. The Panel failed to appreciate that the Council took two separate actions, with independent significance: a *decision* to adopt the *Tax Legislation Cases* reports and an accompanying "*understanding*". Although the Chairman stated that the *decision* does not affect the interpretation of the *Tokyo Round Subsidies Code*, the Chairman did not make the same statement as regards the "*understanding*". To the contrary, the United States alleges that the third sentence of the "understanding" shows that it would affect future interpretations of the *Tokyo Round Subsidies Code*, and that this guidance has been carried forward into the WTO.

30. Even if the 1981 "understanding" were not a part of the GATT 1994, the United States submits that it would nevertheless be a "decision" within the meaning of Article XVI:1 of the *WTO Agreement*, by which panels and the Appellate Body should be guided. The Panel erred in finding that the "understanding" was not relevant to this dispute when, as the United States has demonstrated, the 1981 "understanding" and footnote 59 are inextricably bound together. Even though the 1981 "understanding" involved an interpretation of Article XVI of the GATT 1947, the text of the *SCM Agreement*, the jurisprudence of the Appellate Body[50], as well as the interconnected history of the *SCM Agreement* and Article XVI, all make clear that the *SCM Agreement* and Article XVI are not to be construed in isolation from one another.

2. Articles 3.3, 8, 9.1(d) and 10.1 of the *Agreement on Agriculture*

31. The United States requests the Appellate Body to reverse the Panel's findings that the United States has acted inconsistently with its obligations under Articles 3.3 and 8 of the *Agreement on Agriculture* by providing export subsidies listed in Article 9.1(d) of the *Agreement on Agriculture* in

[49]The United States refers to the statements of the Belgian, French, Dutch and Swiss representatives of 14 January 1981 (C/M/145).

[50]Appellate Body Report, *Brazil – Measures Affecting Desiccated Coconut* ("*Brazil - Desiccated Coconut*"), WT/DS/22/AB/R, adopted 20 March 1997.

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

(a) Article 9.1(d) of the *Agreement on Agriculture*

32. According to the United States, the Panel wrongly interpreted the phrase "to reduce the costs of marketing" in Article 9.1(d) of the *Agreement on Agriculture* and, as a consequence, erred in finding the FSC tax exemption to be an Article 9.1(d) export subsidy. The Panel defined an Article 9.1(d) subsidy in terms of the nature of the activities performed by the entity receiving the subsidy rather than the nature of the subsidy itself. In the view of the United States, the Panel's analysis suffers from a "fundamental flaw"[51], namely the conclusion that subsidies which benefit export entities generally should be deemed specifically to "reduce the costs of marketing".

33. The United States considers the ordinary meaning of the phrase "costs of marketing" to refer to "marketing costs" – which would not include income taxes – and finds support for this meaning in the specific examples listed in Article 9.1. The Panel's interpretation of Article 9.1(d) ignores the context of that sub-paragraph and is so broad that it subsumes all but one of the other subparagraphs of Article 9.1 and renders them redundant. Additional relevant context to demonstrate the error in the Panel's analysis can, in the view of the United States, be found in paragraph 13 of Annex 3 of the *Agreement on Agriculture* (which sets out a calculation methodology for "marketing-cost reduction measures" that could not work if an income tax exemption were a marketing cost), the *SCM Agreement's* Illustrative List (which distinguishes tax-related subsidies from other types of subsidies), as well as footnote 59 to the *SCM Agreement* and the 1981 "understanding". The United States adds that the Panel's interpretation is inconsistent with the object and purpose of the *SCM Agreement*, in particular because it appears to assume that Article 9.1 is intended to cover *all* export subsidies to agricultural products, even though Article 10.1 makes it clear that the drafters did not intend Article 9.1 to be so broad in scope.

(b) Article 3.3 of the *Agreement on Agriculture*

34. The United States argues that the Panel erred in ruling that the mere availability of the FSC tax exemption for unscheduled products constituted a violation of Article 3.3 of the *Agreement on Agriculture*. The United States considers the Panel's reasoning on this issue to be inconsistent with established principles of treaty interpretation and with the meaning of the term "provide".

[51]United States' appellant's submission, para. 323.

35. The United States contends that the Panel wrongly relied upon one dictionary definition of "provide", namely "make available", rather than upon the more common meaning of the term, namely "supply or furnish for use" or, in other words, to "grant or pay". That the latter definition of "provide" is the correct one under Article 3.3 is confirmed by reference to the equivalent verbs used in the French ("accorder") and Spanish ("otorgar") versions of Article 3.3. Further context supporting this meaning is found elsewhere in the *Agreement on Agriculture*. In Article 9.2(b), "provide" can only mean to "grant or pay". Articles 9.4 and 10.1 refer to Article 9.1 subsidies being "*applied*"; Articles 9.2(a)(ii) and 10.3 refer to an export subsidy being "*granted*"; and Article 11 of the *Agreement on Agriculture* refers to an export subsidy "*paid*". Moreover, the United States considers that the Appellate Body has itself effectively defined "provided" as synonymous with "granted".[52] The United States adds that the Panel's analysis means that the word "provide" has a different meaning in the first clause of Article 3.3 than in the second clause, and that this reading "flies in the face of the basic interpretive principle that a word is presumed to mean the same thing when used in different parts of an agreement."[53]

3. Article 4.2 of the *SCM Agreement*

36. The United States requests the Appellate Body to reverse the Panel's refusal to dismiss the claims of the European Communities under Article 3 of the *SCM Agreement* on the grounds that the European Communities failed to include a statement of available evidence in its request for consultations, as required by Article 4.2 of that Agreement.

37. The United States emphasizes that Article 4.2 of the *SCM Agreement* creates a *supplemental* requirement – applicable to requests for consultations under Article 4.1 of the *SCM Agreement* involving prohibited subsidy claims – which is additional to the requirements contained in the DSU. The United States observes that Appendix 2 to the DSU specifically identifies Article 4.2 of the *SCM Agreement* as a "special or additional rule or procedure" which, pursuant to Article 1.2 of the DSU, may add to and prevail over provisions of the DSU. The United States contends that the term "shall" makes clear that the obligation to include a "statement of available evidence" under Article 4.2 is *mandatory*.[54]

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[52]Appellate Body Report, *Brazil – Export Financing Programme for Aircraft* ("*Brazil – Aircraft*"), WT/DS46/AB/R, adopted 20 August 1999, para. 148.

[53]United States' appellant's submission, para. 341.

[54]Panel report, *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather* ("*Australia – Leather*"), WT/DS126/R, adopted 16 June 1999, para. 9.29.

38. The United States alleges that the Panel erred in refusing to rule on whether evidence subsequently submitted by the European Communities was "available" at the time of the requests for consultations. The Panel further erred in indicating that the European Communities' consultation requests, which simply identified the relevant provisions of the IRC, could satisfy Article 4.2. The Panel justified this conclusion based on its characterization of the European Communities' claims as involving a *de jure* export subsidy. This approach ignores the distinction between law and fact, and between arguments and evidence. In any event, the United States argues, this is not a *de jure* case, but a dispute that has been fact-intensive from the outset.

39. In the view of the United States, the Panel's determination that it lacked authority to dismiss the European Communities' Article 3 claims even if the European Communities violated Article 4.2 is inconsistent with the governing WTO provisions, previous WTO practice, and the significance accorded to consultations in the dispute settlement process. The failure of a complaining party to satisfy the mandatory requirement in Article 4.2 must have a consequence. As the Appellate Body has demonstrated, the fact that dismissal is not expressly provided for in the *SCM Agreement* or the DSU does not mean that such a remedy is not authorized.[55]

40. The United States also contests the Panel's conclusion that any failure by the European Communities to meet the requirements of Article 4.2 was excused by the fact that the United States did not object to the European Communities' request when it was made. This apparent exercise of "equitable powers" is contrary to Article 3.2 of the DSU.[56] The United States emphasizes that the obligation to include a statement of available evidence serves to ensure that defending Members receive due process – particularly in view of the short time periods applicable to subsidy claims.

4. Appropriate Forum

41. The United States requests the Appellate Body to reverse the decision of the Panel not to dismiss or defer consideration of the European Communities' claims relating to the administrative pricing rules unless and until these rules had been raised in an appropriate tax forum. The United States believes that this issue is relevant even though the Panel did not make findings with respect to the FSC administrative pricing rules for two reasons: the Panel *did* make findings regarding footnote 59, and the European Communities has made clear throughout this dispute that it views arm's length pricing as integral to its claims.

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[55]Appellate Body Report, *Guatemala – Anti-Dumping Investigation Regarding Portland Cement from Mexico* ("*Guatemala - Cement*"), WT/DS60/AB/R, adopted 25 November 1998.

[56]United States' appellant's submission, para. 381.

42. The United States contends that the Panel misconstrued the meaning of the relevant portion of footnote 59, which directs Members to resort to appropriate tax fora before invoking WTO dispute settlement. According to the United States, "shall normally" should be read to mean that WTO Members raising transfer pricing issues are under a duty, in the absence of unusual, abnormal, or extraordinary circumstances, to invoke the assistance of a tax forum. In support of this interpretation, the United States refers to a previous interpretation of the term "shall normally" in Article 5.1 of the *Tokyo Round Agreement on Implementation of Article VI of the GATT 1947*[57], as well as to the Appellate Body's interpretation of the word "should".[58]

43. The United States believes that the Panel's interpretation renders the fourth sentence of footnote 59 essentially unenforceable. There are compelling reasons for resorting to an appropriate tax forum, in particular because the application of the *SCM Agreement* to measures involving direct taxes raises complicated issues which implicate international tax principles and tax treaties. In this case, the European Communities did not attempt to raise its concerns about the administrative pricing rules through the facilities of existing bilateral tax treaties or other international institutions, such as the Organization for Economic Cooperation and Development. Finally, the United States argues that the fact that footnote 59 is not listed in Appendix 2 of the DSU as a "special or additional" rule is not relevant. Appendix 2 does not list special rules that apply *outside* the context of the DSU – such as the language of footnote 59 instructing Members to take transfer pricing issues first to a tax forum *outside* the WTO.

B. *Arguments by the European Communities – Appellee*

1. The *SCM Agreement*

44. The European Communities requests the Appellate Body to uphold the Panel's findings under the *SCM Agreement,* and to reject the United States' appeal against the Panel's "finding that a failure to tax foreign source income constitutes the foregoing of revenue that is 'otherwise due' within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*".[59]

45. The European Communities objects that the United States' argument that the FSC measure can be justified as a measure for the avoidance of double taxation within the meaning of the last sentence of footnote 59 is inadmissible. The United States is relying on a new "affirmative

[57]Panel report, *United States - Imposition of Anti-Dumping Duties on Imports of Seamless Stainless Steel Hollow Products from Sweden*, ADP/47, issued 20 August 1990 (unadopted), para. 5.20.

[58]Appellate Body Reports, *Canada – Measures Affecting the Export of Civilian Aircraft* ("*Canada – Aircraft*"), WT/DS70/AB/R, adopted 20 August 1999, para. 187; *EC Measures Concerning Meat and Meat Products (Hormones)*, WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, para. 133.

[59]European Communities' appellee's submission, para. 86.

defence" [60], which it did not raise before the Panel. As a practical matter, the Appellate Body cannot deal with this issue as it would require the examination of factual issues not examined by the Panel.

46. The European Communities rejects the order in which the United States claims the Panel should have addressed the issues in this appeal. In the view of the European Communities, the United States wants the analysis to begin with footnote 59 and its "controlling legal principle" so as to avoid dealing with the clear terms of Article 3.1(a) of the *SCM Agreement*. The European Communities agrees with the Panel that the correct order to interpret the relevant provisions is to begin with the definition of a subsidy in Article 1, examine contingency upon export performance under Article 3.1(a), and then consider whether the prohibition is confirmed by item (e) and footnote 59 of the Illustrative List or whether this provision contains an affirmative defence.

47. It seems to the European Communities that the United States accepts the Panel's interpretation of Article 1.1(a)(1)(ii) of the *SCM Agreement* and the "but for" test, but argues that an exception exists – that taxation of foreign-source income is never "otherwise due". However, neither footnote 5, footnote 59, nor the 1981 "understanding" relate to or can create such an exception. In this regard, the European Communities considers that even if all measures in the Illustrative List were contingent upon export, this does not mean that measures referred to as not constituting export subsidies are not subsidies. By its terms, footnote 5 cannot exempt measures from the Article 1 definition of a subsidy. Furthermore, footnote 59 has nothing to do with the general proposition that Members are not required to tax foreign-source income, and the 1981 "understanding" is irrelevant to the interpretation of revenue "otherwise due" under Article 1.1(a)(1)(ii) of the *SCM Agreement*. The European Communities notes in this regard that saying that "foreign source income 'need not be subject to taxation by the exporting country'" is not tantamount to saying that revenue is not "otherwise due" [61], and that the 1981 "understanding" relates to Article XVI of the GATT 1947, which does not include a definition of subsidy.

48. The European Communities observes that the United States does not deny that the FSC measure provides subsidies that come within the general terms of Article 3.1(a) or within item (e) of the Illustrative List. However, for the footnote 5 exception to Article 3.1(a) to apply, the FSC measures must be referred to in Annex I as "not constituting export subsidies". Footnote 59 does not have such an effect. The second sentence of footnote 59 simply points out that allowing enterprises to

[60]European Communities' appellee's submission, para. 13.

[61]European Communities' appellee's submission, para. 214, referring to the United States' appellant's submission, para. 295.

use non-arm's length pricing may give rise to an export subsidy when this is done in connection with export-related measures. The fifth sentence is not properly before the Appellate Body, and in any case, the European Communities adds, the FSC regime is not intended "to avoid double taxation".

49. The European Communities asks the Appellate Body to uphold the Panel's findings that the 1981 "understanding" is not an "other decision" within the meaning of paragraph (1)(b)(iv) of the introductory language to GATT 1994. The European Communities rejects the United States' argument that the *decision* to adopt the *Tax Legislation Cases* reports and the "*understanding*" are separate acts. As the text of the 1981 "understanding" and the Chairman's statement clearly indicate, the Council adopted a single decision – the "understanding" and the adoption of the panel reports were inextricably connected. Even if the "understanding" were separate from the decision to adopt the *Tax Legislation Cases* reports, the European Communities does not accept that it would constitute a "legal instrument" under paragraph 1(b)(iv).

50. The European Communities adds that the 1981 "understanding" cannot be relevant context for the interpretation of the *SCM Agreement* because it is neither contemporaneous with, nor related to, that Agreement. Since Article XVI:4 of the GATT 1947 has been substantially modified by the new WTO system of rules, pre-1994 interpretations are doubly obsolete. Finally, the European Communities emphasizes that the 1981 "understanding" states that foreign "economic processes" *need not* be subject to tax, *not* that foreign "economic processes" may be *exempted* from tax on any condition a country wishes to impose, including export contingency. Since FSC subsidies are not granted to "foreign economic processes", the European Communities concludes that they cannot benefit from the 1981 "understanding".

2. Articles 3.3, 8, 9.1(d) and 10.1 of the *Agreement on Agriculture*

(a) Article 9.1(d) of the *Agreement on Agriculture*

51. The European Communities argues that, with respect to scheduled products, the Panel correctly held that the FSC measure is an export subsidy under Article 9.1(d) and therefore violates the first clause of Article 3.3 and Article 8 of the *Agreement on Agriculture.* In the alternative, the European Communities argues that even if the FSC measure is *not* an export subsidy under this provision, it nevertheless violates Article 10.1 and Article 8 of the *Agreement on Agriculture.*

52. The European Communities recalls that there are certain well-defined activities which an FSC *must* perform in order to be eligible to profit from FSC exemptions. All of these activities cover parts of the ordinary meaning of the term "marketing". Consequently, the European Communities believes that the Panel was correct in finding that the FSC measure "involves the provision of a subsidy to reduce the costs of marketing exports of agricultural products within the meaning of Article 9.1(d) of

the *Agreement on Agriculture*."[62] In this regard, the European Communities also observes that the Panel's interpretation of Article 9.1(d) is much narrower than the characterization of it by the United States would imply. Only because the FSC measure is so intrinsically linked with the requirements to perform the specified "marketing" activities did the Panel decide that the purpose of the FSC measure is to reduce the costs of marketing exports, and that it is covered by Article 9.1(d).

53. The European Communities rejects the United States' argument that "income taxes" are not "marketing costs". Article 9.1(d) sets out such a wide range of illustrative examples (of different types of "marketing") that support the argument that the term "marketing" should be interpreted broadly. Furthermore, the *Agreement on Agriculture* contains contextual support demonstrating that tax-related subsidies are included in the scope of Article 9.1(d). The European Communities adds that the Panel's interpretation of Article 9.1(d) is supported by the object and purpose of the *Agreement on Agriculture* and, in particular, its export subsidy disciplines.

54. If the Appellate Body reverses the Panel's conclusion that the United States has provided export subsidies listed in Article 9.1(d) in excess of its reduction commitment levels for wheat, the European Communities requests, in the alternative, that the Appellate Body find a violation of Articles 10.1 and 8 of the *Agreement on Agriculture*. The European Communities recalls that all subsidies which are "contingent upon export performance" are subject to the provisions of Article 10.1 relating to the prevention of circumvention of export subsidy commitments.[63] In this case, the two elements of an Article 10.1 violation are present, namely: (1) "export subsidies not listed in paragraph 1 of article 9"; (2) which are "applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments". The first element is satisfied by the finding that the FSC measure is an "export subsidy" under Article 3.1(a) of the *SCM Agreement.* Regarding the second element, when Article 10.1 is read together with Article 10.3, it is clear that granting non-Article 9.1 export subsidies to a product subject to reduction commitments, in excess of the reduction commitment level, may threaten or lead to the circumvention of such commitments.[64] The United States presented no evidence to establish that no export subsidies have been granted with respect to wheat exports in excess of the reduction commitment levels.[65]

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[62]Panel Report, para. 7.159.

[63]Panel report, *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products*, WT/DS103/R, WT/DS113/R, adopted 27 October 1999, as modified by the Appellate Body Report.

[64]*Ibid*.

[65]Panel Report, para. 7.163.

55. Finally, the European Communities presents a further alternative argument. Article 8 of the *Agreement on Agriculture* is a "fundamental general provision"[66] that makes clear that Members must not grant export subsidies otherwise than in conformity with that Agreement. Since Article 9 is the principal provision of the *Agreement on Agriculture* that allows export subsidies, the European Communities argues that if the FSC subsidies are not covered by Article 9.1(d), then their availability for agricultural products is a violation of Article 8 of the *Agreement on Agriculture*.

(b) Article 3.3 of the *Agreement on Agriculture*

56. The European Communities asks the Appellate Body to uphold the Panel's finding that, with respect to unscheduled agricultural products, the United States has acted inconsistently with its obligations under the second clause of Article 3.3 (and Article 8) of the *Agreement on Agriculture* by "providing" subsidies listed in paragraph 9.1(d).

57. In the view of the European Communities, the Panel correctly found that the term "to provide" in the second clause of Article 3.3 *Agreement on Agriculture* includes "the notion of making something available *as well as* that of actually granting or paying that thing."[67] The European Communities does not believe that the French and Spanish texts of Article 3.3 of the *Agreement on Agriculture* differ in any way from the English text. The European Communities also refers to the context and the grammatical setting of the phrase "to provide" in support of the Panel's interpretation. The European Communities finds further support for its argument that the existence and availability of the FSC measure *itself* can be a ground for a violation of Article 3.3 of the *Agreement on Agriculture* in certain statements made and reasoning employed by panels[68] and by the Appellate Body.[69]

58. If the Appellate Body should find that the FSC subsidies are not subsidies listed in paragraph 9.1(d), the European Communities argues, in the alternative, that the availability of the FSC measure with respect to unscheduled agricultural products nevertheless violates Article 8, because the *Agreement on Agriculture* contains no explicit or implicit provision which *allows* Members to provide export subsidies of the kind involved in this case for unscheduled products.

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[66]European Communities' appellee's submission, para. 273, citing the Panel Report in *Canada – Milk*, *supra*, footnote 63, para. 7.27.

[67]Panel Report, para. 7.170 (all emphasis added by the European Communities).

[68]The European Communities refers to the Panel reports, *Australia - Leather*, *supra*, footnote 54, paras. 9.38 and 9.41; and *Canada – Aircraft*, WT/DS70/R, adopted 20 August 1999, as modified by the Appellate Body Report, *supra*, footnote 58.

[69]The European Communities refers to the Appellate Body Reports, *Brazil – Aircraft*, *supra*, footnote 52, para. 158; and *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*, WT/DS56/AB/R, adopted 22 April 1998, para. 55.

3. Article 4.2 of the *SCM Agreement*

59. The European Communities argues that the Panel correctly interpreted Article 4.2 of the *SCM Agreement*, and correctly held that even if there had been non-compliance with the requirements of Article 4.2, this would not require dismissal of any of the European Communities' claims. In the view of the European Communities, Article 4.2 of the *SCM Agreement* is a specific application to subsidy cases of the general requirements contained in the second sentence of Article 4.4 of the DSU. The European Communities underlines, however, that while both the panel and the consultation stages are important elements of dispute resolution, the procedural rules applicable to consultations are intended to be effective *only at the consultation stage.*

60. The European Communities believes that the Panel correctly determined the meaning of a statement of available evidence, and correctly found that the European Communities' request for consultations constituted "evidence" within the meaning of Article 4.2 of the *SCM Agreement.* Since the FSC measure is a case where the nature and existence of the subsidy derives from the law, no "evidence" is required other than the law itself. The European Communities further argues that the Panel correctly held that even non-compliance with the requirements of Article 4.2 of the *SCM Agreement* does not require the dismissal of any of the claims of the European Communities. The consequences, if any, for such non-compliance should be found at the consultation stage rather than the panel stage. The European Communities submits that the jurisprudence of the Appellate Body supports this approach.[70]

61. Finally, the European Communities does not accept that the United States' due process rights have been violated because: (1) the request for consultations did contain a statement of available evidence and the United States never argued otherwise during consultations; (2) the United States was well aware of the features of the FSC measure; and (3) although the United States had ample opportunity, it did not ask for further evidence during three rounds of consultations.

4. Appropriate Forum

62. The European Communities requests the Appellate Body to uphold the Panel's findings on the fourth sentence of footnote 59 to the *SCM Agreement.* The WTO is the appropriate forum for these proceedings *because they involve export subsidies prohibited by the SCM Agreement*, and the "alternatives" suggested by the United States are in any case inappropriate.

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[70]The European Communities cites the Appellate Body Reports, *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, adopted 16 January 1998; *Brazil – Aircraft*, *supra*, footnote 52; and *Korea – Taxes on Alcoholic Beverages*, WT/DS75/AB/R, WT/DS84/AB/R, adopted 17 February 1999.

63. The European Communities agrees with the Panel, and with the Appellate Body Report in *India – Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*[71], that Members have a fundamental right to resort to dispute resolution *at any time*, and that such right can only be restricted by clear and unambiguous language. No such basis exists in the non-obligatory language of footnote 59. To the contrary, as the Panel found, the fact that footnote 59 is not identified as a special or additional dispute settlement provision in Appendix 2 of the DSU confirms that footnote 59 cannot circumscribe the fundamental right of a Member to pursue dispute settlement at any time. Finally, since the United States did not raise its arguments concerning the exhaustion of remedies in tax fora at the consultations stage, the European Communities argues that the objections by the United States must now be rejected because they were brought too late.

C. *Claims of Error by the European Communities – Appellant*

1. The FSC Administrative Pricing Rules

64. The European Communities requests the Appellate Body to find that the availability of the FSC administrative pricing rules either gives rise to a separate prohibited export subsidy for the reasons advanced by the European Communities before the Panel, or gives rise to a prohibited export subsidy when combined with the tax exemptions contained in the FSC measure. The European Communities considers that the Panel's findings encompassed the administrative pricing rules, because the Panel recommended in paragraph 8.3 of its Report that the United States "withdraw the FSC *subsidies*", and the term "FSC subsidies" was used throughout the proceedings to refer to *both* the exemptions and the administrative pricing rules.[72] To confirm this understanding, the European Communities has taken the precaution of bringing this cross-appeal, which is "conditional" upon "the unlikely event" that any of the Panel's recommendations are overturned.

65. The European Communities agrees with the Panel that the FSC exemptions by themselves are sufficient to justify a finding that there is a prohibited export subsidy, but adds that the administrative pricing rules make this conclusion even clearer since these rules can be considered to *compound* the subsidy. The European Communities alleges that a finding on the administrative pricing rules would not require the Appellate Body to engage in a complex examination of the functioning of the administrative pricing rules or make new factual findings. There are two administrative pricing rules, one of which may give a result up to twice as high as the other. Since the FSC and its parent may

[71]Appellate Body Report, WT/DS90/AB/R, adopted 22 September 1999.

[72]Panel Report, para. 4.274.

choose transaction by transaction whether to use the administrative pricing rules when these are available, as well as which of the two administrative pricing rules to use, it is clear that the *availability* of the administrative pricing rules increases the tax advantage that may be obtained.

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

66. The European Communities requests that, *if* the Appellate Body concludes that the United States could bring the FSC measure into consistency with the Panel's recommendations *without* eliminating the provision that FSC subsidies are only available in respect of goods no more than 50 per cent of the fair market value of which is attributable to imports, the Appellate Body reverse the Panel's finding that there was no need to make a finding on the European Communities' claim under Article 3.1(b) of the *SCM Agreement*. In that event, the European Communities asks the Appellate Body to find that the FSC measure violates Article 3.1(b) of the *SCM Agreement*.

67. The European Communities explains that one of the conditions for obtaining the FSC subsidies is that foreign trade income must derive from transactions involving "export property". Subparagraph (C) of Section 927(a)(1) of the IRC imposes a requirement that not more than 50 per cent of the fair market value of "export property" be attributable to articles imported into the United States. This, the European Communities argues, makes the FSC subsidies contingent in law upon the use of domestic over imported goods, in violation of Article 3.1(b) of the *SCM Agreement*.

68. The European Communities observes that, if the United States could make the FSC measure consistent with Article 3.1(a) of the *SCM Agreement* by removing only the export contingency, for example by making the FSC measure available also to sales of goods by FSCs to domestic purchasers, then FSC subsidies would remain conditional on the sale of goods with no more than 50 per cent of their fair market value attributable to imports. In that case, the Panel's finding on Article 3.1(a) alone would not ensure that the United States complies with its obligations under the *SCM Agreement*, since the violation of Article 3.1(b) would persist.

D. *Arguments by the United States – Appellee*

1. The FSC Administrative Pricing Rules

69. If the Appellate Body reverses the findings of the Panel under Article 3.1(a) of the *SCM Agreement*, the United States submits, the Appellate Body may complete the Panel's legal analysis "to the extent possible on the basis of the factual findings of the Panel and/or of undisputed

facts in the Panel record ... ".[73] In that case, the United States believes that the factual findings of the Panel and/or the undisputed facts in the Panel record would require the Appellate Body to conclude that the European Communities has failed to satisfy its burden of proof, as complainant, of demonstrating that the FSC administrative pricing rules are inconsistent with the *SCM Agreement.*

70. The United States objects to the European Communities' assertion that the Panel's recommendation that the "FSC subsidies" be withdrawn means that the Panel also ruled on the administrative pricing rules. Examination of the Panel Report reveals that the Panel expressly refused to make such a finding. The United States also highlights that, in this appeal, it has not addressed possible implementation issues in any way.

71. The United States rejects the European Communities contention that the mere *availability* of a choice between transfer pricing methods can contravene the *SCM Agreement.* Determining whether or not a particular regime of transfer pricing rules is consistent with the principles set forth in footnote 59 is necessarily a fact-intensive task. The European Communities has presented no evidence that the administrative pricing rules improperly shift domestic-source income abroad in order to avoid payment of taxes. Finally, the United States argues that the European Communities has not satisfied the burden of proof imposed upon it under the third sentence of footnote 59 to prove that the administrative pricing rules "result in a significant saving of direct taxes in export transactions".

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

72. If the Appellate Body reverses the findings of the Panel under Article 3.1(a) of the *SCM Agreement*, then, the United States submits, the Appellate Body may complete the Panel's legal analysis "to the extent possible on the basis of the factual findings of the Panel and/or of undisputed facts in the Panel record ... ".[74] In this case, the United States believes that the factual findings of the Panel and/or the undisputed facts in the Panel record require the Appellate Body to conclude that the European Communities has failed to satisfy its burden of proof, as complainant, of demonstrating that the FSC definition of "export property" is inconsistent with Article 3.1(b) of the *SCM Agreement.*

73. The United States maintains that neither the tax exemption nor the FSC administrative pricing rules constitutes a prohibited export subsidy under Articles 3.1(a) or 3.1(b) of the *SCM Agreement* and neither is a "subsidy" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement.* Assuming *arguendo* that the FSC tax exemption and the FSC administrative pricing rules are not

[73]Appellate Body Report, *Australia – Measures Affecting Importation of Salmon* ("*Australia – Salmon*"), WT/DS18/AB/R, adopted 6 November 1998, para. 118; see also Appellate Body Report, *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products* ("*Korea – Dairy*"), WT/DS98/AB/R, adopted 12 January 2000, para. 92.

[74]Appellate Body Report, *Australia – Salmon*, *supra*, footnote 73, para. 118.

protected by footnote 5 of the *SCM Agreement* and that one or both measures constitutes a subsidy, the United States argues that in any case neither measure is contingent upon the use of domestic over imported goods. The requirement in section 927(a)(1)(C) applies to the overall *value* of the exported product, not to the domestic versus foreign content of its component parts. Therefore, a product could qualify under section 927(a)(1)(C) even if it consisted *entirely* of imported components, provided those components comprise no more than 50 per cent of the fair market value of the product. Since the European Communities has provided *no* evidence to support its assertion that section 927(a)(1)(C) forces a producer to make decisions on the sourcing of parts that would not be made in the absence of the 50 per cent requirement, the United States requests the Appellate Body to find that this requirement is not inconsistent with Article 3.1(b) of the *SCM Agreement.*

E. *Arguments by the Third Participants*

1. Canada

74. Canada disagrees with the United States' assertion that taxation of foreign-source income is not "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement* since, absent the FSC measure, income generated by export performance would be subject to United States taxation. Canada fully agrees with the Panel's conclusions regarding Article 3.1(a) of the *SCM Agreement.* With respect to the United States' argument, based on the fifth sentence of footnote 59, Canada observes that the FSC measure does not alleviate double taxation; rather, it enhances United States exports. Canada urges the Appellate Body to make a finding that the FSC measure is also a prohibited subsidy under Article 3.1(b) of the *SCM Agreement.* Finally, Canada notes that it agrees with the findings of the Panel under the *Agreement on Agriculture*.

2. Japan

75. Japan agrees with the Panel's interpretation of the term "otherwise due" in Article 1.1(a)(1)(ii) of the *SCM Agreement*, and requests that the Appellate Body confirm the Panel's findings and conclusions with respect to Article 3.1(a) of the *SCM Agreement.* Japan also supports the European Communities' request that the Appellate Body examine the consistency of the FSC measure with Article 3.1(b) of the *SCM Agreement*, as Japan considers that the FSC measure violates both Articles 3.1(a) and 3.1(b) of the *SCM Agreement.*

IV. Issues Raised in This Appeal

76. This appeal raises the following issues:

(a) whether the Panel erred in finding that the FSC measure constitutes a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*, including whether the Panel erred in finding that the FSC measure involves a "subsidy" under Article 1.1 of the *SCM Agreement*;

(b) whether the Panel erred in its interpretation and application of Article 3.3 of the *Agreement on Agriculture*, in particular:

i) in its interpretation and application of the term "costs of marketing" in Article 9.1(d) of the *Agreement on Agriculture*; and

ii) in its interpretation and application of the words "shall not provide such subsidies" in Article 3.3 of the *Agreement on Agriculture*.

(c) whether the Panel erred in its interpretation and application of Article 4.2 of the *SCM Agreement*;

(d) whether the Panel erred in its interpretation and application of footnote 59 of the *SCM Agreement* by declining to dismiss or defer the European Communities' claims regarding the FSC administrative pricing rules until the European Communities had attempted to resolve this matter through the facilities of existing bilateral tax treaties or other specific international instruments;

(e) whether the Panel erred in finding that it was neither necessary nor appropriate to make findings with respect to the European Communities' claims under Article 3.1(a) of the *SCM Agreement* relating to the FSC administrative pricing rules;

(f) whether the Panel erred in finding that it was neither necessary nor appropriate to make findings with respect to the European Communities' claims under Article 3.1(b) of the *SCM Agreement.*

V. Article 3.1 of the *SCM Agreement*

77. At the outset, the Panel stated that it would begin its examination of the dispute with the European Communities' claims under Article 3.1(a) of the *SCM Agreement*, rather than with the United States' arguments under footnote 59 of that Agreement. Under Article 3.1(a), the Panel determined, first, whether the FSC measure involved a "subsidy" as that term is defined in Article 1.1

of the *SCM Agreement*. The Panel examined, in particular, whether the FSC measure involved the foregoing of "government revenue that is *otherwise due*" under Article 1.1(a)(1)(ii). (emphasis added) The Panel stated:

> … we took the term "*otherwise* due" to refer to the situation that would prevail but for the measures in question. It is thus a matter of determining whether, absent such measures, there would be a higher tax liability. In our view, this means that a panel, in considering whether revenue foregone is "otherwise due", must examine the situation that would exist but for the measure in question. Under this approach, the question presented in this dispute is whether, if the FSC scheme did not exist, revenue would be due which is foregone by reason of that scheme.[75] (underlining added)

78. The Panel next considered whether this reading of the term "otherwise due" was altered by the 1981 Council action.[76] The Panel concluded that that action was "not a legal instrument with binding legal force on all contracting parties"[77] and that it did not, therefore, form part of the GATT 1994 under paragraph 1(b)(iv) of the language incorporating the GATT 1994 into the *WTO Agreement*.[78]

79. The Panel went on to find that the 1981 Council action was a "decision" which "guided" the WTO under Article XVI:1 of the *WTO Agreement*. However, the Panel took the view that the 1981 Council action was not "*relevant* to this dispute" because the 1981 Council action was limited to Article XVI:4 of the GATT 1947 and because Article XVI:4 of the GATT 1947 "differs dramatically from the export subsidy disciplines in the SCM Agreement".[79] (emphasis added)

80. The Panel also examined whether its reading of the term "otherwise due" was affected by footnote 59 of the *SCM Agreement*. The Panel opined:

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[75]Panel Report, para. 7.45.

[76]Throughout our findings, we use the term "1981 Council action" to refer to the action taken by the GATT 1947 Council when adopting the panel reports in the *Tax Legislation Cases*, *supra*, footnotes 44 and 45.

[77]Panel Report, para. 7.74.

[78]*Ibid*., para. 7.85.

[79]*Ibid*., paras. 7.79 and 7.85.

> … even assuming for the sake of argument that footnote 59 is predicated on the assumption that income arising from foreign economic processes is not as a general matter "otherwise due" within the meaning of Article 1.1(a)(1)(ii), we could at most conclude that a decision by a Member not to tax any income arising from foreign economic processes would not represent the foregoing of revenue "otherwise due". There is in our view however nothing in footnote 59 which would lead us to conclude that a Member that decides that it will tax income arising from foreign economic processes does not forego revenue "otherwise due" if it decides in a selective manner to exclude certain limited categories of such income from taxation.[80]

81. The Panel, therefore, dismissed the United States argument that footnote 59 altered the interpretation of the term "otherwise due". Thereafter, the Panel examined whether the FSC measure involves the foregoing of government revenue "otherwise due". The Panel found:

> Viewed as an integrated whole, the exemptions provided by the FSC scheme represent a systematic effort by the United States to exempt certain types of income which would be taxable in the absence of the FSC scheme. Thus, application of special source rules for FSCs serves to protect a certain proportion of the foreign trade income of a FSC from direct taxation, whether or not that income would be taxable under the source rules provided for in Section 864 of the US Internal Revenue Code. The exemption from the anti-deferral rules of Subpart F of the US Internal Revenue Code ensure that the undistributed foreign trade income of a FSC is not immediately taxable to the US parent of a FSC, even though such income might otherwise be subject to the anti-deferral rules. Finally, the 100 per cent dividends-received deduction ensures that, even when the FSC distributes earnings attributable to foreign trade income to the US parent company, the US parent will not be subject to US income taxes on that income. Taken together, it is clear that the various exemptions under the FSC scheme result in a situation where certain types of income are shielded from taxes that would be due in the absence of the FSC scheme.[81]

82. The Panel, therefore, concluded that "the various exemptions under the FSC scheme, taken together, result in the foregoing of revenue which is otherwise due and thus give rise to a financial contribution within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement."[82] Having also found that the FSC measure involves a "benefit" to the recipients of the FSC tax exemptions[83], the Panel

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[80]Panel Report, para. 7.92.

[81]*Ibid*., para. 7.100.

[82]*Ibid*., para. 7.102.

[83]*Ibid*., para. 7.103.

concluded that the FSC tax exemptions "represent a subsidy within the meaning of Article 1 of the SCM Agreement."[84]

83. The Panel then considered whether the FSC subsidies are "contingent upon export performance" under Article 3.1(a) of the *SCM Agreement.* The Panel examined the provisions of the IRC, notably those relating to the "foreign trading gross receipts" of an FSC[85] and the definition of "export property".[86] In light of these provisions, the Panel concluded that the FSC tax exemptions are "contingent upon export performance" under Article 3.1(a) of the *SCM Agreement.* The Panel then examined footnote 59 again and reiterated that footnote 59 does not mean that "a Member is … entitled to … assert its taxing authority over income derived from foreign economic activities generally and then create an exemption from such taxation specifically for income derived from export activities."[87]

84. On the basis of this reasoning, the Panel concluded that the United States has "acted inconsistently with its obligations under Article 3.1(a) of the SCM Agreement by granting or maintaining export subsidies prohibited by that provision".[88]

85. The United States appeals, first, from the Panel's decision to begin its examination of the European Communities' claims under the *SCM Agreement* with Article 3.1 of that Agreement rather than with footnote 59, which the United States contends is the "controlling legal provision" in this case.[89] As regards the substantive interpretation of Article 1.1 of the *SCM Agreement*, the United States accepts, *as a general proposition*, the Panel's interpretation of the term "otherwise due" as establishing a "but for" test; however, the United States argues that this standard "is not unqualified" and "must yield" in situations where a specific standard exists for determining whether revenue is "otherwise due". In the view of the United States, footnote 59 provides such a "controlling" standard in this dispute.[90] The United States argues that this footnote provides the "most relevant context" for interpreting the term "otherwise due" because, under footnote 59, the FSC measure does not involve the foregoing of revenues "otherwise due".[91] The United States submits that this reading of footnote 59 is "confirmed" by the 1981 Council action.[92] In that regard, the

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[84]Panel Report, para. 7.104.

[85]Section 924 IRC.

[86]Section 927(a) IRC.

[87]Panel Report, para. 7.119.

[88]*Ibid*., para. 8.1.

[89]United States' appellant's submission, para. 64.

[90]*Ibid*.

[91]*Ibid*., para. 283.

[92]*Ibid*., para. 133 and the heading on page 48.

United States appeals against the Panel's finding that the 1981 Council action is not part of the GATT 1994 and, in any event, has no relevance to this dispute. The United States contends that the 1981 Council action was a "decision" of the CONTRACTING PARTIES which entered into force before the *WTO Agreement* and which had a binding effect in determining the rights and obligations of all contracting parties to the GATT 1947. The United States concludes, accordingly, that the 1981 Council action *is* a "decision" under paragraph 1(b)(iv) of the language incorporating the GATT 1994 into the *WTO Agreement* and, therefore, may be relevant in dispute settlement proceedings.

86. The United States' appeal from the Panel's specific findings under Article 3.1(a) is limited to the Panel's treatment of footnote 59 and the 1981 Council action. The United States argues that footnote 59 means that "an exemption of foreign-source income from taxation, such as that provided by the FSC, does not fall within the scope of the prohibition [against export subsidies] even where the exemption in question is limited to income earned in export transactions."[93] The United States places particular reliance on the second and fifth sentences of footnote 59. It is "implicit" in the second sentence, argues the United States, that "foreign-source income may be exempted from tax or taxed to a lesser extent than domestic-source income."[94] Moreover, the United States contends that the fifth sentence of footnote 59 allows Members to adopt certain measures "to avoid double taxation", and that the FSC measure is such a measure. The United States maintains that this reading of footnote 59 is "confirmed" by the 1981 Council action, which is, therefore, relevant to this dispute.[95]

87. In reply, the European Communities supports the Panel's reasoning and findings on Article 3.1(a) of the *SCM Agreement*.

88. We will examine the United States' appeal on these various issues in the following order. First, we will consider whether the Panel ought to have begun its analysis with footnote 59, rather than with Articles 1.1 and 3.1 of the *SCM Agreement*. Second, we will examine the Panel's findings under Article 3.1(a) of the *SCM Agreement*, including the Panel's finding that the FSC measure involves a "subsidy" under Article 1.1 of the *SCM Agreement* and, in particular, the Panel's interpretation of the term "otherwise due" in Article 1.1. We will then address the Panel's finding that the FSC subsidy is "contingent upon export performance" and the United States' arguments that footnote 59, as "confirmed" by the 1981 Council action, means that the FSC measure is not an export subsidy.

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[93]United States' appellant's submission, para. 65.

[94]*Ibid.*, paras. 74 and 83.

[95]*Ibid.*, para. 133 and the heading on page 48.

89. We start with the United States' argument that the Panel erred by failing to begin its examination of the European Communities' claim under Article 3.1(a) of the *SCM Agreement* with footnote 59 of that Agreement. Instead, the Panel began its examination with the general definition of a "subsidy" that is set forth in Article 1.1 of the *SCM Agreement*.[96] This definition applies throughout the *SCM Agreement*, to all the different types of "subsidy" covered by that Agreement. In our view, it was not a legal error for the Panel to begin its examination of whether the FSC measure involves export *subsidies* by examining the general definition of a "*subsidy*" that is applicable to export *subsidies* in Article 3.1(a).[97] In any event, whether the examination begins with the general definition of a "subsidy" in Article 1.1 or with footnote 59, we believe that the outcome of the European Communities' claim under Article 3.1(a) would be the same.[98] The appropriate meaning of both provisions can be established and can be given effect, irrespective of whether the examination of the claim of the European Communities under Article 3.1(a) begins with Article 1.1 or with footnote 59.[99]

(a) Article 1.1 of the *SCM Agreement*

90. We turn now to the definition of the term "subsidy" and, in particular, to Article 1.1(a)(1)(ii), which provides that there is a "financial contribution" by a government, sufficient to fulfil that element in the definition of a "subsidy", where "government revenue that is *otherwise due* is foregone or not collected". (emphasis added) In our view, the "*foregoing*" of revenue "*otherwise* due" implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, "otherwise". Moreover, the word "foregone" suggests that the government has given up an entitlement to raise revenue that it could "otherwise" have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues. There must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised "otherwise". We, therefore,

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[96]Panel Report, para. 7.39.

[97]We note that, in *Brazil – Aircraft*, we stated that in a dispute involving claims under Article 3.1(a) brought against a developing country Member, it is incumbent on the complaining Member to demonstrate, first, that the developing country Member in question is not in compliance with Article 27.4 of the *SCM Agreement*. The reason for this is that, in the circumstances described in Article 27, Article 3.1(a) *does not apply* to developing country Members. It is, therefore, necessary to establish, first, that Article 3.1(a) actually *applies* to the dispute (*supra*, footnote 52, para. 141). However, Article 27 does not apply to this dispute, which does not involve a complaint against a developing country Member, and the applicability of Article 3.1(a) is not, therefore, in issue.

[98]The United States agreed with this view in reply to questioning during the oral hearing.

[99]We note that the relationship between Article 1.1 and footnote 59 of the *SCM Agreement* is, therefore, different in this way from the relationship between the chapeau of Article XX of the GATT 1994 and the particular exceptions listed in sub-paragraphs (a) to (j) of that Article. In our Report in *United States – Import Prohibitions of Certain Shrimp and Shrimp Products* ("*United States – Shrimp*"), we observed that the application of the general standards of the chapeau of Article XX of the GATT 1994 is rendered very difficult, if not impossible, if the treaty interpreter does not, first, identify and examine the specific exception at issue (WT/DS58/AB/R, adopted 6 November 1998, para. 120).

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 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.[100] What is "otherwise due", therefore, depends on the rules of taxation that each Member, by its own choice, establishes for itself.

91. The Panel found that the term "otherwise due" establishes a "but for" test, in terms of which the appropriate basis of comparison for determining whether revenues are "otherwise due" is "the situation that would prevail but for the measures in question".[101] In the present case, this legal standard provides a sound basis for comparison because it is not difficult to establish in what way the foreign-source income of an FSC would be taxed "but for" the contested measure. However, we have 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. We observe, therefore, that, although the Panel's "but for" test works in this case, it may not work in other cases. We note, however, that, in this dispute, the European Communities does not contest either the Panel's interpretation of the term "otherwise due" or the Panel's application of that term to the facts of this case.[102] The United States also accepts the Panel's interpretation of that term as a general proposition.

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[100]See *Japan – Taxes on Alcoholic Beverages* ("*Japan – Alcoholic Beverages*"), WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, p. 16, and *Chile – Taxes on Alcoholic Beverages*, WT/DS87/AB/R, WT/DS110/AB/R, adopted 12 January 2000, paras. 59 and 60.

[101]Panel Report, para. 7.45.

[102]In the Panel proceedings, the European Communities advanced an interpretation of the term "otherwise due" that differed from that retained by the Panel. The European Communities considered the Panel's interpretation to be "formalistic". See Panel Report, paras. 4.591 and 7.46.

92. The United States does, however, argue that the Panel erred because the general interpretation of the term "otherwise due" "must yield"[103] to the standard the United States perceives in footnote 59 of the *SCM Agreement*, which the United States contends, is the "controlling legal provision"[104] for interpretation of the term "otherwise due" with respect to a measure of the kind at issue.[105] In the view of the United States, footnote 59 means that the FSC measure is not a "subsidy" under Article 1.1 of the *SCM Agreement*. Thus, the United States does not read footnote 59 as providing context for the general interpretation of the term "otherwise due"; rather, the United States views footnote 59 as a form of exception to that general interpretation. The United States submits further that this reading of footnote 59 is "confirmed" by the 1981 Council action, which, it will be recalled, the United States contends forms part of the GATT 1994.

93. Article 1.1 sets forth the general definition of the term "subsidy" which applies "for the purpose of this Agreement". This definition, therefore, applies wherever the word "subsidy" occurs throughout the *SCM Agreement* and conditions the application of the provisions of that Agreement regarding *prohibited* subsidies in Part II, *actionable* subsidies in Part III, *non-actionable* subsidies in Part IV and countervailing measures in Part V. By contrast, footnote 59 relates to one item in the Illustrative List of Export Subsidies. Even if footnote 59 means – as the United States also argues – that a measure, such as the FSC measure, is *not* a prohibited *export* subsidy, footnote 59 does not purport to establish an exception to the general definition of a "*subsidy*" otherwise applicable throughout the entire *SCM Agreement*. Under footnote 5 of the *SCM Agreement*, where the Illustrative List indicates that a measure is not a prohibited *export* subsidy, that measure is *not* deemed, for that reason alone, not to be a "subsidy". Rather, the measure is simply *not prohibited* under the Agreement. Other provisions of the *SCM Agreement* may, however, still apply to such a "subsidy". We note, moreover, that, under footnote 1 of the *SCM Agreement*, "the exemption of an exported *product* from duties or taxes *borne by the like product* when destined for domestic consumption … shall not be deemed to be a subsidy". (emphasis added) The tax measures identified in footnote 1 as not constituting a "*subsidy*" involve the exemption of exported *products* from *product-based* consumption taxes. The tax exemptions under the FSC measure relate to the taxation of *corporations* and not *products*. Footnote 1, therefore, does *not* cover measures such as the FSC measure.

94. In light of the above, we do not accept the United States' argument that footnote 59 qualifies the general interpretation of the term "otherwise due". That being so, it is not necessary for us to examine, at this point, the United States' arguments on the interpretation of footnote 59 or the

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[103]United States' appellant's submission, para. 279.

[104]*Ibid*., para. 64.

[105]*Ibid*., para. 111.

United States' belief that its interpretation of footnote 59 is "confirmed" by the 1981 Council action. These arguments will be examined below when we consider Article 3.1(a) of the *SCM Agreement* and footnote 59 of that Agreement, which is attached to item (e) of the Illustrative List.

95. The United States' appeal from the Panel's findings under Article 1.1 of the *SCM Agreement* is limited to its contention that the general interpretation of the term "otherwise due" is qualified by footnote 59. As we do not accept that sole ground of appeal, we uphold the Panel's finding that, under the FSC measure, the government of the United States foregoes revenue that is "otherwise due" under Article 1.1(a)(1)(ii) of the *SCM Agreement*. We note, in this respect, that the United States acknowledges that the FSC measure represents a departure from the rules of taxation that would "otherwise" apply to FSCs. [106] We note also that the United States does not contest that, absent the FSC measure, the tax liability of the FSCs would be higher.

(b) Article 3.1(a) of the *SCM Agreement*

96. The United States' appeal from the Panel's findings under Article 3.1(a) is limited to its contention that footnote 59, as "confirmed" by the 1981 Council action, means that the FSC measure is not an "export subsidy". Footnote 59 reads:

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

[106] In paragraphs 7.95, 7.96 and 7.97 of the Panel Report, the Panel described, in detail, the manner in which the three tax exemptions provided under the FSC measure constitute a departure from the rules of taxation that would "otherwise" apply. At the oral hearing, the United States confirmed the correctness of the description given of the rules of taxation that would "otherwise" apply and of the three FSC exemptions in paragraphs 7.95, 7.96 and 7.97 of the Panel Report. The FSC measure is also described, *supra*, in paragraphs 11 to 18.

97. We need to examine footnote 59 sentence by sentence. The first sentence of footnote 59 is specifically related to the statement in item (e) of the Illustrative List that the "full or partial exemption remission, or deferral specifically related to exports, of direct taxes" is an export subsidy. The first sentence of footnote 59 qualifies this by stating that "deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected." Since the FSC measure does not involve the *deferral* of direct taxes, we do not believe that this sentence of footnote 59 bears upon the characterization of the FSC measure as constituting, or not, an "export subsidy".

98. The second sentence of footnote 59 "reaffirms" that, in allocating export sales revenues, for tax purposes, between exporting enterprises and controlled foreign buyers, the price for the goods shall be determined according to the "arm's length" principle to which that sentence of the footnote refers. Like the Panel, we are willing to accept, for the sake of argument, the United States' position that it is "implicit" in the requirement to use the arm's length principle that Members of the WTO are not obliged to tax foreign-source income, and also that Members may tax such income less than they tax domestic-source income.[107] We would add that, even in the absence of footnote 59, Members of the WTO are *not* obliged, by WTO rules, to tax *any* categories of income, whether foreign- or domestic-source income. The United States argues that, since there is no requirement to tax export-related foreign-source income, a government cannot be said to have "foregone" revenue if it elects not to tax that income. It seems to us that, taken to its logical conclusion, this argument by the United States would mean that there could *never* be a foregoing of revenue "otherwise due" because, in principle, under WTO law generally, *no* revenues are ever due and *no* revenue would, in this view, ever be "foregone". That cannot be the appropriate implication to draw from the requirement to use the arm's length principle.

99. Furthermore, we do not believe that the requirement to use the arm's length principle resolves the issue that arises here. That issue is *not*, as the United States suggests, whether a Member is or is not obliged to tax a particular category of foreign-source income. As we have said, a Member is not, in general, under any such obligation. Rather, the issue in dispute is whether, *having decided to tax a particular category of foreign-source income*, namely foreign-source income that is "effectively connected with a trade or business within the United States", the United States is *permitted to carve out an export contingent exemption from the category of foreign-source income that is taxed under its other rules of taxation*. Unlike the United States, we do not believe that the second sentence of footnote 59 addresses this question. It plainly does not do so expressly; neither, as far as we can see, does it do so by necessary implication. As the United States indicates, the arm's length principle operates when a Member chooses not to tax, or to tax less, certain categories of foreign-source income. However, the operation of the arm's length principle is unaffected by the choice a Member

[107] United States' appellant's submission, para. 83.

makes as to *which* categories of foreign-source income, if any, it will not tax, or will tax less. Likewise, the operation of the arm's length principle is unaffected by the choice a Member might make to grant exemptions from the generally applicable rules of taxation of foreign-source income that it has selected for itself. In short, the requirement to use the arm's length principle does not address the issue that arises here, nor does it authorize the type of export contingent tax exemption that we have just described. Thus, this sentence of footnote 59 does not mean that the FSC subsidies are not export subsidies within the meaning of Article 3.1(a) of the *SCM Agreement*.

100. The third and fourth sentences of footnote 59 set forth rules that relate to remedies. In our view, these rules have no bearing on the substantive obligations of Members under Articles 1.1 and 3.1 of the *SCM Agreement*. So, we turn to the fifth and final sentence of footnote 59. That sentence provides:

> 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.

101. On appeal, the United States maintains that the FSC measure is a measure "to avoid double taxation of foreign-source income" *under footnote 59*.[108] As a consequence, the United States further contends that the FSC measure is excluded from the prohibition against export subsidies in Article 3.1(a) of the *SCM Agreement*. During the oral hearing, we asked the United States to identify where it had asserted before the Panel that the FSC measure is a measure "to avoid double taxation of foreign-source income" under footnote 59. That is, we asked the United States to tell us specifically where it had invoked the fifth sentence of footnote 59 as a means of justifying the FSC measure. In reply, the United States pointed to its first written submission to the Panel. In that submission, in describing the FSC measure and before setting forth its legal arguments, the United States stated that "the FSC is designed to prevent double taxation of export income earned outside the United States by exempting a portion of the FSC's income from taxation."[109] The United States pointed also to certain general arguments it made before the Panel concerning the fifth sentence of footnote 59. However, 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. Our conclusion is confirmed by the Panel's statement, in footnote 682 of the Panel Report, that the United States had not

[108]United States' appellant's submission, para. 268.

[109]United States' first submission to the Panel, para. 54, reproduced at para. 4.348 of the Panel Report.

asserted that the fifth sentence of footnote 59 was "relevant to this dispute".[110] It follows, therefore, that this issue was not properly litigated before the Panel and that the Panel was not asked to examine whether the FSC measure is a measure "to avoid double taxation of foreign-source income" under footnote 59.

102. We said, in our Report in *Canada – Aircraft*, that "new arguments are not *per se* excluded from the scope of appellate review, simply because they are new."[111] However, that statement should not be read as allowing *any* new argument to be raised for the first time on appeal. Our ability to consider new arguments is circumscribed by our mandate under Article 17 of the DSU. In *Canada – Aircraft*, for example, we declined to examine a new argument that would have required us "to solicit, receive and review new facts", which we cannot do under Article 17.6 of the DSU.[112]

103. Our mandate under Article 17.6 is to address "*issues of law* covered in the panel report and *legal interpretations* developed by the panel". The argument which the United States asks us to address under the fifth sentence of footnote 59 involves two separate legal issues: first, that the FSC measure is a measure "to avoid double taxation of foreign-source income" within the meaning of footnote 59; and second, that, in consequence, the FSC measure is *excluded* from the prohibition in Article 3.1(a) of the *SCM Agreement* against export subsidies. In our view, examination of the substantive issues raised by this particular argument would be outside the scope of our mandate under Article 17.6 of the DSU, as this argument does not involve either an "issue of law covered in the panel report" or "legal interpretations developed by the panel". The Panel was simply not asked to address the issues raised by the United States' new argument. Further, the new argument now made before us would require us to address legal issues quite different from those which confronted the Panel and which may well require proof of new facts. The United States appears in effect to be appealing from the failure of the Panel to make a ruling or legal interpretation concerning the fifth sentence of footnote 59. That failure seems to us due to the failure of the respondent Member properly to litigate the matter before the Panel. We, therefore, decline to examine the United States' argument that the FSC measure is a measure "to avoid double taxation" within the meaning of footnote 59, and we reserve our opinion on this issue.

104. We turn next to the 1981 Council action and to the United States' argument that this action confirms its reading of footnote 59 of the *SCM Agreement.* The United States contends that the 1981 Council action is relevant to this dispute because, contrary to the Panel's finding[113], that action forms part of the GATT 1994 and that, as such, it "confirms" the United States reading of

[110]Panel Report, para. 7.118.

[111]*Supra*, footnote 58, para. 211.

[112]*Ibid*.

[113]Panel Report, para. 7.85.

footnote 59.[114] For that reason, the United States also appeals from the Panel's finding that, although the 1981 Council action provides "guidance" to the WTO as a "decision" under Article XVI:1 of the *WTO Agreement*, it has no relevance to this dispute.[115]

105. The 1981 Council action arose out of four disputes, known commonly and collectively as the *Tax Legislation Cases*. These cases involved tax measures of, respectively, France, Belgium, the Netherlands and the United States.[116] Each of the tax measures was alleged to involve export subsidies under Article XVI:4 of the GATT 1947. The panels in these disputes, each of which had the same composition, circulated their reports to the contracting parties of the GATT 1947 in November 1976. In each dispute, the panels found that the tax measure at issue was inconsistent with Article XVI:4 of the GATT 1947. These panel reports proved to be highly controversial with the contracting parties, and resulted in an impasse among them which, for some time, prevented the adoption of any of these reports under the rules of Article XXIII of the GATT 1947. After several years of deadlock, and, indeed, after some of the contracting parties had signed the *Tokyo Round Subsidies Code*, in December 1981, the CONTRACTING PARTIES adopted the four panel reports in the *Tax Legislation Cases*. These reports were adopted on the basis of a particular action, which we have called the "1981 Council action", which reads in full:

> The Council adopts *these reports on the understanding that with respect to these cases, and in general,* economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.[117] (emphasis added)

106. The 1981 Council action was accompanied by a statement of the Chairman of the GATT 1947 Council:

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[114]United States' appellant's submission, para. 133 and the heading on page 48.

[115]Panel Report, para. 7.79.

[116]*Supra*, footnote 44; Panel Report, paras. 7.52-7.54.

[117]*Supra*, footnote 45.

> Following the adoption of these reports the Chairman noted that the Council's decision and understanding does not mean that the parties adhering to Article XVI:4 are forbidden from taxing the profits on transactions beyond their borders, it only means that they are not required to do so. *He noted further that the decision does not modify the existing GATT rules in Article XVI:4 as they relate to the taxation of exported goods. He noted also that this decision does not affect and is not affected by the Agreement on the Interpretation and Application of Articles VI, XVI and XXIII. Finally, he noted that the adoption of these reports together with the understanding does not affect the rights and obligations of contracting parties under the General Agreement.*[118] (emphasis added)

107. The first issue relating to the 1981 Council action is whether it forms part of the GATT 1994 as an "other decision" under paragraph 1(b)(iv) of the language incorporating the GATT 1947 into the *WTO Agreement.* Paragraph 1(b) stipulates that the GATT 1994 includes certain "legal instruments … that entered into force under the GATT 1947", such as "other decisions of the CONTRACTING PARTIES to the GATT 1947" under sub-paragraph (b)(iv). As the Panel said, in terms of Article II:2 of the *WTO Agreement*, these various "legal instruments" are, in themselves, "integral parts" of the *WTO Agreement* and are "binding on all Members". The inclusion of these "legal instruments" in the GATT 1994 recognizes that the legal character of the rights and obligations of the contracting parties under the GATT 1994 is not fully reflected by the text of the GATT 1994 because those rights and obligations are conditioned by the "protocols", "decisions" and other "legal instruments" to which paragraph 1(b) refers.

108. In our Report in *Japan – Alcoholic Beverages*, we stated that not *every* decision of the CONTRACTING PARTIES to the GATT 1947 is an "other decision" within the meaning of paragraph 1(b)(iv) of the language incorporating the GATT 1994 into the *WTO Agreement.* In that respect, we disagreed with the view that "adopted panel reports in themselves constitute '*other decisions* of the CONTRACTING PARTIES to GATT 1947' for the purposes of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the *WTO Agreement.*"[119] (emphasis added) The reason for this conclusion was that adopted panel reports "are *not binding, except with respect to resolving the particular dispute between the parties to that dispute*".[120] (emphasis added) As we said there, the decision to adopt a panel report was not intended by the GATT 1947 CONTRACTING PARTIES to "constitute a *definitive interpretation of the relevant provisions of GATT 1947*." [121] (emphasis added)

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[118] *Supra*, footnote 45.

[119] *Supra*, footnote 100, p. 14.

[120] *Ibid*. In that Report, we noted that Article 59 of the Statute of the International Court of Justice makes explicit provision to the same effect (p. 14).

[121] *Ibid*., p. 13.

109. The opening clause of the 1981 Council action states: "The Council adopts *these reports* on the understanding that *with respect to these cases, and in general…*". The 1981 Council action is, therefore, somewhat equivocal in tenor. On the one hand, it is clear from the text that the 1981 Council action relates specifically to the *Tax Legislation Cases* and is an integral part of the resolution of those disputes. This would suggest that, consistently with our Report in *Japan – Alcoholic Beverages*, the Council action is binding only on the parties to those disputes, and only for the purposes of those disputes.

110. On the other hand, we note that the opening clause of the 1981 Council action also prefaces the substance of the statement with the words "*in general*". The United States argues that these words indicate that the 1981 Council action was an "authoritative interpretation" of Article XVI:4 of the GATT 1947 that has "general" application and that, therefore, bound all the contracting parties. The European Communities counters that the 1981 Council action formed part of the resolution of the *Tax Legislation Cases* and that, in adopting that decision, the GATT 1947 Council was acting in dispute settlement "mode".[122] The European Communities contends further that disputes are resolved on the basis of the generally applicable rules that are, first, interpreted "in general" and then applied to the facts of a specific dispute. It is in this limited sense that the European Communities contends that the GATT 1947 Council meant the term "in general".[123]

111. The remainder of the text of the 1981 Council action embodies the substantive statement of the GATT 1947 Council on Article XVI:4 of the GATT 1947 and does not, in our view, shed any additional light on whether that statement bound *all* the contracting parties or only the parties to the *Tax Legislation Cases*.[124] We, therefore, share the Panel's view that the text of the 1981 Council action alone does not resolve the ambiguity highlighted by the conflicting arguments of the United States and the European Communities.[125] Thus, we consider that the Panel was correct to examine the circumstances surrounding the 1981 Council action.

112. When the 1981 Council action was adopted, the Chairman of the GATT 1947 Council stated, *inter alia*, that "the adoption of these reports together with the understanding *does not affect the rights and obligations of contracting parties under the General Agreement.*" In our view, if the contracting parties had intended to make an *authoritative* interpretation of Article XVI:4 of the GATT 1947, binding on all contracting parties, they would have said so in reasonably recognizable terms.

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[122]European Communities' appellee's submission, para. 154.

[123]*Ibid*., para. 158.

[124]We note, in that respect, that we do not share the Panel's misgivings regarding the use of the word "should" in a "legal instrument" (Panel Report, para. 7.65). In our view, many binding legal texts employ the word "should" and, depending on the context, the word may imply either an exhortation or express an obligation (see, further, *Canada – Aircraft*, *supra*, footnote 58, para. 187).

[125]Panel Report, para. 7.65.

We think it most unlikely that the Chairman would have stated that the action did "*not affect the rights and obligations of contracting parties*", if it represented an authoritative interpretation of Article XVI:4 of the GATT 1947.[126] In our view, an authoritative, and generally binding, interpretation of Article XVI:4 would, in all probability, have been perceived by the contracting parties as affecting their rights and obligations and would not, therefore, have been accompanied by such a statement.[127] Thus, we are of the view that the statement of the GATT 1947 Council Chairman is consistent with a reading of the 1981 Council action which views that action as an integral part of the resolution of the *Tax Legislation Cases*, binding only the parties to those disputes.

113. As the Panel observed[128], it is also noteworthy that, in the report of the GATT 1947 Council to the CONTRACTING PARTIES on its actions during that year, the 1981 Council action was addressed under the heading "Recourse to Articles XXII and XXIII". This tends to support the view that the 1981 Council action was a part of the resolution of the *Tax Legislation Cases* and not an authoritative interpretation of Article XVI:4 of the GATT 1947, binding on *all* the contracting parties.

114. In light of these surrounding circumstances, we conclude that the Panel was correct to find, in paragraph 7.85 of the Panel Report, that the 1981 Council action is not an "other decision" under paragraph 1(b)(iv) of the language incorporating the GATT 1994 into the *WTO Agreement*, and does not form part of the GATT 1994.

115. We recognize that, as "decisions" within the meaning of Article XVI:1 of the *WTO Agreement*, the adopted panel reports in the *Tax Legislation Cases*, together with the 1981 Council action, could provide "guidance" to the WTO. The United States believes that the "guidance" to be drawn from the 1981 Council action, through footnote 59, is that the FSC measure is not an "export subsidy". The present dispute involves the interpretation and application of Article 3.1(a) of the *SCM Agreement* and the question of whether the FSC measure involves export subsidies *under that provision*. In contrast, the 1981 Council action addresses the interpretation and application of Article XVI:4 of the GATT 1947. The "guidance" that the 1981 Council action might provide, therefore, depends, in part, on the relationship between these different provisions.

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[126]This view is borne out by the statements made by a number of delegations, speaking either before or after the adoption of the panel reports in the *Tax Legislation Cases*. These delegations also expressed the view that the 1981 Council action did not affect or diminish their rights and obligations under the GATT 1947 (Panel Report, paras. 7.70 – 7-72).

[127]The distinction between an authoritative interpretation and an interpretation made in dispute settlement proceedings is made clear in the *WTO Agreement*. Under the *WTO Agreement*, an authoritative interpretation by the Members of the WTO, under Article IX:2 of that Agreement, is to be distinguished from the rulings and recommendations of the DSB, made on the basis of panel and Appellate Body Reports. In terms of Article 3.2 of the DSU, the rulings and recommendations of the DSB serve only "to clarify the existing provisions of those agreements" and "cannot add to or diminish the rights and obligations provided in the covered agreements."

[128]Panel Report, para. 7.67.

116. Although we have not previously had an opportunity to examine the relationship between these two particular provisions, we have in the past examined the relationship between the provisions of the GATT 1994 and certain other Multilateral Agreements on Trade in Goods.[129] In *Brazil – Desiccated Coconut*, we observed that the "relationship between the GATT 1994 and the other goods agreements in Annex 1A is complex and must be examined on a case-by-case basis."[130] In that case, we examined aspects of the relationship between the GATT 1994 and the provisions of Part V of the *SCM Agreement* relating to *countervailing duties*. The *SCM Agreement* has specific provisions that address the relationship between the provisions of the GATT 1994 and the *SCM Agreement* on countervailing duties.[131] Similarly, in *Korea – Dairy*[132] and *Argentina – Safeguard Measures on Imports of Footwear*[133], we examined the relationship between Article XIX of the GATT 1994 and the *Agreement on Safeguards*. There, too, the "precise nature of the relationship between Article XIX of the GATT 1994 and the *Agreement on Safeguards*" was explicitly addressed in the *Agreement on Safeguards*, in Articles 1 and 11.1(a).[134]

117. In contrast, the provisions of the *SCM Agreement* do not provide explicit assistance as to the relationship between the export subsidy provisions of the *SCM Agreement* and Article XVI:4 of the GATT 1994.[135] In the absence of any such specific textual guidance, we must determine the relationship between Articles 1.1(a)(1) and 3.1(a) of the *SCM Agreement* and Article XVI:4 of the GATT 1994 on the basis of the texts of the relevant provisions as a whole. It is clear from even a cursory examination of Article XVI:4 of the GATT 1994 that it differs very substantially from the subsidy provisions of the *SCM Agreement*, and, in particular, from the export subsidy provisions of both the *SCM Agreement* and the *Agreement on Agriculture*. First of all, the *SCM Agreement* contains an express definition of the term "subsidy" which is not contained in Article XVI:4. In fact, as we have observed previously, the *SCM Agreement* contains a broad package of new export subsidy

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[129]In particular, the *Agreement on Safeguards* and Part V of the *SCM Agreement*.

[130]*Supra*, footnote 50, p. 14.

[131]Articles 10 and 32.1 of the *SCM Agreement*. See *Brazil – Desiccated Coconut*, *supra*, footnote 50, p. 16.

[132]*Supra*, footnote 73.

[133]Appellate Body Report, WT/DS121/AB/R, adopted 12 January 2000.

[134]*Ibid*., para. 82.

[135]We note, however, that under Article 1.1(a)(2) of the *SCM Agreement*, a "subsidy" may exist if "there is any form of income or price support in the sense of Article XVI of GATT 1994". This is a reference to Article XVI:1 and not Article XVI:4 of the GATT 1994. Footnote 1 of the *SCM Agreement*, which is attached to Article 1.1(a)(1)(ii) of that Agreement, also makes reference to Article XVI of the GATT 1994 in connection with "the exemption of an exported product from duties or taxes borne by like products destined for domestic consumption …". This is a reference to the Interpretative Note *Ad* Article XVI of the GATT and is not a specific reference to Article XVI:4 of the GATT 1994. This reference to the Interpretative Note also has no relevance to this dispute. These references do not, therefore, provide us with guidance in determining the relationship between the export subsidy provisions of the *SCM Agreement* and Article XVI:4 of the GATT 1994.

disciplines that "go well beyond merely applying and interpreting Articles VI, XVI and XXIII of the GATT 1947".[136] Next, Article XVI:4 prohibits export subsidies only when they result in the export sale of a product at a price lower than the "comparable price charged for the like product to buyers in the domestic market." In contrast, the *SCM Agreement* establishes a much broader prohibition against *any* subsidy which is "contingent upon export performance". To say the least, the rule contained in Article 3.1(a) of the *SCM Agreement* that all subsidies which are "contingent upon export performance" are prohibited is significantly different from a rule that prohibits only those subsidies which result in a lower price for the exported product than the comparable price for that product when sold in the domestic market. Thus, whether or not a measure is an export subsidy under Article XVI:4 of the GATT 1947 provides no guidance in determining whether that measure is a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*. Also, and significantly, Article XVI:4 of the GATT 1994 does not apply to "primary products", which include agricultural products. Unquestionably, the explicit export subsidy disciplines, relating to agricultural products, contained in Articles 3, 8, 9 and 10 of the *Agreement on Agriculture* must clearly take precedence over the *exemption* of primary products from export subsidy disciplines in Article XVI:4 of the GATT 1994.

118. Furthermore, as the Panel observed, the text of the 1981 Council action itself contains reference only to Article XVI:4, and the Chairman of the GATT 1947 Council stated expressly that the 1981 Council action did *not* affect the *Tokyo Round Subsidies Code*. We share the Panel's view that, in these circumstances, it would be incongruous to extend the scope of the action, beyond that intended, to the *SCM Agreement*.[137] If the 1981 Council action did not affect the *Tokyo Round Subsidies Code*, which existed in 1981, it is difficult to see how that action could be seen to affect the *SCM Agreement*, which did not.

119. Against this background, we agree with the Panel that the 1981 Council action does not dispose of the issue before us, in particular, with respect to the determination of what constitutes an "export subsidy" under Article 3.1(a) of the *SCM Agreement*. The 1981 Council action related to a different provision, Article XVI:4 of the GATT 1947, and not to the export subsidy disciplines established by Articles 1.1 and 3.1(a) of the *SCM Agreement*.

[136] *Brazil – Desiccated Coconut*, *supra*, footnote 50, p. 17.

[137] Panel Report, para. 7.85.

120. In any event, even if the United States had been correct that the 1981 Council action could be relevant to Article 3.1(a) of the *SCM Agreement*, we do not believe that the 1981 Council action is of guidance in resolving *this* dispute because, in our view, that action does not address the issues that arise in this dispute. Through the 1981 Council action, the GATT 1947 Council made a statement about the conclusions of the panel reports in the *Tax Legislation Cases*. The factual and legal issues that arose in those disputes were quite different from the issue that arises here. That is, the GATT 1947 Council was not addressing the issue of whether, *having decided to tax a particular category of foreign-source income*, namely foreign-source income that is "effectively connected with a trade or business within the United States", the United States may provide *an export contingent exemption from the category of foreign-source income that is taxed under its other rules of taxation.* We, therefore, believe that the 1981 Council action does not provide useful interpretative "guidance" in resolving the legal issue relating to the FSC measure that is raised in this appeal.

121. In light of all the foregoing, we uphold the Panel's conclusion, in paragraph 8.1 of the Panel Report, that the FSC tax exemptions involve subsidies contingent upon export performance that are prohibited under Article 3.1(a) of the *SCM Agreement.*

VI. Articles 3.3 and 9.1(d) of the *Agreement on Agriculture*

122. The Panel began its examination of the European Communities' claims under the *Agreement on Agriculture* by noting that an inconsistency with Article 3.3 of that Agreement could arise only if a Member had provided export subsidies *listed in Article 9.1 of that Agreement.*[138] Furthermore, the Panel pointed out that with respect to agricultural products for which Members have made specific export subsidy commitments in Section II of Part IV of its Schedule ("scheduled agricultural products"), an inconsistency under Article 3.3 would arise only if the Member provided export subsidies listed in Article 9.1 "in excess of the budgetary outlay and/or quantity commitment levels".[139] In contrast, the Panel observed that, with respect to agricultural products for which a Member has made no specific commitments in Part IV of its Schedule ("unscheduled agricultural products"), an inconsistency under Article 3.3 would arise if a Member provided *any* export subsidies listed in Article 9.1.[140] The Panel set out to determine whether the FSC measure was a subsidy "to reduce the costs of marketing exports" under Article 9.1(d), the only sub-paragraph of Article 9.1 that the European Communities had specified in its claim.

[138]Panel Report, para. 7.146.

[139]*Ibid*.

[140]*Ibid*.

123. The Panel stated that:

> … as a practical commercial matter and in ordinary parlance, *income taxes are a cost of doing business*. Because FSC subsidies reduce an exporter's income tax liability with respect to marketing activities, they *effectively reduce the cost of marketing agricultural products*.[141] (emphasis added)

124. The Panel added:

> In any event, *a subsidy such as the FSC, which is provided to offset costs of marketing agricultural products, should be considered to reduce the costs of marketing agricultural products*.[142] (emphasis added)

125. Thus, focusing on the "purpose and role of the subsidies", the Panel concluded that the FSC measure involved export subsidies as listed in Article 9.1(d).[143] This, in turn, led the Panel to conclude that the United States had acted inconsistently with Article 3.3 of the *Agreement on Agriculture*. With respect to *scheduled* agricultural products, the Panel found that that inconsistency related to FSC subsidies provided for wheat, the only scheduled product for which the European Communities had presented any evidence in relation to the relevant "budgetary outlay and quantity commitment levels".[144] With respect to *unscheduled* products, the Panel concluded that the word "provide" in the second clause of Article 3.3 means "making available", and the Panel held that, by establishing a statutory entitlement for qualifying corporations to receive FSC subsidies, the United States was acting inconsistently with Article 3.3 because it was "providing" or "making available" export subsidies, as listed in Article 9.1(d), with respect to all unscheduled products.[145]

126. The United States submits that the Panel erred in its interpretation of Article 9.1(d) by focusing on the nature of the activities carried out by the recipient of the subsidy and, in particular, on whether the recipient is engaged in marketing activities, rather than on the nature of the subsidy itself and whether it reduces "the costs of marketing exports".[146] The United States maintains that, although income taxes may, as the Panel said, be a cost of doing business, they are not part of the "costs of marketing exports" under Article 9.1(d). The United States also disagrees with the Panel's interpretation of the word "provide" in the second clause of Article 3.3 of the *Agreement on Agriculture*. The United States contends that "provide" must mean more than "make available" and

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[141]Panel Report, para. 7.155.

[142]*Ibid*., para. 7.156.

[143]*Ibid*., paras. 7.156 and 7.159.

[144]*Ibid*., para. 7.165.

[145]*Ibid*., paras. 7.174-7.176.

[146]United States' appellant's submission, para. 309.

should be read, instead, to mean "grant" or "pay". Thus, the United States maintains that the FSC measure does not "provide" subsidies merely by making them available as an entitlement by law to those who meet the law's requirements.

127. Article 3.3 of the *Agreement on Agriculture* reads:

> Subject to the provisions of paragraphs 2(b) and 4 of Article 9, a Member *shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitments levels* specified therein and *shall not provide such subsidies in respect of any agricultural product not specified in that Section of its Schedule*. (emphasis added)

128. Article 9.1(d) of the *Agreement on Agriculture* provides:

> 1. The following export subsidies are subject to reduction commitments under this agreement:
>
> …
>
> (d) the provision of subsidies *to reduce the costs of marketing exports of agricultural products* (other than widely available export promotion and advisory services) including *handling*, *upgrading* and *other processing* costs, and the costs of international *transport* and *freight*; (emphasis added)

129. We turn, first, to the word "marketing" in Article 9.1(d), which is at the heart of the phrase "to reduce the costs of *marketing* exports" in Article 9.1(d). Taken alone, that word can have, as the Panel indicated, a range of meanings. The Panel noted the *Webster's Dictionary* meaning, according to which "marketing" is the "aggregate of functions involved in transferring title and in moving goods from producer to consumer including among others buying, selling, storing, transporting, standardizing, financing, risk bearing and supplying market information".[147] *The New Shorter Oxford Dictionary* provides a similar meaning: "The action, business, or process of promoting and selling a product…".[148] However, we must look beyond dictionary meanings, because, as we have said before, "dictionary meanings leave many interpretive questions open."[149]

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[147]Panel Report, para. 7.154, citing *Webster's Third International Dictionary*, Vol. II.

[148]*The New Shorter Oxford English Dictionary*, Lesley Brown (ed.) (Clarendon Press, 1993), Vol. I, p. 1700.

[149]*Canada – Aircraft*, *supra*, footnote 58, para. 153.

130. The text of Article 9.1(d) lists "handling, upgrading and other processing costs, and the costs of international transport and freight" as examples of "costs of marketing". The text also states that "export promotion and advisory services" are covered by Article 9.1(d), provided that they are not "widely available". These are not examples of just *any* "cost of doing business" that "effectively reduce[s] the cost of marketing" products.[150] Rather, they are specific types of costs that are incurred *as part of* and *during* the process of selling a product. They differ from general business costs, such as administrative overhead and debt financing costs, which are not specific to the process of putting a product on the market, and which are, therefore, related to the marketing of exports only in the broadest sense.

131. It seems to us that income tax liability under the FSC measure can also be viewed as related to the business of marketing exports only in the very broadest sense. Income tax liability under the FSC measure arises only when goods are actually sold for export, that is, *when they have been the subject of successful marketing.* Such liability arises *because* goods have, in fact, been sold, and not as *part of the process* of marketing them. Furthermore, at the time goods are sold, the costs associated with putting them on the market – costs such as handling, promotion and distribution costs – have already been incurred and the amount of these costs is not altered by the income tax, the amount of which is calculated by reference to the sale price of the goods. In our view, if income tax liability arising from export sales can be viewed as among the "costs of marketing exports", then so too can virtually any other cost incurred by a business engaged in exporting. This cannot be what was intended by Article 9.1(d). We, therefore, hold that income tax liability arising from export sales is not part of the "costs of marketing" a product.

132. Accordingly, we do not agree with the Panel that the FSC measure is a subsidy "to reduce the costs of marketing exports of agricultural products" under Article 9.1(d), and we, therefore, reverse the Panel's finding, in paragraph 7.159 of the Panel Report, that the FSC measure involves export subsidies listed in Article 9.1(d) of the *Agreement on Agriculture.* A finding of inconsistency with Article 3.3 of the *Agreement on Agriculture* is dependent on the Member having provided export subsidies *listed in Article 9.1*. As we have reversed the Panel's finding that the FSC measure involves export subsidies listed in Article 9.1(d), and as the European Communities has not claimed that the FSC measure involves export subsidies listed in any other sub-paragraph of Article 9.1, we also reverse the Panel's finding that the United States has acted inconsistently with Article 3.3 of the *Agreement on Agriculture* by providing export subsidies as listed in Article 9.1 of that Agreement. Having reversed the Panel's finding under Article 3.3, we do not find it necessary to examine the United States' appeal that the Panel erred in its interpretation of the word "provide" in the second clause of Article 3.3 of the *Agreement on Agriculture.* As we have found that the FSC measure does

[150]See Panel Report, para. 7.155.

not involve an export subsidy as listed in Article 9.1, and that, consequently, there is no inconsistency with Article 3.3, the Panel's interpretation of the word "provide" in the second clause of Article 3.3 is moot and of no legal effect.

133. As an alternative to its claims under Articles 3.3 and 9.1 of the *Agreement on Agriculture*, the European Communities claims that the FSC measure is inconsistent with Article 10.1, as read together with Article 8 of that Agreement. As we have reversed the Panel's findings under Articles 9.1 and 3.3 of the *Agreement on Agriculture*, it is necessary for us to examine this alternative claim under Articles 10.1 and 8 of that Agreement.

134. Article 8 of the *Agreement on Agriculture* stipulates:

> 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.

135. Article 10.1 of the *Agreement on Agriculture* reads:

> 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*; … (emphasis added)

136. We observe that Article 1(e) of the *Agreement on Agriculture* states that the term "export subsidies" "refers to subsidies contingent upon export performance". However, we note also that the *Agreement on Agriculture* does not contain a definition of the terms "subsidy" or "subsidies". In our Report in *Canada – Milk*, a case that involved "export subsidies" under the *Agreement on Agriculture*, we stated that "a 'subsidy' involves a transfer of economic resources from the grantor to the recipient for less than full consideration."[151] In making this statement, we drew, as context, upon the definition of a "subsidy" in Article 1.1 of the *SCM Agreement*:

> … a "subsidy", within the meaning of Article 1.1 of the *SCM Agreement*, arises where the grantor makes a "financial contribution" which confers a "benefit" on the recipient, as compared with what would have been otherwise available to the recipient in the marketplace.[152]

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[151] Appellate Body Report, *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products* ("*Canada – Milk*"), WT/DS103/AB/R, WT/DS113/AB/R, adopted 27 October 1999, para. 87.

[152] *Ibid*.

137. Therefore, in this case, we will consider, first, whether the FSC measure involves a transfer of economic resources by the grantor, which in this dispute is the government of the United States, and, second, whether any transfer of economic resources involves a benefit to the recipient.

138. The alleged subsidy here involves a transfer of resources through the foregoing of revenue. We held, in *Canada – Milk*, that "export subsidies" under the *Agreement on Agriculture* may involve, not only direct payments, but also "*revenue foregone*".[153] We believe, however, that in disputes brought under the *Agreement on Agriculture*, just as in cases under Article 1.1(a)(1)(ii) of the *SCM Agreement*, it is only where a government foregoes revenues that are "*otherwise due*" that a "subsidy" may arise.

139. In our examination of the Panel's findings under Article 1.1 of the *SCM Agreement*, we concluded that the FSC measure involves the foregoing of fiscal revenues that are "otherwise due" under that Agreement. We see no reason to reach any different conclusion under the *Agreement on Agriculture*. Under the FSC measure, the fiscal treatment of agricultural products is not materially different, for present purposes, from the fiscal treatment of products falling within the scope of application of the *SCM Agreement*.

140. As to whether there is a benefit, the United States did not contest that if the FSC measure involved a "financial contribution" under Article 1.1 of the *SCM Agreement*, it also involved a "benefit" under Article 1.1(b) of that Agreement.[154] The tax exemptions provided by the FSC measure, whether provided for agricultural or other products, confer upon the recipient the obvious benefit of reduced tax liability and, therefore, reduced tax payments. We find, therefore, that the FSC measure involves a "subsidy" under the *Agreement on Agriculture*.

141. We turn next to the requirement that "export subsidies" under Article 1(e) of the *Agreement on Agriculture* be "contingent upon export performance". We see no reason, and none has been pointed out to us, to read the requirement of "contingent upon export performance" in the *Agreement on Agriculture* differently from the same requirement imposed by the *SCM Agreement*. The two Agreements use precisely the same words to define "export subsidies". Although there are differences between the export subsidy disciplines established under the two Agreements, those differences do not, in our view, affect the common substantive requirement relating to export contingency. Therefore, we think it appropriate to apply the interpretation of export contingency that we have adopted under the *SCM Agreement* to the interpretation of export contingency under the *Agreement*

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[153] *Canada – Milk*, *supra*, footnote 151, para. 112. In reaching this conclusion, we observed that, under Article 1(c) of the *Agreement on Agriculture*, the terms "budgetary outlays" and "outlays" may include "*revenue foregone*".

[154] Panel Report, para. 7.103.

on Agriculture.[155] We also recall that we have upheld the Panel's finding that the FSC measure involves subsidies contingent upon export performance under Article 3.1(a) of the *SCM Agreement.* In making that finding, the Panel stated:

> The subsidy is only available with respect to "foreign trading income"; foreign trading income arises from the sale or lease of "export property" or the provision of services relating to the sale or lease of export property; and export property is limited in effect to goods manufactured, produced, grown or extracted in the United States which are held for direct use, consumption or disposition outside the United States. Thus, *the existence and amount of the subsidy depends upon the existence of income arising from the exportation of US goods* or *the provision of services relating to the exportation of such goods. The existence of such income, in turn, depends upon the exportation of US goods or, at a minimum, in the case of income from services related to the exportation of US goods, upon "anticipated exportation" within the meaning of footnote 4 to Article 3.1(a) of the SCM Agreement.*[156] (emphasis added)

142. We agree with the Panel that the provision of subsidies under the FSC measure, whether for agricultural or other products, is "contingent upon export performance". The provision of subsidies under the FSC measure is *dependent* or *conditional* upon either the *exportation* of "export property", or, in the case of services provided before exportation, at the very least, the *anticipation of that exportation.* For these reasons, we find that the FSC measure involves "subsidies contingent upon export performance" under the *Agreement on Agriculture*. Further, these subsidies have not been found to be listed in Article 9.1 of that Agreement.

143. We turn, consequently, to the issue of whether these subsidies have been "applied in a manner which *results in*, or which *threatens to lead to*, *circumvention* of *export subsidy commitments*". (emphasis added) We begin with the words "export subsidy commitments", because the meaning of those words defines the obligations that are to be protected under Article 10.1.

144. The word "commitments" generally connotes "engagements" or "obligations".[157] Thus, the term "export subsidy *commitments*" refers to commitments or obligations relating to export subsidies assumed by Members under provisions of the *Agreement on Agriculture*, in particular, under Articles 3, 8 and 9 of that Agreement.

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[155]See, further, *Canada – Aircraft*, *supra*, footnote 58, paras. 162 – 180.

[156]Panel Report, para. 7.108.

[157]*The New Shorter Oxford English Dictionary*, *supra*, footnote 148, p. 452.

145. Under Article 3, Members have undertaken two different types of "export subsidy commitments". Under the first clause of Article 3.3, Members have made a commitment that they will not "provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitments levels specified therein". This is the commitment for *scheduled* agricultural products. Article 3.1 confirms that:

> The domestic support and *export subsidy commitments in Part IV of each Member's Schedule constitute commitments limiting subsidization* and are hereby made an integral part of GATT 1994. (emphasis added)

146. Under the second clause of Article 3.3, Members have committed *not* to provide *any* export subsidies, *listed in Article 9.1*, with respect to *unscheduled* agricultural products. This clause clearly also involves "export subsidy commitments" within the meaning of Article 10.1. Our interpretation of this term is confirmed by the title of Article 9, which is "*Export Subsidy Commitments*". Consistently with our reading of that term, Article 9.1 relates *both* to (1) the commitments made for *scheduled* agricultural products, under the first clause of Article 3.3, and to (2) the general prohibition, in the second clause of Article 3.3, against providing export subsidies listed in Article 9.1 to *unscheduled* agricultural products.

147. We also find support for this interpretation of the term "export subsidy commitments" in Article 10 itself, which draws a distinction, in sub-paragraphs 1 and 3, between "export subsidy commitments" and "*reduction commitment levels*".[158] In our view, the terms "export subsidy commitments" and "reduction commitments" have different meanings. "*Reduction* commitments" is a narrower term than "export subsidy commitments" and refers only to commitments made, under the first clause of Article 3.3, with respect to *scheduled* agricultural products. It is only with respect to *scheduled* products that Members have undertaken, under Article 9.2(b)(iv) of the *Agreement on Agriculture*, to *reduce* the level of export subsidies, as listed in Article 9.1, during the implementation period of the *Agreement on Agriculture*.[159] The term "export subsidy commitments" has a wider reach that covers commitments and obligations relating to *both* scheduled and unscheduled agricultural products.

[158]The term "reduction commitments" also appears in the chapeau to Article 9.1.

[159]Article 9.2(b)(iv) provides that, with respect to *scheduled* products, the budgetary outlay and quantity commitment levels must, by the end of the implementation period, not exceed certain threshold levels, expressed as a percentage of the 1986-1990 base period levels.

148. We turn next to whether the subsidies under the FSC measure are "applied in a manner which *results in*, or which *threatens to lead to*, *circumvention* of export subsidy commitments". (emphasis added) The verb "circumvent" means, *inter alia*, "find a way round, evade…".[160] Article 10.1 is designed to prevent Members from circumventing or "evading" their "export subsidy commitments". This may arise in many different ways. We note, moreover, that, under Article 10.1, it is not necessary to demonstrate *actual* "circumvention" of "export subsidy commitments". It suffices that "export subsidies" are "applied in a manner which … *threatens to lead to circumvention* of export subsidy commitments".

149. In determining whether the FSC measure in this case is "applied in a manner which … threatens to lead to circumvention of export subsidy commitments", it is important to consider the structure and other characteristics of that measure. The FSC measure creates, in itself, a *legal entitlement* for recipients to receive export subsidies, not listed in Article 9.1, with respect to agricultural products, both scheduled and unscheduled. As we understand it, that legal entitlement arises in the recipient when it complies with the statutory requirements and, at that point, the government of the United States must grant the FSC tax exemptions. There is, therefore, no discretionary element in the provision by the government of the FSC export subsidies. If the statutory eligibility requirements are met, then an FSC is entitled by law to the statutorily established tax exemption. Furthermore, there is no limitation on the amount of exempt foreign trade income that may be earned by an FSC. Therefore, the legal entitlement that the FSC measure establishes is unqualified as to the *amount* of export subsidies that may be claimed by FSCs. There is, in other words, no mechanism in the measure for stemming, or otherwise controlling, the flow of FSC subsidies that may be claimed with respect to any agricultural products. In this respect, the FSC measure is unlimited.

150. With respect to *unscheduled* agricultural products, Members are *prohibited* under Article 3.3 from providing *any* export subsidies as listed in Article 9.1. Article 10.1 prevents the application of export subsidies which "*results in*, or which *threatens to lead to*, *circumvention*" of that prohibition. Members would certainly have "found a way round", a way to "evade", this prohibition if they could transfer, through tax exemptions, the very same economic resources that they are prohibited from providing in other forms under Articles 3.3 and 9.1. Thus, with respect to the *prohibition* against providing subsidies listed in Article 9.1 on *unscheduled* agricultural products, we believe that the FSC measure 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.

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[160] *The New Shorter Oxford English Dictionary*, *supra*, footnote 148, Vol. I, p. 406.

151. With respect to *scheduled* agricultural products, the nature of the commitment made under the first clause of Article 3.3 is different. Members are not subject to a general prohibition against providing export subsidies as listed in Article 9.1; rather, there is a *limited authorization* for Members to provide such subsidies up to the level of the reduction commitments specified in their Schedule. Given that the nature of the "export subsidy commitment" differs as between scheduled and unscheduled products, we believe that what constitutes "circumvention" of those commitments, under Article 10.1, may also differ.

152. As regards *scheduled* products, when the specific reduction commitment levels have been reached, the *limited authorization* to provide export subsidies as listed in Article 9.1 is transformed, effectively, into a *prohibition* against the provision of those subsidies. However, as we have seen, the FSC measure allows for the provision of an unlimited amount of FSC subsidies, and scheduled agricultural products may, therefore, benefit from those subsidies when the reduction commitment levels specified in the United States' Schedule for those agricultural products have been reached. In our view, Members would have found "a way round", a way to "evade", their commitments under Articles 3.3 and 9.1, if they could transfer, through tax exemptions, the very same economic resources that they were, *at that time*, prohibited from providing through other methods under the first clause of Article 3.3 and under 9.1.

153. Thus, we conclude that the FSC subsidies are 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.

154. In light of the foregoing, we reverse the Panel's finding, in paragraph 7.159 of the Panel Report, that the FSC measure involves export subsidies as listed in Article 9.1(d) of the *Agreement on Agriculture.* However, we find that the United States has acted inconsistently with its obligations under Article 10.1 of the *Agreement on Agriculture* by applying FSC 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*. Moreover, and in consequence, by providing export subsidies that are inconsistent 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.*…".

VII. Section 4.2 of the *SCM Agreement*

155. Before the Panel, the United States entered a preliminary objection that the claim by the European Communities under Article 3 of the *SCM Agreement* should be dismissed because the request for consultations by the European Communities did not include a "statement of available evidence", as required by Article 4.2 of the *SCM Agreement*.[161] The Panel denied this preliminary objection. The Panel explained in the Panel Report that "it may well be that the European Communities' request for consultations does contain a statement of available evidence", in part because "the primary evidence on which the European Communities relies is Sections 921 through 927 of the United States Internal Revenue Code".[162] The Panel also found that, in any event, no specific provision of the DSU or the *SCM Agreement* would require dismissal of a claim under Article 3 of the *SCM Agreement* as a consequence of a failure to comply with Article 4.2 of that Agreement.[163] Finally, the Panel did not agree with the argument by the United States that its due process rights had been violated by the alleged failure of the European Communities to provide a statement of available evidence.[164]

156. The relevant part of the European Communities' request for consultations in this case stated:

> The European Communities wish to convey to the United States of America a request for consultations under Article 4 of the "Understanding on Rules and Procedures Governing the Settlement of Disputes" (hereinafter also referred to as the "Understanding"), Article XXIII:1 GATT 1994, and Article 4 of the Agreement on Subsidies and Countervailing Measures (ASCM) *with respect to Sections 921-927 of the Internal Revenue Code and related measures establishing special tax treatment for "Foreign Sales Corporations" (FSC).*[165] (emphasis added).

157. In criticizing the content of this request, on appeal, the United States disagrees with the Panel that the requirement in Article 4.2 of the *SCM Agreement* "may … be" satisfied solely by the reference to the relevant statutory provisions. The United States maintains that Article 4.2 is for the benefit of a *responding* Member, not a complaining Member, and that there must be a consequence for a failure to include a "statement of available evidence". In this case, the United States maintains that the consequence should be dismissal of the European Communities' claims under Article 3 of the *SCM Agreement.*

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[161]Panel Report, para. 7.1.

[162]*Ibid*., para. 7.6.

[163]*Ibid*., para. 7.7.

[164]*Ibid*., para. 7.10.

[165]WT/DS108/1, 28 November 1997.

158. Article 4.2 of the *SCM Agreement* provides:

> A request for consultations under paragraph 1 [of Article 4] *shall include a statement of available evidence* with regard to the existence and nature of the subsidy in question. (emphasis added)

159. Article 1.2 of the DSU states that "the rules and procedures of the DSU shall apply subject to the special or additional rules and procedures on dispute settlement contained in the covered agreements as are identified in Appendix 2 to this Understanding". Article 4.2 of the *SCM Agreement* is listed as a "special or additional rule or procedure" in Appendix 2 to the DSU. In our Report in *Guatemala - Cement*, we said that "the rules and procedures of the DSU apply *together with* the special or additional provisions of the covered agreement" except that, "in the case of a *conflict* between them", the special or additional provision prevails.[166] Article 4.4 of the DSU requires that all requests for consultations, under the covered agreements, "give reasons for the request, including *identification of the measures at issue* and an *indication of the legal basis for the complaint*." (emphasis added) It is clear to us that Article 4.4 of the DSU and Article 4.2 of the *SCM Agreement* can and should be read and applied together, so that a request for consultations relating to a prohibited subsidy claim under the *SCM Agreement* must satisfy the requirements of both provisions.

160. Article 4 of the *SCM Agreement* provides for accelerated dispute settlement procedures for claims involving prohibited subsidies under Article 3 of the *SCM Agreement*. The determination of whether a prohibited subsidy is being granted or maintained under Article 3 of the *SCM Agreement* raises complex factual questions, particularly in the case of subsidies that are claimed to be *de facto* contingent upon export performance. Also, Article 4.5 of the *SCM Agreement* allows a panel to request the assistance of the Permanent Group of Experts on whether the measure is a prohibited subsidy. Given the accelerated timeframes for disputes involving claims of prohibited subsidies, and given that the issue of whether a measure is a prohibited subsidy often requires a detailed examination of facts, it is important to stress the requirement of Article 4.2 that there be "a statement of available evidence with regard to the existence and nature of the subsidy in question" at the consultation stage in a dispute.

161. We emphasize that this additional requirement of "a statement of available evidence" under Article 4.2 of the *SCM Agreement* is distinct from – and not satisfied by compliance with – the requirements of Article 4.4 of the DSU. Thus, as well as giving the reasons for the request for consultations and identifying the measure and the legal basis for the complaint under Article 4.4 of the DSU, a complaining Member must also indicate, in its request for consultations, the evidence that it has available to it, at that time, "with regard to the existence and nature of the subsidy in question". In

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[166] *Guatemala – Cement*, *supra*, footnote 55, para. 65.

this respect, it is available evidence of the character of the measure as a "subsidy" that must be indicated, and not merely evidence of the existence of the measure. We would have preferred that the Panel give less relaxed treatment to this important distinction.

162. Following the European Communities' request for consultations, the United States and the European Communities held three separate sets of consultations over a period of nearly five months.[167] It appears that, during this entire five-month period, the United States did not raise any objection to the content of the European Communities' request for consultations under Article 4.2 of the *SCM Agreement*. Once these proceedings reached the panel stage, the United States explained its view that nothing in either the DSU or the *SCM Agreement* "requires us to perfect the European Communities' pleadings for it".[168] The Panel, however, found that "the United States consciously chose not to seek clarification regarding the evidence in question at the point it received the request for consultations".[169]

163. Nor, it seems, did the United States object to the allegedly deficient request for consultations during those DSB meetings when the European Communities' request for establishment of a panel was on the agenda of the DSB and the Panel was established.[170] Indeed, the first occasion on which the United States objected to the request for consultations was in a request for preliminary findings, submitted to the Panel on 4December 1998, more than a year after the date of the request for consultations.[171]

164. The thrust of the United States' position is that the European Communities' request for consultations is defective to the point that it cannot form the basis for proceedings before a panel. However, despite the defects that it saw in the request for consultations, the United States allowed that request to be acted upon and to form the basis of three sets of consultations with the European Communities about the FSC measure during a period of five months.

165. As we have said, a year passed between submission of the request for consultations by the European Communities and the first mention of this objection by the United States – despite the fact that the United States had numerous opportunities during that time to raise its objection. It seems to us that, by engaging in consultations on three separate occasions, and not even raising its objections in

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[167]Consultations were held on 17 December 1997, 10 February 1998, and 3 April 1998 (Panel Report, para. 1.3).

[168]Panel Report, para. 7.10.

[169]*Ibid*.

[170]The first request for establishment of a panel was on the agenda of the DSB at the meeting held on 23 July 1998 (WT/DSB/M/47). The panel was established at the DSB meeting held on 22 September 1998 (WT/DSB/M/48).

[171]Panel Report, p. 5, footnote 19.

the two DSB meetings at which the request for establishment of a panel was on the agenda, the United States acted as if it had accepted the establishment of the Panel in this dispute, as well as the consultations preceding such establishment. In these circumstances, the United States cannot now, in our view, assert that the European Communities' claims under Article 3 of the *SCM Agreement* should have been dismissed and that the Panel's findings on these issues should be reversed. Accordingly, we decline the United States' appeal from the Panel's refusal to dismiss the European Communities' claim under Article 3 of the *SCM Agreement* due to the European Communities' alleged failure to comply with Article 4.2 of that Agreement. Thus, we do not find it necessary to rule on whether the European Communities' request for consultations includes a "statement of available evidence" that satisfies the requirements of Article 4.2 of the *SCM Agreement.*

166. Article 3.10 of the DSU commits Members of the WTO, if a dispute arises, to engage in dispute settlement procedures "in good faith in an effort to resolve the dispute". This is another specific manifestation of the principle of good faith which, we have pointed out, is at once a general principle of law and a principle of general international law.[172] This pervasive principle requires both complaining and responding Members to comply with the requirements of the DSU (and related requirements in other covered agreements) in good faith. By good faith compliance, complaining Members accord to the responding Members the full measure of protection and opportunity to defend, contemplated by the letter and spirit of the procedural rules. The same principle of good faith requires that responding Members seasonably and promptly bring claimed procedural deficiencies to the attention of the complaining Member, and to the DSB or the Panel, so that corrections, if needed, can be made to resolve disputes. The procedural rules of WTO dispute settlement are designed to promote, not the development of litigation techniques, but simply the fair, prompt and effective resolution of trade disputes.

VIII. Appropriate Tax Forum

167. Before the Panel, the United States argued that under footnote 59 to item (e) of the Illustrative List annexed to the *SCM Agreement*, the European Communities' claims regarding the FSC administrative pricing rules should have been raised first in an appropriate tax forum, before they could then be made the subject of WTO dispute settlement proceedings. The Panel concluded:

[172] *United States – Shrimp*, *supra*, footnote 99, para. 158. In that report, we addressed the issue of good faith in the context of the chapeau of Article XX of the GATT 1994.

> Even assuming that footnote 59 requires Members to attempt to resolve their differences through alternative tax fora, that footnote does not provide that the right to resort to WTO dispute settlement at any time is circumscribed by that alleged requirement.[173]

168. As a consequence, the Panel denied the United States' request to dismiss or defer the European Communities' claims regarding the FSC administrative pricing rules, pending consideration of these rules in an appropriate tax forum.[174]

169. The United States urges us to review the Panel's finding because "the Panel chose to rule on this issue"[175], and because the European Communities has "framed this dispute as one involving transfer pricing issues".[176] The United States contends that footnote 59 *requires* Members raising transfer pricing issues to use the facilities of an appropriate tax forum before initiating WTO dispute settlement procedures, unless there are "unusual, abnormal or extraordinary circumstances".[177]

170. The relevant part of footnote 59 of the *SCM Agreement* provides:

> … Any Member may draw the attention of another Member to administrative or other practices which may contravene [the arm's length] principle and which result in a significant saving of direct taxes in export transactions. *In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence*. … (emphasis added)

171. We note, first, that this issue of the appropriate tax forum relates *solely* to the European Communities' claim *regarding the FSC administrative pricing rules*.[178] The United States does *not* argue that the European Communities should have raised *its other claims* concerning the FSC measure in another forum. The Panel found that in light of the findings and conclusions it made under Article 3.1(a) of the *SCM Agreement*, "it would be neither necessary nor appropriate" for it to rule on the FSC administrative pricing rules.[179] We have, for our part, found it unnecessary to rule on the European Communities' conditional appeal with respect to the administrative pricing rules.[180] As neither we nor the Panel have examined, or ruled on, the European Communities' claim relating to the

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[173]Panel Report, para. 7.18.

[174]*Ibid*., para. 7.22.

[175]United States' appellant's submission, para. 389.

[176]*Ibid*., para. 391.

[177]*Ibid*., para. 400.

[178]*Ibid*., para. 389.

[179]Panel Report, para. 7.127.

[180]See Section IX of this Report, *infra*.

administrative pricing rules, we consider that the issue of whether the European Communities should have first availed itself of the facilities of a forum other than the WTO is moot. For this reason, we believe that it is not necessary for us to rule on this part of the United States' appeal, and we reserve our opinion thereon.

IX. FSC Administrative Pricing Rules

172. Before the Panel, the European Communities submitted that the FSC administrative pricing rules, which may be used by an FSC to determine both its foreign trade income and the exempt part of that income, are inconsistent with Article 3.1(a) of the *SCM Agreement.* The Panel ruled that:

> … having found that the exemptions provided by the FSC scheme are an export subsidy inconsistent with the SCM Agreement, it would be neither necessary nor appropriate for us to make a further and independent ruling on the consistency of that scheme's administrative pricing rules.[181]

173. The European Communities makes a conditional appeal against this finding, the condition being that we have reversed or modified some aspect of the Panel's findings or recommendations so that it would then be necessary for us "to complete the Panel's work".[182] As we have upheld all the Panel's findings under the *SCM Agreement*, the condition on which the European Communities' appeal is predicated does not arise. In these circumstances, there is no need for us to examine the conditional appeal of the European Communities on the FSC administrative pricing rules.

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

174. Before the Panel, the European Communities claimed that the FSC measure is also inconsistent with Article 3.1(b) of the *SCM Agreement.* The European Communities alleged that the definition of "export property," in Section 927(a) of the U.S. Internal Revenue Code, imposes a condition, contrary to Article 3.1(b) of the *SCM Agreement,* that makes the FSC subsidies contingent "upon the use of domestic over imported goods". Section 927(a)(1)(C) provides that "export property" is property "not more than 50 percent of the market value of which is attributable to articles imported into the United States". The Panel declined to examine this claim on the basis that, in light of its other findings on the FSC measure, it was neither necessary not appropriate to do so.[183]

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[181]Panel Report, para. 7.127.

[182]European Communities' other appellant's submission, para. 62.

[183]Panel Report, para. 7.132.

175. The European Communities makes a conditional appeal against this finding of the Panel. The conditions under which this appeal is made are, first, that we have reversed or modified some aspect of the Panel's findings or recommendations so that it would then be necessary for us "to complete the Panel's work" or, second, that we consider that the United States could implement the recommendations and rulings of the DSB in this case without removing the value-based condition found in Section 927(a)(1)(C) of the United States Internal Revenue Code.[184] As we have upheld all the Panel's findings under the *SCM Agreement*, we believe that the first condition on which the European Communities' appeal is predicated does not arise. As for the second condition, we do not consider that it is appropriate for us to speculate on the ways in which the United States might choose to implement the rulings and recommendations of the DSB.

176. For these reasons, we decline to rule on the European Communities' conditional appeal relating to Article 3.1(b) of the *SCM Agreement*.

XI. Findings and Conclusions

177. For the reasons set out in this Report, the Appellate Body:

(a) upholds the Panel's finding, in paragraph 7.130 of the Panel Report, that the FSC measure constitutes a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*;

(b) reverses the Panel's finding, in paragraph 7.159 of the 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, reverses the Panel's findings, in paragraphs 7.165 and 7.176 of the Panel Report, that the United States has acted inconsistently with its obligations under Article 3.3 of the *Agreement on Agriculture*;

(c) declines to examine the Panel's interpretation of the word "provide" in the second clause of Article 3.3 of the *Agreement on Agriculture*, since, in light of our findings in paragraph (b) above, that interpretation has no legal effect;

(d) finds 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;

[184] European Communities' other appellant's submission, para. 62.

(e) upholds the Panel's denial, in paragraph 7.11 of the Panel Report, of the United States' request to dismiss the European Communities' claims under Article 3 of the *SCM Agreement* on the ground that the European Communities failed to include in its request for consultations "a statement of available evidence regarding the existence and nature of the subsidy in question", as required by Article 4.2 of the *SCM Agreement*;

(f) declines to examine the Panel's denial, in paragraph 7.22 of the Panel Report, of the request by the United States that the Panel dismiss or defer the European Communities' claims regarding the FSC administrative pricing rules pending recourse by the European Communities to the facilities of an appropriate tax forum;

(g) declines to examine the Panel's finding, in paragraph 7.127 of the Panel Report, that it was neither necessary nor appropriate to make findings with respect to the European Communities' claims under Article 3.1(a) of the *SCM Agreement* relating to the FSC administrative pricing rules; and

(h) declines to examine the Panel's finding, in paragraph 7.132 of the Panel Report, that it was neither necessary nor appropriate to make findings with respect to the European Communities' claims under Article 3.1(b) of the *SCM Agreement.*

178. The Appellate Body *recommends* that the DSB request the United States to bring the FSC measure that has been found, in this Report and in the Panel Report as modified by this Report, to be inconsistent with its obligations under Articles 3.1(a) and 3.2 of the *SCM Agreement* and under Articles 10.1 and 8 of the *Agreement on Agriculture*, into conformity with its obligations under those Agreements.

179. We wish to emphasize that our ruling is on the FSC measure only. As always, our responsibility under the DSU is to address the legal issues raised in an appeal in a dispute involving a particular measure. Consequently, this ruling is in no way a judgement on the consistency or the inconsistency with WTO obligations of any other tax measure applied by any Member. Also, this is not a ruling that a Member must choose one kind of tax system over another so as to be consistent with that Member's WTO obligations. In particular, this is not a ruling on the relative merits of "worldwide" and "territorial" systems of taxation. A Member of the WTO may choose any kind of tax system it wishes – so long as, in so choosing, that Member applies that system in a way that is consistent with its WTO obligations. Whatever kind of tax system a Member chooses, that Member will not be in compliance with its WTO obligations if it provides, through its tax system, subsidies contingent upon export performance that are not permitted under the covered agreements.

180. By entering into the *WTO Agreement*, each Member of the WTO has imposed on itself an obligation to comply with *all* the terms of that Agreement. This is a ruling that the FSC measure does not comply with *all* those terms. The FSC measure creates a "subsidy" because it creates a "benefit" by means of a "financial contribution", in that government revenue is foregone that is "otherwise due". This "subsidy" is a "prohibited export subsidy" under the *SCM Agreement* because it is contingent upon export performance. It is also an export subsidy that is inconsistent with the *Agreement on Agriculture*. Therefore, the FSC measure is not consistent with the WTO obligations of the United States. Beyond this, we do not rule.

Signed in the original at Geneva this 10th day of February 2000 by:

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Julio Lacarte-Muró
Presiding Member

_____ _____

James Bacchus
Member

Florentino Feliciano
Member