ANNEX A

First Submission by the Parties

ANNEX A-1

FIRST WRITTEN SUBMISSION OF THE EUROPEAN COMMUNITIES

(17 January 2001)

TABLE OF CONTENTS

1. INTRODUCTION

1. The *FSC Repeal and Extraterritorial Income Exclusion Act of 2000* (the "FSC Replacement Act"), adopted on 15 November 2000 as US Public Law No 106-519, is the measure taken by the US ostensibly to comply with the recommendations and rulings of the DSB following the earlier proceedings before the Panel.[1] It does not however bring the US into compliance with those recommendations and rulings for the reasons the EC will explain in detail below. Although the FSC

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

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

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

- The FSC Replacement scheme preserves the tax benefits available under the FSC scheme and

Source: Joint Committee on Taxation.

22. Despite its disappointment with the fact that the US has refused to comply with the recommendations of the DSB, the EC has endeavoured to de-escalate this dispute in the hope that a calm political environment would facilitate the task of the US in ultimately coming into compliance. For this reason, it has entered into a procedural agreement with the US, which it has notified to the WTO[11] and which underlines the importance that the EC attaches to the multilateral character of the WTO dispute settlement system.

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

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

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

3. LEGAL ANALYSIS

3.1. Introduction

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

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

28. Accordingly, the mandate of the Panel pursuant to Article 21.5 of the *DSU* and in the light of Article 4 of the Agreement on Subsidies and Countervailing Measures ("*SCM Agreement*") is to determine whether the US has withdrawn the subsidy and complied wiidee12.6(s)-tR1(aJ-.3(Snd com)(c)0a,-10.)10

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

- that the FSC Replacement scheme provides subsidies which are contingent upon export performance contrary to Article 3.1(a) of the *SCM Agreement* and specifically related to export contrary to item (e) of Annex 1 of the *SCM Agreement*;

-

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

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

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

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

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

equal to that available under the FSC scheme[18] (multiplying 15/23 by 1.83 per cent yields 1.2 per cent.). The new Section 941(a)(1)(C) provides an exclusion equal to 15 per cent of foreign trade income, which is equal to that available under FSC scheme[19] (multiplying 15/23 by 23 per cent yields 15 per cent).

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

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

39. The EC will show below that the FSC Replacement scheme is just as much a subsidy as was (and is) the FSC scheme. The EC will first explain why the US is playing with words when it claims that the scheme is different from the FSC scheme by *excluding* income from tax rather than *exempting*

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

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

44. Thus, it is immediately apparent that it is only "qualifying foreign trade income" that is "excluded." The invention of an additional category of "extraterritorial income" is largely unnecessary, misleading and irrelevant. Read together, paragraphs (a) and (b) do nothing other than

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

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

53. The EC submits that the factor that determines whether the FSC Replacement scheme gives

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

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

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

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

59. "Extraterritorial income" is not however foreign source income. As noted in Section 2 above it may be earned entirely in the US and the only "extraterritorial" characteristic is that it is revenue from sales for final consumption outside the US. Although new Section 942(b) IRC establishes a number of foreign economic process requirements, there is no relationship between the value of these processes and the exten-1.1413or Mre 01413or ption luvtnT1

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

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

66. The availability of the FSC Replacement scheme to transactions involving foreign produced goods gives rise to revenue forgone and confers a benefit in the same way as the application of the scheme to the export of US produced goods. Indeed, it is arguably even clearer, since foreign produced goods will only be qualifying foreign trade property where the foreign producer affirmatively elects to be treated as a US domestic corporation and benefit from the scheme, whereas the scheme is supposed to apply automatically in the case of exports of US produced goods (unless

71. The US has replaced the requirement of export with a requirement that goods not be sold “for ultimate use in the United States”.

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

Export

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

> An article that is exported[45]

and the verb "export" means:

> Send (esp. goods) to another country[46]

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

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

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

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

Performance

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

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

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

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

---

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

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

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

[50] Article V:1 provides that:

Goods (including baggage), and also vessels and other means of transport, shall be deemed to be in transit

Conclusion

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

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

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

3.3.2.3. Application to the FSC Replacement scheme

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

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

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

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

101. The phrase "for ultimate use within the US" is for US goods obviously simply another way of saying "not exported". Thus, the key distinction for the availability of the FSC Replacement subsidy

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

103. It is also true that the same consequence can arise through production and sales of certain

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

125. It is true that a where a subsidy is made available, for example, to all producers of shoes, some producers may in fact qualify by producing shoes which they export, but this does not make the subsidy export contingent. Each producer is free to sell on the domestic market or to export and this

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

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

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

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

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

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

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

> Property which (without regard to this paragraph) is qualifying foreign trade property and which is manufactured, produced, grown, or extracted outside the United States shall be treated as qualifying foreign trade property only if it is manufactured, produced, grown, or extracted by
>
> (A) a domestic corporation,
>
> (B) an individual who is a citizen or resident of the United States,
>
> (C) a foreign corporation with respect to which an election under subsection (e) (relating to foreign corporations electing to be subject to United States taxation) is in effect, or
>
> (D) a partnership or other pass-thru entity all of the partners or owners of which are described in subparagraph (A), (B) or (C);

56

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

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

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

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

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

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

> (B) EFFECT OF ELECTION, REVOCATION, AND TERMINATION. -
>
> (i) ELECTION. - For purposes of section 367, a foreign corporation making an election under this subsection shall be treated as transferring (as of the first day of the first taxable year to which the election applies) all of its assets to a domestic corporation in connection with an exchange to which section 354 applies.
>
> (ii) REVOCATION AND TERMINATION. - For purposes of section 367, if -
>
> (I) an election is made by a corporation under paragraph (1) for any taxable year, and
>
> (II) such election ceases to apply for any subsequent taxable year,
>
> such corporation shall be treated as a domestic corporation transferring (as of the 1st day of the first such subsequent taxable year to which such election ceases to apply) all of its property to a foreign corporation in connection with an exchange to which section 354 applies.

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

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

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

139. Electing to be treated as US domestic corporations for US tax purposes may subject foreign corporations them to reporting and other requirements inconsistent with their domestic law and possibly impact in other ways on their business. The principle behind bilateral tax treaties is that a corporation will be resident in one jurisdiction or another (even though it may be subject to tax as a non-resident in the jurisdiction where it is not resident). Traditionally, the primary purpose of such treaties is to eliminate or reduce double taxation, with the ancillary goal of determining the taxing

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

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

3.3.6. Conclusion

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

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

3.4.1. Introduction

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

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

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

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

150. The Panel considered Item (e) in its report in the original proceeding[58] and considered it to be applicable to the FSC scheme – in particular that the provision applied to exemptions from corporation taxes and that the beneficiary taxpayers were "industrial or commercial enterprises".

151. Although th2.4(h s14)0.5(l)e(4ttd c)10(ie)10.ps sp13.9(i)7.7(h)(i)-2.5(d app6(ff13.2(.2(p(sp13.lapp6(i1.)-1

Having relation; having mutual relation; connected[60]

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

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

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

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

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

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

158. Accordingly item (e) supports and confirms the conclusion that the FSC Replacement

IRC RULES APPLICABLE TO FSC SCHEME

164. Article 3.1(b) prohibits:

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

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

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

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

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

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

168. Just as in the case of the FSC scheme, the foreign content limitation under the FSC Replacement scheme must in principle be satisfied for each transaction for which the benefit is sought. The difference with the FSC scheme lies in the fact that the foreign content limitation is also imposed on companies producing goods outside the US that make an election to be treated as a domestic US corporation pursuant to Section 943(e) of the IRC. In this respect, the FSC Replacement Act .2(rk)110.6((est(i)7.8(e)-031.141 (est(leom)18.7tice0.9u(s e)10.6(tice0. 6.8(7 19.4(e)0.6( )10.9(Tg)126S.4(ood e(0.3f)9.4(f)9. 9(i)8/TT6 Tcf39.663 00 -1.002548TD0.Tc06US

difficult to respect the 50 per cent foreign content limitation. The foreign content limitation would

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

178. Further, the fact that a US producer may have alternative means of avoiding a breach of the

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

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

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

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

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

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

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

190. In view of the t(I)208f as of Articw[(19sf)13.2(i)-2.9(of)10.9(the)21.8(k1ice.”60:4urc)11.4(t)od tn

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

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

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

3.7.2. Domestic parts and materials are "like" the imported goods

196. The distinction operated by the foreign content limitation relates to the origin of the products:

> a measure which provides that an advantage can be obtained by using domestic products but not by using imported products [74]

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

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

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

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

Accordingly, it concluded that

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

205. In the same way, since it will in many cases be easier to respect the foreign content limitation

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

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

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

210. However, Article III:4 of GATT must be respected in each and every case, for each and every transaction. The fact that an analysis transaction by transaction is necessary under Article III:4 is confirmed by the panel report in *United States - Standards for reformulated and conventional gasoline*. [77] In that report the panel rejected the argument that the US measures involved in that case could be justified because imported gasoline was treated "on the whole" no less favourably than domestic gasoline. The US did not appeal this element of the panel report. The panel in the *US – Gasoline* case rejected the "on the whole" reasoning because it would mean that less favourable treatment in one instance could be offset by more favourable treatment in another instance and noted that such an approach had also been rejected under GATT 1947. [78]

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

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

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

213. In *Canada – FIRA*, the Panel found that the undertakings given to the Canadian Government by some foreign investors to, *inter alia*, purchase goods of Canadian origin in specified amounts or proportions was contrary to Article III:4.[79]

214. Similarly, in *EEC- Parts and Components*, the Panel concluded that, by making the suspension of anti-circumvention proceedings conditional upon an undertaking to limit the use of Japanese parts and materials, the EC acted inconsistently with Article III:4.[80]

215. In *Indonesia – Autos*, the Panel found that the grant of certain tax and import duty benefits to a so-called "National Car" manufacturer conditional upon meeting a certain local content percentage was in violation of Article III:4.[81]

---

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

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

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

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

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

216. Finally, in *Canada – Automobiles*, the Panel held that the grant of a customs duty exemption to certain manufacturers of motor vehicles subject to compliance with certain "Canadian Value Added" requirements was inconsistent with Article III:4.[82]

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

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

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

3.7.6. Conclusion

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

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

3.8.1. Introduction

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

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

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

222. The Panel will recall that it found[84] that the US had

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

---

[82] *Canada – Automobiles*, Panel Report, para. 10.58 *et seq.*
[83] Panel Report, para. 4.1211.
[84] Panel Report, para. 8.1(b).

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

- Article 10.1 of the *Agreement on Agriculture* prohibits export subsides being "applied in a manner which *results in*, or which *threatens to lead to*, *circumvention* of export subsidy commitments." Since the FSC scheme creates *legal entitlements* to receive unlimited amounts

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

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

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

244. Given that it had become clear that the United States would not be able to comply within this mandatory deadline, the US requested the DSB a modification of the time period for compliance, to which the DSB acceded on 12 October 2000.[93]

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

246. Accordingly, the EC submits that the US failed to comply with the DSB recommendations

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

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

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

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

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

256. The panel in that case expressly recognized that the fact of sending third parties only copies of what is - normally - the first round of submissions is a mere "practice" under Article 10.3.[96] This rather confirms that there is no legal requirement to this effect in the DSU.

257. The panel further recalled the expedited nature of proceedings under Article 21.5. The EC

to be effective, the EC requests that the Panel make its ruling, and communicate it to the parties and the third parties as soon as possible after the US has had an opportunity to comment, that is after

ANNEX

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

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

property—

(C) not more than 50 per cent of the fair market value of which is attributable to—

(i) articles manufactured, produced, grown, or extracted outside the United States, and

(b) Heavy Steel Plate

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

The cost of materials involved in production:

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

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

(c) Stainless Steel Fasteners

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

2. Other metal products

(a) Aluminium household foil

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

3. Woven glass fibre fabrics

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

4. Chemicals and synthetic fibres

(a) Polyethylene Terephthalate Bottle Resin

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

5. Aircraft

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

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

List of Exhibits

EC-1 Extract from Inside US Trade, 24 March 2000 (page 9).

EC-2 The initial US proposal to replace the FSC scheme.

EC-3 Letter of Commissioner Lamy to US Deputy Secretary of State Eizenstat of 26 May 2000.

EC-4 Letter of Commissioner Lamy to US Deputy Secretary of State Eizenstat of 31 August 2000.

EC-5 *FSC Repeal and Extraterritorial Income Exclusion Act of 2000* (the "FSC Replacement Act").

EC-5A *Technical Explanation of the Senate Amendment to H.R. 4986, the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000* (JCX-111-00) of 1 November 2000.

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

EC-7 Report of US Deputy Secretary of State Eizenstat speaking during the Senate Finance Committee passing of the FSC Replacement Bill on 19 September 2000, Inside US Trade, 3 November 2000 (Article starts on page 26 and continues on pages 24 and 25. The quoted text is on page 25).

EC-8 The Congressional Budget Office Cost Estimate of 13 September 2000.

EC-9 List of provisions in Subtitle A, Chapter 1, Subchapter B, Part III of the IRC excluding certain income from US tax.

ANNEX A-2

FIRST WRITTEN SUBMISSION OF THE UNITED STATES

(7 February 2001)

TABLE OF CONTENTS

earned. In the context of this worldwide approach to taxation, the United States relied principally on tax credits to offset foreign taxes paid in order to avoid taxation of the same income by two taxing

II. PROCEDURAL BACKGROUND

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

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

11. Both the United States and the EC appealed certain of the Panel's findings. The Appellate h th1(a).

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

16. The United States and the EC consulted on 4 December 2000, but were unable to resolve the matter. On 7 December 2000, the EC requested the establishment of a panel under Article 21.5.[14] On 20 December 2000, the DSB established a panel.[15]

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

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

III. FACTU(e av 4 1 Tf-10.9(EC)]TJ0 -1.152(ucCK)-.2(GRO)-.2(U(Fgnt a)7)-3.4(h)12n.4(h)1250 0 11.04 299.

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

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

(a) Compliance with the Panel and Appellate Body Reports

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

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

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

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

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

---

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

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

[22] The Act § 5(b)(1).

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

[24] *Senate Report*, page 17.

[25] *Id.*, page 16.

[26] *Id.*, page 5.

(c) A Measure to Avoid Double Taxation

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

2. Description of Excluded Extraterritorial Income

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

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

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

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

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

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

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

---

[27] *Id.*, pages 2, 6.

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

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

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

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

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

31. In addition, the Act requires that the gross receipts from which excluded extraterritorial income arises must have a nexus with activity occurring in a foreign jurisdiction. Excluded

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

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

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

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

4. The Act's Effective Date

36. The Act is effective for transactions after 30 September 2000.[46] All provisions of the Act have effect from this date. Thus, no FSCs may be created after 30 September 2000.[47] A foreign corporation created after 30 September 2000, will be treated under general rules applicable to all foreign corporations. None of the rules under the former FSC provisions, including the special

binding contracts to which the transition rules may apply are transactions between a FSC (or a related person) and an unrelated person that are already in effect on 30 September 2000.[50]

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

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

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

40. European tax exemptions for offshore income apply to three types of transactions: imports, wholly foreign transactions, and exports. In most cases, European countries do not require the foreign tax rate to be equal to or greater than the home country rate and, in some instances, no minimum

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

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

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

45. To appreciate how the Dutch system operates, assume that a Dutch manufacturing company and its Netherlands Antilles sales subsidiary engage in an export transaction in which the subsidiary acts on the parent company's behalf to sell items exported from the Netherlands, and the companies together earn a total of $100,000.[58] Further assume that each company earns the equivalent of $50,000 under arm's-length transfer pricing principles. The Netherlands Antilles subsidiary's income from the transaction – that is, $50,000 – would be fully exempt from taxation by the Netherlands and, at a 3 per cent rate, would owe tax of only $1,500 to the Netherlands Antilles.

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

C. THE ACT IS FUNDAMENTALLY DIFFERENT FROM THE FSC

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

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

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

---

[57] *FSC (Panel)*, para. 4.809.
[58] For a more detailed discussion of this example, see *FSC (Panel)*, paras. 4.809 and 4.1042.
[59] *See, e.g.*, First EC 21.5 Submission, para. 121.

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

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

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

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

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

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

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

3. The Act Does Not Require Exportation

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

[60] IRC § 951 (US-4).

IV. ISSUES RAISED IN THIS PROCEEDING

56. The following issues are raised in this proceeding for resolution by the Panel:

(a) Whether the Act's exclusion of extraterritorial income from US taxation confers a subsidy within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.

(b) Whether the Act's exclusion of extraterritorial income from US taxation is contingent upon export performance within the meaning of Article 3.1(a) of the SCM Agreement.

(c) Whether the Act's exclusion of extraterritorial income from US taxation constitutes a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59 of the SCM Agreement and whether, for that reason, the exclusion does not constitute a prohibited export subsidy under Article 3.1(a) of the SCM Agreement.

(d) Whether, if the Act's exclusion of extraterritorial income from US taxation does not constitute a prohibited export subsidy by virtue of the fifth sentence of footnote 59, the exclusion is not prohibited by any other provision of the SCM Agreement by virtue of footnote 5 of that Agreement.

(e) Whether the Act's 50 per cent rule on certain foreign value renders the Act's exclusion of extraterritorial income from US taxation contingent upon the use of domestic goods over

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

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

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

1. Under Article 1, the Normative Benchmark Is the Member's "Prevailing Domestic Standard"

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

61. With respect to the ordinary meaning of the critical terms used in subparagraph (ii), the meaning of "revenue" most applicable to this case is "the annual income of a government or State, from all sources, out of which the public expenses are met".[63] The definition of "forego" is "to abstain or refrain from" or "go without; deny to oneself".[64] "Otherwise" is defined as "by other means; differently; in another case; in other circumstances",[65]

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

64. Moreover, both the *FSC* Panel and the Appellate Body made clear that the normative

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

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

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

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

71. The definition of "gross income" is thus the "prevailing domestic standard" for US taxation.

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

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

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

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

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

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

77. Applying the standard of Article 1, as articulated by the *FSC* Panel and the Appellate Body, the Act does not constitute a subsidy because tax on the excluded income is not "otherwise due". Because the United States lacks statutory authority to tax anything that falls outside the definition of

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

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

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

82. Similarly, the Act meets other elements of the standard articulated by the Appellate Body. To constitute an Article 1 "subsidy", the government must have "given up an entitlement to raise revenue" and that entitlement must be based on "some defined, normative benchmark against which a comparison can be made between the revenue en [illegible]

86. This line of argument is defective for several reasons. First, it fails to address the law that the United States did adopt. Instead, it seeks to redesign that law and then critique the redesigned version

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

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

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

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

96. To give just a few brief examples:

- In *Belgium*, resident companies are subject to Belgian corporate income taxes on profits from their activities, wherever conducted, unless specifically excluded by domestic law or as a result of a tax treaty. One such exclusion is that 75 per cent of foreign branch income generated in a country with which Belgium has not concluded an income tax treaty – whether export-related or otherwise – is exempt from Belgian tax. Another source of profit that is excluded from taxation is foreign-source dividend income. Nineyfive per cent of dividend income from a foreign subsidiary to a shareholder owning at least 5 per cent of the shares of the subsidiary (or holding an interest in the subsidiary with an acquisition value of at least BFr 50 million) is not taxed, but the remaining five per cent is taxed. Therefore, the tax exclusion is not unqualified.

- In *France*, foreign income directly attributable to operations conducted abroad – either by a company directly or though a branch – is exempt from tax. As a result, 95 per cent of the gross amount of dividends receivable from a foreign company by either a 10 per cent shareholder or a shareholder holding an interest in the foreign company of at least FF 150 million is exempt from French tax. However, this qualified exemption is further limited. A French corporate taxpayer is required to include in its taxable income its *pro rata* share of the income of a foreign company in which it either has a direct or indirect interest of 10 per cent or more or at least FF 150 million, if the foreign company is subject to a "privileged tax regime". A foreign tax regime is considered "privileged" if the foreign tax rate is two-thirds or less than the tax rate that would have been payable in France on the same

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

income. This "low tax exception" does not apply if the foreign company at issue has an effective commercial or industrial activity predominantly performed in the local market. The

1. The Meaning of Article 3.1(a)

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

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

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

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

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

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

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

---

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

[85] *Id.*

[86]

income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems. While exporters may be among those who are eligible for the exclusion, this fact does not make that exclusion ''export contingent''. If it did, every general exclusion from tax applicable to, among others, exporters would 19(el2(4(om)18.4(e)-)13a prooth)12.ibthtere

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

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

126. Transactions involving property used or consumed in the United States are not covered by the

Agreement. The EC cites paragraphs (d), (f), (g), (h), and (l) of Annex I as instances in which treatment of exported products is to be compared to that afforded to domestic products.[112] However,
i c h h - e e n
a p d e d h e r s
r e i a r a g r a p o r d i a d e t s t p

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

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

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

144. For example, assume that a foreign manufacturing corporation is incorporated in country X and is the supplier to a distribution company located in the United States. Assume further that the country X tax rate is greater than or equal to the US tax rate. It is true that the corporation, upon making the election, 19((thu9i)-3.6d bthu9i)9ue4ruppu9i143.
143.

149. To ensure that this limitation did not cause the Act's exclusion to apply only to foreign sales

D. BECAUSE THE ACT'S E

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

159. The EC's theory of paragraph (e) is untenable, because the EC ignores the relationship between Article 3.1(a) and Annex I. Article 3.1(a) expressly states that the subsidies listed in Annex I

1

163. The first sentence of footnote 59 states that "[t]he Members recognize that deferral need not

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

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

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

175. This is a distinction made by the panel in the *Brazil Aircraft* case.[146] The panel first found that "in its ordinary meaning, footnote 5 relates to situations where a measure is referred to as *not* constituting an export subsidy."[147] In addition, the panel observed that the ordinary meaning of footnote 5 "could extend more broadly to cover cases where the Illustrative List contained some other form of affirmative statement that a measure is not subject to the Article 3.1(a) prohibition."[148] The panel then indicated that this reasoning applied to the first and fifth sentences of footnote 59.[149] Thus, following this reasoning, measures to avoid double taxation are "referred" to in Annex I as not being

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

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

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

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

180. The OECD Model Convention provides in pertinent part:

METHODS FOR ELIMINATION OF DOUBLE TAXATION

Article 23A

EXEMPTION METHOD

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

---

[150] Annex EC-2, page 1 (US-5).

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

[152] Annex EC-2, page 2 (US-5).

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

[154] The rest of Article 23A states:

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

* * * * *

Article 23B

CREDIT METHOD

the non-taxation of income subject to double tax.[159] As long as income "may be taxed" in another country, the Commentary states that a country of residence must not tax that same income.[160]

activities must be performed with respect to the sales and distribution functions associated with qualifying transactions.[170]

192. It is because of these considerations that income excluded under the Act may properly be characterized as extraterritorial and, thus, "foreign-source." Although the EC complains that the Act "does not concern 'extraterritorial' income in any real [sense] of that word",[171] the EC acknowledges that the Act applies to income "derived from foreign sales."[172] As discussed above, "extraterritorial income" under the Act is income derived from non-domestic sources. As such, it comes within the ordinary meaning of "foreign-source."

(c) The Act's Exclusion Is Akin to Territorial Exemptions Under EC Member State Systems

193. The exclusion established by the Act was designed to parallel aspects of the territorial exclusions or exemptions used by EC member states. The Act's legislative history makes this plain:

> The Committee emphasizes that the extraterritorial income excluded by this legislation from the scope of US income taxation is parallel to the foreign-source income excluded from tax under most territorial tax systems. Under neither the US tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems. While exporters may be among those who are eligible for the exclusion, this fact does not make that exclusion ''export contingent.'' If it did, every general exclusion from tax applicable to, among others, exporters would become a prohibited export subsidy.[173]

194. The exclusion provided under the Act is similar to the practice of a number of EC member-state tax systems in exempting foreign-source income from taxation.[174] Like the Act, these EC systems do not tax at least a portion of the income generated by foreign sales. Among EC tax systems that apply the territorial principle of taxation, the form and extent of each country's application of that principle vary. Some countries, such as France, have historically exempted all income earned outsin(ly)12.6TJ6.48 0
o 1 (7 o 4) - 5 (d

E. THE 50 PER CENT RULE ON CERTAIN FOREIGN VALUE DOES NOT RENDER THE ACT'S EXCLUSION OF EXTRATERRITORIAL INCOME INCONSISTENT WITH ARTICLE 3.1(B) OF THE SCM AGREEMENT

196. The EC argues that the 50 per cent rule on certain foreign value in the Act violates Article 3.1(b) of the SCM Agreement.[176] The Panel need not reach this issue for two reasons. First, as demonstrated above, the Act's exclusion does not constitute a subsidy within the meaning of Article 1.1(a)(1)(ii). Second, footnote 5 provides that measures not constituting export subsidies under

States and direct labour costs incurred outside the United States.[180] Under this rule, a good can meet this requirement even if 100 per cent of its content is foreign.

201. The 50 per cent rule takes into account only the value of foreign articles and foreign direct labour costs used in producing a finished product. It does not limit other foreign value. Thus, the remaining 50 per cent of fair market value of the finished product can be attributed to non-tangible elements, including intellectual property rights, goodwill, capital, marketing, distribution, and other services, which may be of either US or foreign origin. The articles used in manufacturing, whatever their origin, account for only part of the total value.

202. The operation of the 50 per cent rule can be illustrated through an example. Assume a product consists of 100 per cent foreign articles and is manufactured using only foreign direct labour. Assume further that the sum of value of the foreign articles and foreign direct labour costs is $200. Assume also that, because of significant foreign brand name value and foreign capital costs, the fair market value of the product (i.e., the price at which it can be sold to consumers) is $450. The sale of such a product qualifies for the exclusion under the Act, notwithstanding the fact that no US goods are involved, because $200 is less than 50 per cent of $450.

203. The practical effect of the 50 per cent rule is further diminished by the principle of origin applicable to components incorporated into manufactured products. An input sourced from a US supplier may be deemed US-origin for purposes of the 50 per cent rule, despite the fact that the goods from which that component was manufactured may have been primarily, or even entirely, imported goods. In such circumstances, there is no preference for domestic over imported goods because the finished component typically is deemed to be a US-origin good.[181]

4. *Canada Autos* Confirms that the Exclusion of Extraterritorial Income Is Not Contingent Upon the Use of Domestic Over Imported Goods

204. The foregoing discussion of why the Act's 50 per cent rule does not violate Article 3.1(b) is confirmed by the Appellate Body report in *Canada Autos*. In that case, the Appellate Body found that even a 60-per cent value-added requirement does not necessarily raise a presumption of inconsistency with Article 3.1(b) of the SCM Agreement. The Appellate Body concluded that only where there is evidence that a manufacturer actually will be *required* to use domestic over imported goods will the prohibition in Article 3.1(b) be implicated.

(a) The Appellate Body's Decision

205. In *Canada-Autos*, the panel and the Appellate Body considered whether a Canadian value-

50 per cent of their value derives from inputs or tangible articles.[190] The basis for these descriptions are "some data relating to the production in certain sectors . . . cross-checked . . . with information from certain European industries and in the course of various trade investigations."[191] This "evidence", though, does not describe how the Act's 50 per cent rule actually operates with respect to US taxpayers that are eligible to exclude extraterritorial income. Based on the teaching of the Appellate Body in *Canada Autos*, only through evidence showing that the 50 per cent rule actually requires the use of domestic goods can the EC make a viable claim under Article 3.1(b).

F. THE ACT'S 50 PER CENT RULE IS NOT INCONSISTENT WITH ARTICLE III:4 OF GATT 1994

211. The EC claims that the 50 per cent rule of the Act provides less favourable treatment to imported products than to like domestic products in violation of Article III:4 of GATT 1994.[192] Similar to the claim it makes in relation to Article 3.1(b) of the SCM Agreement, the EC's argument under Article III:4 rests on an inaccurate description of the 50 per cent rule and suffers from insufficient proof to establish a *prima facie* violation.

1. The Meaning of Article III:4

212. Article III:4 provides in relevant part that:

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

To establish a violation of Article III:4, the EC must demonstrate the existence of: (a) a law, regulation or requirement affecting the internal sale, offering for sale, or distribution of an imported product; and (b) treatment accorded in respect of the law, regulation or requirement that is less favourable to the imported product than to like products of national origin.[193] The requirement of Article III:4 that imported products be accorded treatment "no less favourable" than that accorded to like products of national origin has been interpreted to ensure "effective equality of opportunities between imported products and domestic products."[194]

2. The EC Inaccurately Describes the 50 Per cent Rule

213. The EC's argument regarding Article III:4 is littered with erroneous descriptions of the 50 per cent rule contained in the Act. To start with, the EC states that "the limit on . . . foreign inputs is one of the conditions to obtain the tax benefit."[195] The EC also claims that the Act contains a "legal requirement that the foreign inputs and labour not be used above a certain ceiling, if a taxpayer wants to obtain the tax benefit."[196] The EC maintains that the Act "requires in some cases the use of a minimum amount of domestic parts and materials . . . [and] precludes producers wishing to benefit . . . from using an equivalent amount of imported parts and materials."[197] Finally, the EC asserts that the

---

[190] *EC First 21.5 Submission*, Annex.
[191] *Id.*
[192] *EC First 21.5 Submission*, paras. 187-219.
[193] *Japan - Measures Affecting Consumer Photographic Film and Paper* ("*Japan Film*"), WT/DS44/R, Report of the Panel adopted 22 April 1998, para. 10.369.
[194] *Canada - Certain Measures Affecting the Automotive Industry* ("*Canada Autos (Panel)*"), WT/DS139/R, WT/DS142/R, Report of the Panel, as modified by the Appellate Body, adopted 19 June 2000, para 10.78.
[195] *EC First 21.5 Submission*, para. 195.
[196] *Id.*, para. 203.
[197] *Id.*, para. 206.

Act *requires* "the . . . use by an enterprise of products of domestic origin . . ., whether specified in terms of . . . value of products, or in terms of a proportion of . . . value of its local production."[198]

214. These statements simply do not accurately describe the Act. As discussed throughout this submission, including the immediately preceding section, the Act does not require the use of any US-origin goods for a transaction to earn excluded extraterritorial income. Instead, the Act provides that up to 50 per cent of the fair market value of goods involved in a transaction may be attributable to

to be carried out at the level of an individual product, not at the level of the application of the law to all possible products."[205]

218. Many of the GATT and WTO panel cases cited by the EC involve laws, regulations, and requirements explicitly applicable to a particular class or category of imports.[206] In such cases, it is not difficult to consider how such imports would be "affected" by those measures. However, in cases involving a generally applicable measure, there must be a heightened evidentiary burden for the complaining party. Measures of general application, like the Act, do not necessarily affect imported *goods*. Evidence must be introduced to establish a "meaningful nexus" between such a measure and adverse effects on competitive conditions for a like class of imported goods before determining that the measure accords less favourable treatment to imports.[207]

219. The foregoing discussion demonstrates that the EC has failed to make a *prima facie* case of inconsistency with Article III:4. By inaccurately portraying the measure it seeks to invalidate and by failing to provide adequate evidence to substantiate its conclusions, the EC has not proven its claim that the Act is inconsistent with Article III:4.

G. THE ACT'S EXCLUSION OF EXTRATERRITORIAL INCOME DOES NOT VIOLATE US OBLIGATIONS UNDER THE AGREEMENT ON AGRICULTURE

220. The EC contends that the Act's exclusion of extraterritorial income violates Article 10.1 of the Agreement on Agriculture, as read together with Article 8 of that Agreement, or, in the alternative, Articles 3.3 and 8, in conjunction with Article 9.1, of the Agreement.[208] For the following reasons, the EC's claim lacks merit.

221. Article 10.1 of the Agriculture Agreement provides that "[e]xport subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments ... ." In the *FSC* case, the Appellate Body relied upon the definitions of subsidy in Article 1 of the SCM Agreement and export contingency in Article 3.1(a) of the SCM Agreement as context in considering what is an "export subsidy" under the Agriculture Agreement.[209] For the same reasons already discussed by the United States that the Act's exclusion does not constitute an export subsidy within the meaning of Articles 1 and 3.1(a) of the SCM Agreement, the exclusion does not constitute an export subsidy within the meaning of Article 1(e) of the Agriculture Agreement. Thus, the exclusion of extraterritorial income under the Act does not violate US obligations under the Agriculture Agreement.[210]

---

[205] *Id.*, para. 211.

[206] *See, e.g.*, *Canada Autos (Panel)*; and *United States - Standards for Reformulated and Conventional Gasoline*, WT/DS2/R, Report of the Panel, as modified by the Appellate Body, adopted 20 May 1996.

[207] *See, e.g.*, *Japan Film*, para. 10.381.

[208] *EC First 21.5 Submission*, paras. 222-233; *see also id.*, paras. 67-68. The EC provides an extraneous and seemingly irrelevant description of the 50 per cent rule in its discussion of the Agriculture Agreement. *Id.*, paras. 220-21. Because the EC has failed to make any legal claim under the Agriculture Agreement with respect to this aspect of the Act, the United States does not address the factual inaccuracies contained in the EC's description in this section. The United States respectfully refers the Panel to the discussion in Section V.E, above, that explains the operation of the 50 per cent rule.

[209] *FSC (AB)*, paras. 136-142, *citing Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products*, WT/DS103/AB/R, WT/DS113/AB/R, Report of the Appellate Body adopted 27 October 1999.

[210] The EC posits an alternative argument under the Agriculture Agreement that is conditioned on the United States making an argument that the Act confers export subsidies that are covered by Article 9.1 of the Agriculture Agreement. Because the United States does not make this argument, the EC's alternative argument need not be addressed.

H. THE U

with that in mind."[219] In several recent cases, WTO panels have excused procedural violations in the absence of prejudice to the complaining party, essentially taking into account equitable considerations in issuing their decisions.[220]

228. A limited transition period allowing taxpayers to adjust to a new tax regime appears all the more reasonable in light of the circumstances surrounding this case. Specifically, notwithstanding the EC's assertions that it never agreed that the FSC was GATT- or WTO-consistent, it waited until thirteen years after the FSC was enacted before challenging it. During that time, US taxpayers came

time the EC made its panel request to commence this Article 21.5 proceeding, the measure it ostensibly was challenging no longer existed. Panels typically refrain from examining measures that cease to be in existence or in effect before a panel's terms of reference are set.[224]

I. THE PANEL SHOULD REJECT THE

> A panel under Article 21.5 has to follow DSU panel procedures. But it is obliged to do so in a different context, namely in the context of a much stricter timeframe. As a result, this Panel decided to hold only one meeting; not two as is usually the case. The practice of obtaining from the parties two sets of documentation in the form of first written submissions and written rebuttals (both, however, before the single meeting of the Panel) was maintained. In this context, the Panel is of the view that, in order to give effect to Article 10.3, Article 10.3 has to be interpreted as limiting third party rights to the first written submissions only; not including the written rebuttals. The drafters of the DSU restricted third party rights. It is not the task of this Panel to extend them in Article 21.5 procedures.[227]

237. In the view of the United States, the reasoning of these prior panels is sound, and should be followed by this Panel. Thus, the Panel should find that third parties do not have a right to the rebuttal submissions of the parties in this proceeding.[228]

238. Having said that, the United States notes that, with the exception of business confidential information, it routinely makes its submissions to WTO panels available to the public by pl(thi)8..ubmts.7it t is of 8
)(ding)TD4 sge950 -1.001448 603 Tm0[(VIf)19((ding)TD14)Tj/TT3587Tf1.51 603.75 0 TD4
CONCLUSIf ONding l

EXHIBIT LIST