ANNEX B

Third Party Submissions

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

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

(ii) direct costs for labor performed outside the United States.[4]

8. Property shall be treated as qualifying foreign trade property only if it is manufactured, produced, grown or extracted outside the United States by: a domestic corporation; a citizen or resident of the United States; a foreign corporation which has elected to be subject to United States taxation; or a partnership in which all the partners or owners fall within one of the first three categories.[5]

The United States Has Not Withdrawn the Original FSC Subsidies "Without Delay"

9. Section 59(c)(1)(A) provides a transition period for FSCs in existence on 30 September 2000 from the FSC legislation amendments. The amendments do not apply to transactions of such FSCs

manufactured, produced, grown or extracted within or outside the United States and which satisfies two requirements:

(1) it must be held primarily for sale, lease or rental for – in the ordinary course of business - direct use, consumption, or disposition *outside the United States*; and

(2) *at least 50 per cent* of its fair market value is attributable to articles manufactured, produced, grown or extracted in the United States, and the direct costs for labour performed in the United States.

16. Two conclusions can be drawn from this. Firstly, for property manufactured, produced, grown or extracted *within* the United States to qualify for the tax exemption, it must be transacted for direct use, consumption or disposition *outside the United States*. The subsidy is therefore "contingent, in law or in fact ... upon export performance" within the meaning of Article 3.1(a) of the SCM Agreement. This is further reinforced by Section 942(a)(2) of the IRC which excludes from "foreign trading gross receipts" qualifying foreign trade property or services for ultimate use in the United States.

17. Australia emphasises it is not arguing the measure to be an export subsidy simply because it is provided to corporations that produce within the United States for sale, lease or rental outside the United States. Footnote 4 provides that the mere fact that a subsidy is granted to enterprises which export shall not, for that reason alone, be considered to be an export subsidy. However in the present case, the tax exemption to corporations that produce within the United States is *conditioned* on the sale, lease or rental of products for direct use, consumption or disposition *outside* the United States.

a benefit to US-based enterprises by excluding from taxation income that they earn on exports from the United States. Accordingly, there still exists a "subsidy" under Article 1.1 of the *SCM Agreement*.

4. Canada argues that the "subsidy" is contingent upon export performance and, therefore, prohibited under Article 3.1(a) of the *SCM Agreement* as in order to benefit from the "subsidy", US-based enterprises must not sell their goods "for ultimate use in the United States." Canada agrees with the European Communities that these words are simply "another way of saying that they must be exported".

5. Finally, Canada argues that the fact that the FSC Replacement scheme is available to foreign manufacturers on the sale of foreign goods is irrelevant to the determination of whether the "subsidy" provided to US-based enterprises on the income earned from export transactions is contingent upon export performance.

II. INTRODUCTION

6. Canada is appreciative of the opportunity to participate in this proceeding under Article 21.5 of the Understanding on Rules and Procedures for the Settlement of Disputes.[1]

7. Canada participated in previous proceedings before the Panel and the Appellate Body.[2]

III. BACKGROUND

A. FINDINGS OF THE PANEL AND APPELLATE BODY

8. On 24 February 2000, the Appellate Body upheld the Panel's finding that various exemptions for certain types of income under the US Internal Revenue Code earned by foreign sales corporations (the FSC measure or FSC scheme), taken together, constituted a prohibited export subsidy under Article 3.1(a) of the *Agreement on Subsidies and Countervailing Measures (SCM Agreement)*.

9. More particularly, the Appellate Body agreed with the Panel that having decided to tax foreign-source income, the United States could not exclude certain types of this income from taxation without foregoing government revenue that would otherwise be due, and, therefore, without providing a financial contribution under Article 1.1(a)(ii) of the

10. The Appellate Body recommended that the Dispute Settlement Body (DSB) request the United States to bring the FSC measure into conformity with its WTO obligations[4] .

11. The Appellate Body emphasized that its ruling was in no way a judgment on the consistency or the inconsistency of the relative merits of the tax system chosen by the United States. The Appellate Body held that:

> [a] Member of the WTO may chose any kind of tax system it wishes, so long as, in so choosing, that Member applies that system in a way that is consistent with its WTO obligations. Whatever kind of tax system a Member chooses, that Member will not be in compliance with its WTO obligations if it provides, through its tax system, subsidies contingent upon export performance that are not permitted under the covered agreements.[5]

12. The findings and conclusions of the Appellate Body were adopted by the DSB on 20 March 2000.[6]

B. MEASURES TAKEN BY THE UNITED STATES

13. In order to comply with the recommendations and rulings of the DSB, the United States adopted the *FSC Repeal and Extraterritorial Income Exclusion Act of 2000*[7] on 15 November 2000.

14. According to the United States, the new taxiTc004 228.52g1(era-3.3(nd .5(a)28.52g1(e3320 Tc0 Twr)-

substantially broader category of income than that which was exempted from tax under the FSC measure.

IV. ISSUE AND CANADA'S POSITION BEFORE THIS PANEL

18. The issue before this Panel is whether the FSC Replacement scheme is consistent with the recommendations of the DSB to withdraw the FSC measure found to be a prohibited export subsidy inconsistent with Article 3.1(a) of the *SCM Agreement*.[8] In order to be found to have complied, the United States must have ceased providing prohibited export subsidies.[9]

24. The Appellate Body held that the decision as to whether the government has given up an entitlement to raise revenue that it would "otherwise" have raised implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. The Appellate Body agreed with the Panel that the basis for comparison must be the tax rules applied by the Member in question.[12]

25. As noted above, the Appellate Body ruled that a WTO Member has the sovereign authority to tax any particular categories of revenue it wishes, and that it is also free not to tax any particular categories of revenue. However, the Appellate Body ruled that, in both instances, the WTO Member must respect its WTO obligations. The Appellate Body held that what is "otherwise due" depends on the rules of taxation that each Member, by its own choice, establishes for itself.[13]

26. The Appellate Body held that the "but for" test established by the Panel, that is, "the situation that would prevail but for the measure in question", provided "a sound basis for comparison" in the case of the FSC scheme, because it was "not difficult to establish in what way the foreign-source income would be taxed "but for" the contested measure". The Appellate Body stated that it had "certain abiding reservations about applying any legal standard, such as this "but for" test, in the place of the actual treaty language", and "particular misgivings about using a "but for" test if its application were limited to situations where there actually existed an alternative measur11.2(rn0.1399u11.ion)]TJ50024 ica

income excluded from taxation under the definition of "extraterritorial income", would otherwise be subject to tax, absent the FSC Replacement scheme.

foreign sources does not transform the export income into "foreign income" for tax purposes. Exporting goods in a foreign country does not create a sufficient nexus to trigger taxation in the importing country, even when one takes into account the "foreign economic processes" required under the FSC Replacement scheme.[20] Canada submits that such processes do not create a taxable presence abroad, and, therefore, would not be considered foreign business income subject to double taxation. Therefore, no double taxation needs to be relieved with respect to this component of "extraterritorial" income.[21]

35. In Canada's view, since income earned from export transactions cannot by definition face double taxation, the exclusion from taxation provided for this income under the FSC Replacement scheme can only reduce US tax otherwise payable.

36. Canada therefore submits that the revenue or tax that would otherwise be due on "income earned from export transactions", which is part of the income excluded from taxation under the FSC Replacement scheme, would be the tax applicable to such income under US taxation rules. Thus, the US Government is providing a financial contribution to US-based enterprises earning this type of income by foregoing revenue that would otherwise be due in the sense of Article 1.1(a)(ii) of the *SCM Agreement*.

2. The "Financial Contribution" Confers a "Benefit" to US-based Enterprises Earning

B. THE SUBSIDY PROVIDED UNDER THE FSC REPLACEMENT SCHEME TO US-BASED ENTERPRISES IS PROHIBITED UNDER ARTICLE 3.1(A) OF THE *SCM AGREEMENT*, AS IT IS "CONTINGENT UPON EXPORT PERFORMANCE"

40. Canada submits that the "subsidy" provided to US-based enterprises is clearly "contingent upon export performance", as in order to benefit from the "subsidy", goods must not be sold "for ultimate use in the United States."[23] Canada agrees with the EC that this is simply "another way of saying that they must be exported"[24], and that these words are sufficient to make the subsidy *de jure* export contingent. As stated by the Appellate Body in *Canada – Certain Measures Affecting the Automotive Industry*[25]:

> a subsidy is … properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfilment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.[26]

41. In Canada's view, the fact that the FSC Replacement scheme is available to foreign manufacturers is irrelevant to the determination of whether the "subsidy" provided to US-based enterprises on the income earned from export transactions is contingent on export performance.

42. It is clear that, under the FSC Replacement scheme, a US-based enterprise must export in order to qualify for the exclusion from tax. Whether, in addition to US-based enterprises, a foreign entity may qualify or not for the scheme does not modify the requirement imposed on US-based enterprises and the fact that it explicitly discriminates amongst US-based enterprises on the basis of export performance.

43. As indicated earlier, the FSC Replacement scheme, when applied to income earned from exports of domestic goods of US-based enterprises, results in the permanent reduction of US taxes otherwise payable, in particular as compared to taxes payable on equivalent domestic sales of US-based enterprises. The export-contingent nature of the scheme leaves no doubt that the only way that income derived from the sale of a domestic good can qualify under the scheme is if the good is exported.

44. Canada submits that this export-contingent nature of the scheme cannot be eliminated or otherwise mitigated by the fact that the scheme applies to goods sold by a foreign branch or a foreign