ANNEX C

Second Submissions by the Parties

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ANNEX C-1

SECOND WRITTEN SUBMISSION OF THE EUROPEAN COMMUNITIES

(27 February 2001)

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1. Introduction

1. The EC respectfully submits to the Panel its second written submission in this case in rebuttal to the first written submission of the US.

2. The EC finds that the US submission does not respond to a number of the arguments contained in the first written submission of the EC. The EC will therefore commence this submission (Section 2 below) by recalling the arguments to which the US has not responded, as this may assist the Panel in identifying what is not contested.

3. Another feature of the first written submission of the US is that it provides little in the way of concrete information in response to that furnished by the EC but instead contains a number of misleading statements. The EC will comment on the US presentation of the facts in Section 3 below in order to clarify these issues for the Panel.

4. The legal arguments of the US are rebutted in Section 4 below. This section commences with a discussion of the questions of the burden and standard of proof to be applied in Article 21.5 *DSU* proceedings and its consequences for the present proceedings. It will continue with a discussion of the legal issues in the following order:

- Arguments relating to the existence of a subsidy;
- Arguments relating to export contingency;
- Arguments relating to the requirement to use US over foreign articles;
- The double taxation defence;
- Arguments relating to Article III:4 *GATT 1994;*
- Arguments concerning the transitional period;
- Arguments concerning the failure of the US to implement the rulings and recommendations of the DSB by 1 November 2000.

5. Finally, the EC will summarise its conclusions (Section 5).

6. The EC notes that the third parties who have submitted comments agree with the EC position. The EC will comment on these submissions as required during the discussion of the arguments.

2. The EC Arguments that remain unaddressed

7. The US has failed to address a number of claims and arguments made by the EC in its first written submission. The EC wishes to draw the attention of the Panel to the following unanswered claims and arguments.

2.1. The EC's basic argument concerning export contingency and illustrations

8. In paragraphs 77 to 79 of the EC's first written submission, the EC explained that one basic error of the US was to consider that extending a tax exemption (or exclusion) to other categories of income than that earned by selling US goods could prevent it being contingent upon export in those situation where export is a necessary condition for obtaining the tax exemption. More generally, a

subsidy that is export contingent in *some situations* does not cease to be so if it can also be obtained in *other situations* which may not require export.

9. In other words, it should not be possible for the US to hide, what is essentially the same subsidy as that before the Panel in the original proceeding, within a slightly wider subsidy by adding to the basic FSC Replacement subsidy what the EC has called the extended FSC Replacement subsidy.[1]

10. The simple fact that tax-free income – or even income that is given the name "extraterritorial"

16. Again, the EC finds no answer to these arguments in the first written submission of the US.

2.2. The EC argument that the *extended* FSC Replacement Subsidy is also contingent upon export performance and specifically related to exports

17. The US also fails to comment at all on the EC's further argument that adding the extended FSC Replacement subsidy to the basic FSC Replacement subsidy cannot, in any event, prevent the

23. First, as the EC explained, in particular in paragraphs 35 to 37 of its first written submission,

only a variable part of "extraterritorial income" from gross income and therefore tax, and does so subject to numerous conditions.[17]

29. The EC refers the Panel to an Article published in the US specialist publication Tax Notes International entitled "US Treasury Official Denies FSC Repeal Signals Move to Territoriality.[18] The Article is attached as Exhibit EC-10. The official concerned was the US Treasury's acting international tax counsel and was closely involved in the preparation and defence of the FSC Replacement Act, representing the US at the consultations held with the EC on 4 December 2000. She is reported as saying that the FSC Replacement Act "is a narrow exception from the traditional US tax model based on reaching the worldwide income of each tax payer, regardless of where such income is derived." The Article also makes clear that the US review of its subpart F legislation is yet to be completed.[19]

3.3. The US argument that 'extraterritorial income' is 'outside the taxing jurisdiction of the United States'

30. A related argument to that about 'fundamental change' to the US tax system is the often repeated US claim that 'extraterritorial income' is outside the taxing jurisdiction of the US. For example, in paragraph 20 of the first written submission of the US:

> Under the new regime, extraterritorial income is excluded from gross income for US tax purposes, and, as explained below, is thereby placed outside the taxing jurisdiction of the United States.
>
> and in paragraph 25:
>
> the Act creates a new general rule under which excluded extraterritorial income earned by US taxpayers is outside US taxing jurisdiction.

31. These statements are misleading. First, as the EC has explained in its first written submission, the US does tax 'extraterritorial income'. It is only a variable part thereof – qualifying foreign trade income that is excluded and then subject to numerous conditions, some of which were

34. As the EC has pointed out the 'special tax treatment' under the FSC Replacement scheme is only available for 'foreign sales' on condition that they are not 'for ultimate use in the US'[21] and is also only available if certain conditions are met including a limitation on foreign content which restricts availability of the 'special tax treatment' in some cases to foreign goods incorporating US exports.[22]

35. Similarly, the US statement at another point of its first written submission:

> Thus, taxpayers receive the same US tax treatment with respect to income derived from foreign transactions regardless of whether exports are involved.[23]

is also, to say the least, misleading. It is clear that the vast majority of 'foreign transactions' are treated very differently by the US tax system.

36. A general feature of the first written submission of the US is the pervasive confusion that exists between 'foreign transactions', 'foreign sales', 'foreign goods', 'exports' and 'foreign-source income.' Different concepts are often assimilated when in truth they are distinct or only partially overlap. To take a few examples:

- In paragraph 126 of the first written submission, the US attempts to deny the comparability of goods sold domestically and those sold abroad by saying:

  > Products manufactured and sold in the US cannot be said to be foreign.

Obviously, products made in the US and then exported do not suddenly become foreign, even if the transaction is made with a foreign company.

- In quoting the House Report, the US says[24] that under the US and European systems

  > exporting is one way to earn foreign source income…

Of course, under the European systems, only the foreign activities relating to exporting earn such income, while under the Act all the domestic activities relating to exports earn such income.

37. The US also attempts to blur the distinction between "extraterritorial" income and "excluded" income. It erroneously states in paragraph 28 of its first written submission that the FSC Replacement Act gives a detailed definition of extraterritorial income which is contained primarily in sections 114, 941, 942 and 943 of the IRC. It refrains from referring to the straightforward definition contained in section 114(e) IRC but goes on in paragraph 29 to bring into the definition elements of *qualifying* foreign trade income which, as the EC explained, merely limit the extent to which "extraterritorial income" is subject to less tax than other income.

38. Thereafter, the US varies its terminology referring to "excluded income"[25] "excluded extraterritorial income"[26] and even "excludable extraterritorial income"[27].

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[21] Section 942(a)(2)(A)(i) of the IRC as explained, for example, in the first written submission of the EC, paragraphs 100-101.

[22] Section 943(a)(1)(C) of the IRC as explained, for example, in the first written submission of the EC, paragraph 107 *et seq.*

[23] First written submission of the US, paragraph 23.

[24] First written submission of the US, paragraph 193.

[25] E.g., First written submission of the US, paragraph 33.

[26] E.g., First written submission of the US, paragraph 31.

[27] First written submission of the US, paragraph 200.

39. The EC considers that the US attempt to confuse the basic facts concerning its law to be unhelpful. The EC considers that its own description of the FSC Replacement Act is more reliable and notes that the US has not demonstrated any instance in which the EC may have misunderstood any aspect of the FSC Replacement Act.

3.5. US descriptions of European Tax systems

40. The US is also inaccurate in its description of "European" tax systems.[28] The EC has no intention to defend the tax systems of its Member States, which it is convinced comply fully with their international obligations. It will only make the following brief comments:

-

3.6. The FSC Replacement Act as a measure for the avoidance of double taxation

41. The EC will be refuting the double taxation defence in detail in Section 4.6 below. However, in the present context, it takes issue with the US statement that the avoidance of double taxation was a *purpose* of the FSC Replacement Act.[31] The US refers to the House Report in footnote 28, but this, on examination, does not bear out its contention. The passage referred to (page 18 of the House Report) makes no reference to the avoidance of double taxation. The only references to double taxation in the legislative history relate, in fact, to the need to limit the use of foreign tax credits in

these rulings suggesting that a compliance panel should, in principle, apply the basic rule governing the burden of proof as established for original proceedings.[35]

49. Thus, following the decision of the Appellate Body in *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India ("United States – Shirts and Blouses")*,

> the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence.[36]

50. In other words:

> The initial burden lies on the complaining party, which must establish a *prima facie* case of inconsistency with a particular provision … When that *prima facie* case is made, the burden of proof moves to the defending party, which must in turn counter or refute the claimed inconsistency.[37]

51. In short, the claimant in the Article 21.5 proceedings has the onus of establishing a *prima facie* case of inconsistency of the implementing measure with the covered agreements. The EC considers that it has met its burden, so that the onus is on the US to disprove the claims.

4.1.2. The standard of proof in DSU Article 21.5 proceedings

52. The EC takes issue with the statement of the US that in "cases involving a generally applicable measure, there must be a heightened evidentiary burden for the complaining party".[38] In fact, the attempt, on the part of the US, to raise the standard of proof is tantamount to conceding that the EC has successfully reached the initial level of proof which is to make a "presumption" or a "*prima facie* case" of inconsistency with a particular provision.[39] The term *prima facie* denotes the minimum quantum of evidence "which unexplained or uncontradicted is sufficient to maintain the proposition affirmed."[40] The Appellate Body elaborated on the standard of proof in *United States – Shirts and Blouses* when holding:

> In the context of the GATT 1994 and the *WTO Agreement*, precisely how much and precisely what kind of evidence will be required to establish such a presumption will necessarily vary from measure to measure, provision to provision, and case to case.[41]

Thus, the precise requirement of how much and which kind of evidence is necessary to substantiate a claim needs to be tailored on a case-to-case basis.

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[35] Appellate Body Report, *Brazil – Export Financing Programme for Aircraft Recourse by Canada to Article 21.5 of the DSU*, ("*Brazil – Aircraft, 21.5*"), WT/DS46/AB/RW, adopted 4 August 2000, paragraph 66, which reads: "[T]he fact that 0.001to652t004 Tmaph.2064 T3r2r(h)1.4nedece is necessary saryr4 nesaryc-1.4674 9k1siExpor

53. The case before the Panel involves a specific evidentiary situation. The measure at stake is "legislation as such" as opposed to individual measures. Moreover, the Panel is now faced with a measure purportedly implementing its recommendations in the original proceedings. The FSC Replacement scheme is still in the process of being defined by regulation and considered by taxpayers. Thus, no factual evidence exists, e.g., on the question whether the non-US producers will, in practice, ever benefit from the FSC Replacement subsidy. When considering the standard of proof to be applied in this case, the EC submits that the Panel should take account of the following principles and considerations.

54. First, where the evidence regarding the effects of a piece of legislation is limited, panels may be forced to adjudicate the dispute on the basis of the general make-up and design of the measure. Thus, for example, in *Argentina – Textiles and Apparel*, the Appellate Body agreed with the Panel that "the structure and design" of the measure resulted in a violation of Article II of the GATT.[42] More importantly, the Appellate Body did not find it necessary that the application of the measure "result in a breach of Article II for *each and every* import transaction".[43]

55. A further illustration of how a *prima facie* case may be made on the basis of the law is the recent ruling in *Korea – Beef*. In that case, the Appellate Body declined Korea's argument that the Panel's finding on Article III:4 of the GATT 1994 was "seriously flawed, relying largely on

course of determining whether the claiming or the responding Member, as the case may be, has established a *prima facie* case or defence.[48]

57. Finally, the specific situation of these Article 21.5 proceedings also bears upon the application

> The EC submits that the factor that determines whether the FSC Replacement scheme gives rise to a financial contribution and therefore a subsidy is not whether the legislative provisions on which it is based use the word "exclude" or the word "exempt" or neither, but whether there is revenue forgone that is otherwise due within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement.*

78. On this point at least the parties are in agreement.

79. The US next responds to what it calls "a variety of arguments to the effect that the Act confers a subsidy because the exclusion should be larger" although it does also recognise that the EC's arguments related not to the size of the subsidy but the conditions under which it is granted.[59] The US argument is that if it can do more, it must be entitled to do less. In this way the US concludes

> That an exclusion is qualified or moderated, however, does not convert it into a subsidy under Article 1.[60]

80. Again, the US seems to be proclaiming a subsidiser's charter. The very essence of a subsidy is that a government gives to some but not to others. The principle "he who can do more can do less" may apply to the *amount* of an exemption but it does not apply to the *scope* of exemptions (just as it cannot justify discrimination).

81. In defence of its view that it is entitled to exclude from tax whatever arbitrarily defined 'category' of income it wishes on whatever condition it wishes without there being a subsidy the US argues that

> the EC's argument that only the non-taxation of a "ge4(r)-2.2(g)1210.8ln o 6

85. In the case with the FSC Replacement scheme, income from the sale of goods by commercial enterprises is taxed in one way if the goods are for final consumption outside the US and in another if they are for final consumption in the US. These are not in the EC's views properly considered different categories (in the sense of class or type) of income. In addition, as the EC pointed out in its first written submission, the FSC Replacement scheme excludes from tax part of the income from a single taxable event but only if this taxable event satisfies certain strict conditions.[63]

86. Second, the definition of subsidy in Article 1.1 of the *SCM Agreement* is clearly very broad. Apart from the provision on revenue forgone, which concerns us in this case, the definition is also drafted in very wide terms in other respects, covering, for example any actual and potential transfer of funds and even the purchase of goods by government where a benefit is conferred. The limitation on the scope of the disciplines is laid down in Article 1.2, which provides that these disciplines only apply to subsidies that are specific, within the aeryblemOart 2.9212.5(idesr3.223(tha).4(m)18sc0.0306 Tw[(dif)8.9(f9

- the lease or rental of qualifying foreign trade property for use by the lessee outside the United States;

- the provision of services which are related and subsidiary to any sale, exchange, or other disposition of qualifying foreign trade property;

- the provision of services which are related and subsidiary to any lease or rental of qualifying foreign trade property;

- the provision of engineering or architectural services for construction projects located (or proposed for location) outside the United States; or

- the performance of managerial services for a person other than a related person in furtherance of the production of foreign trading gross receipts.

100. The US concludes that this allows a 'broad range of taxpayers' to earn 'extraterritorial income'.[73]

101. A first comment of the EC on this argument is that most of this impressive list relates to services. As the EC argued in its first written submission (and as stated above,[74] the US has ignored), an export-contingent subsidy for goods cannot cease to be so just because it is made available in other, different, circumstances - for the supply of services abroad.[75]

102. The EC argument is that one has to compare like with like. For owners of US produced goods, export is a condition for obtaining the benefits under the scheme for those goods.

103. In the real world (and this is the perspective from which the *SCM Agreement* is drafted and from which contingency must be assessed) companies do not start with a desire to earn excluded income and then consider the various options available for this purpose. They then compare the attractiveness of selling domestically and exporting goods they have produced or plan to produce. If the goods and the place they are produced is taken as given, then the companies have no other option than exporting if they want the benefit of the scheme.

104. Under the "analytical framework" of the US, on the other hand, companies are supposed to compare the option of earning excluded income by exporting the goods they have produced in the US with that of earning it by selling foreign-made goods abroad. Because the objective of companies is to make a profit from selling the goods they produce rather than simply earning "excluded income", this is not the choice that is really before them. This is also clear from the fact that the US analytical framework leaves open the question of what is to happen to the US produced goods if excluded income is earned by selling foreign goods abroad. Assuming that the US produced goods are not to be destroyed, the producer still has the choice of exporting them or selling them domestically. If it

EC's contextual arguments. The argument that the US chooses to respond to is the EC's reference to items (d), (f), (g), (h) and (l) of the Illustrative List as examples of where the benchmark is the domestic sale of goods. The US claims[77] that the comparison made in these items of the Illustrative

118. It is, however, crucial to note that situations whereby the foreign manufacture is performed by

- The fact that reversing the 'domestication election' will give rise to additional and unpredictable tax liability arising out of deemed transfers of assets under sections 367 and 354 of the IRC; [90]

- The conflicts that complying with US taxation requirements may create for foreign

- The FSC scheme is of much greater significance for US exporters who see the WTO-inconsistent FSC scheme replaced by an arithmetically identical scheme.

134. The EC submits that objectively the overwhelming purpose of the FSC Replacement scheme can only be considered to be the preservation of the FSC scheme benefits for US exporters.

4.3.3.4. Evidence

135. The title to Section V.C.5 of the US first written submission,[96] alleges that the EC has not provided *evidence* that the FSC Replacement subsidies are export contingent. It is not entirely clear what argument the US is making but the EC would make two points.

136. First, the EC believes that it has established with the arguments in its first written submission, and developed above, that FSC Replacement subsidies are export contingent.

137. These arguments are based on the text and structure of the FSC Replacement Act and other laws. The US has a responsibility to produce rebuttal arguments and, if necessary evidence. The EC has set out its views on the standard and burden of proof in Section 4.1 above. The EC cannot be expected to produce evidence that is within the control of the US.

138. Second, if the US is suggesting that *factual*

meaning of the first part of Article 3.1(a). It can also mean that the export subsidies defined in Annex I are *deemed* to be included in the prohibition of export subsidies.

143. The US is quoting the dictionary partially when it says that

> The term “include” is defined as “contain as a part of a whole” or “place in a class or category”.[100]

144. The word "include" can also mean, according to the same dictionary:

> contain by implication, involve[101]

> and, even more pertinently, the preposition "including" is defined as meaning

> If one takes into account, inclusive.[102]

Therefore the word "including" can also mean that ‘taking into account’, ‘containing by implication’ and therefore ‘incorporating’. Indeed the same dictionary also gives ‘include’ as one of the meanings of ‘incorporate’

145. This latter meaning of the word ‘including’ (that is ‘incorporating’ or ‘taking into account’) is confirmed by, indeed, required by, the *context*. Footnote 5 expressly excludes from the scope of the prohibition the measures referred to in Annex I as not constituting export subsidies. If the Illustrative List could only *reduce* and not *expand* the prohibition, it would not have been necessary to include the words ‘including those illustrated in Annex I’ in Article 3.1(a) which would then become redundant, a result that the Appellate Body has many times made clear is not acceptable.[103]

146. The meaning of the word ‘including’ is also required by the *object and purpose* of the *SCM Agreement*.

147. One of objectives of the Uruguay Round negotiations, and one to which the US was particularly attached, was to introduce more effective disciplines on certain subsidies which are considered particularly pernicious – export subsidies and import substitution subsidies. This can be seen from the fact that these subsidies are, unlike all other subsidies, *prohibited* and that action can be taken against them without there being any need to prove adverse effects.[104] It is also evident from the tighter deadlines[105] and more expeditious procedures[106] and remedies[107] contained in Article 4 of the *SCM Agreement*.

148. The intent of the parties in incorporating Annex I was not to ensure that everything that was previously not prohibited would now be exempted (which would mean *no progress*). It was to ensure that what was previously prohibited would remain prohibited (which means *no backtracking*). They added footnote 5 to ensure that only what was *referred to* (that is *identified*) in the Illustrative List as not being an export subsidy, would be exempted. If the Illustrative List exempted measures that are simply not identified as export subsidies, the general words of Article 3.1(a) would fail in their basic task of introducing stricter disciplines.

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[100] First written submission of the US, paragraph 160.
[101] New Oxford Shorter English Dictionary (1997 - CD-ROM version)
[102] *Id.*
[103] See e.g. Appellate Body Report, *United States - Import Prohibition ofate22.8()-06(i45(r)-7(sc)1yn3p6f6.bv60 130)Tj*

149. Therefore, the EC maintains that either

- Item (e) is relevant as a separate source of prohibition of export subsidies; or

- It requires the term 'subsidies … contingent upon export performance' in Article 3.1(a) to be read as including, at least as regards direct taxation measures, subsides that are specifically related to exports.

150. In either case the arguments presented by the EC in this connection in its first written

156. The EC notes that in an attempt to rebut the EC's claim, the US makes a very generic allegation that under the foreign content limitation "a good can meet this requirement even if 100 per cent of its content is foreign".[111]

157. It is rather ironic that later in its submission the US contends that in order to establish its case under Article 3.1(b) the EC has the burden of proving how the foreign content limitation works at individual company level, while crafting for itself this very light standard of proof. At any rate, the EC claim does not relate to a hypothetical and unspecified "good". The EC has not argued that for each and every product that can possibly be produced by the beneficiaries of the FSC replacement scheme the foreign content limitation will require use of US over imported goods. Article 3.1(b) however prohibits local-content contingency with respect to each and every product that can be produced by a beneficiary of a subsidy scheme. Therefore, a WTO Member adopting a measure of general application cannot excuse the WTO-inconsistencies of such measure in respect of some products by referring to the possible WTO-conformity of the same measure in respect of other products.

158. The US further tries to disguise the real scope of the foreign content limitation by suggesting that its rules of origin anyway turn non-US inputs into US origin components, thus diluting the real impact of the foreign content limitation.

159. A number of WTO Members have rules of origin turning foreign inputs into a domestic product upon a certain "transformation" or "processing", but this has never affected the application of WTO rules and notably those prohibiting local content requirements. The US rules of origin may increase the scope for some companies to arrange their affairs so as to comply with the requirement but do not remove the requirement.

160. The distinction between components entirely made of US inputs and components made up of a mix of US and foreign inputs nowhere is drawn in the FSC Replacement Act. More importantly, it is completely irrelevant under applicable WTO rules, and rightly so. If Article 3.1(b), in prohibiting subsidies contingent upon "use of domestic over imported goods" made a distinction between "pure" and "mixed" components, a WTO Member could simply dilute the local content contingency to the necessary extent and then escape Article 3.1(b) prohibition.[112] Instead, Article 3.1(b) prohibits local-content contingency to <u>any</u> degree, even a slight bias in favour of domestic goods. There is no *de minimis* rule for prohibited subsidies in the *SCM Agreement*.

161. The foregoing considerations are confirmed by practice under Article III:4 of GATT 1994. If the origin of the inputs of the domestic goods favoured by "local content" requirements were to be relevant, probably hardly any case could have been successfully brought under Article III:4 of GATT. Any country has rules of origin turning foreign inputs into a domestic product upon a certain "transformation" or "processing" but assessing the underlying input composition of a domestic good is not a type of enquiry which is required under WTO rules at issue in this dispute.

162. If moreover, it was true that the foreign content limitation is so limited in its impact, the US has failed to explain why it has been so attached to it over the last fifteen years and continues to be so, to the point of reproducing in identical terms the relevant wording of the FSC Act in the FSC Replacement Act.[113]

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[111] First written submission of the US, paragraph 200.

[112] Suppose, for example that, in order to meet a foreign content limitation, a domestic good is used which is in turn made up of foreign inputs for 85 per cent. According to the country's rules of origin, these foreign inputs are turned into a good of domestic origin by adding 10 per cent domestic inputs and 5 per cent domestic value added. If this new good was not caught by Article 3.1(b), there would be a 10 per cent *de minimis* rules.

[113] See the comparison in the first written submission of the EC, Section 3.5.

4.5.3. Proof of the "contingency" in Article 3.1(b)

163. The US contends that the EC has failed to bring any evidence supporting its claims against the foreign content limitation.[114]

164. The US response to the EC's claims under Article 3.1(b) of the *SCM Agreement* and Article III:4 of GATT 1994 mainly relates to the burden and the standard of proof, and is an adaptation of

"base-year", that is 1963-64).[118] For each of the beneficiaries, a different CVA was set in the "letters

figures indicated therein. This additional explanation is in the form of examples of companies operating in the sectors considered in the Annex, for which the foreign content limitation gives rise to an obligation to use US over foreign goods. For ease of understanding, this information is added to the text of the Annex itself, which is hereby resubmitted. Should the Panel wish to review these data, the EC will ensure that the confidential documents establishing the accuracy of the figures used in the Annex are available at the meeting with the Panel.

179. For the foregoing reasons, the US has not refuted the EC's claim that the foreign content limitation makes the grant of the FSC Replacement subsidy contingent upon the use of domestic over imported products, contrary to Article 3.1(b) of the *SCM Agreement*. Accordingly, the EC requests the Panel to uphold its claim and find that the FSC Replacement Act is contrary to Article 3.1(b) and that the US has not withdrawn its subsidy, thus contravening the DSB recommendations and rulings.

4.6. The Double Taxation Defence

4.6.1. Introduction – The status of footnote 59

180. The US develops in some detail the position that both the first and last sentences of footnote 59 refer to measures that are not export subsidies within the meaning of footnote 5 to the *SCM Agreement*. The EC notes that the US is invoking the last sentence of footnote 59 as a defence.

181. The EC sees no reason to contest that the last sentence of footnote 59 may be an exception to Article 3.1(a). However, for the reasons that it will explain below, the FSC Replacement scheme is not a measure to avoid the double taxation of foreign source income.

182. The first sentence of footnote 59 on the other hand is more in the nature of a reminder that there is only a subsidy if revenue is forgone, rather than a statement concerning export subsidies, and in any event uses the words 'need not'. However, since the first sentence of footnote 59 does not appear relevant to the issues before the Panel, the EC will not comment further.

183. The EC notes that the terms "double taxation" and "foreign-source income" are terms of art with special meanings. It therefore considers that an analysis of the particular meanings these *terms* have acquired in the field of taxation is a more useful starting point than the dictionary definitions of the individual words of which they are composed.

184. The EC will proceed to respond the double taxation defence by making the following points:

- Commenting on the meaning of 'measures to avoid double taxation';
- Explaining that the income excluded by the FSC Replacement scheme is not 'foreign source';
- Explaining why the FSC Replacement Act is not necessary for the avoidance of doub7.8(e t)7(.8(s "6)-3.1ore)o1522 TD6.8(ith6(R)16th6(R)1nfHowev).8(i(fi)8.1)7.8(ng)1[(10.3(t (
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  come

4.6.2. The meaning of 'measures to avoid double taxation'

> which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State

190. Measures for the avoidance of double taxation relate to measures that may legitimately (hence "in accordance with the provisions of this Convention") be taxed in another State.[123] If a country provides a reduction of the tax burden for income that may not legitimately be taxed by another country, that is *single taxation relief*, not double taxation relief. Such a relief is clearly not required by any policy based on the relief from double taxation since double taxation by definition does not exist.

191. This point demonstrates a fundamental flaw in the US defence. That the FSC Replacement scheme income excludes from tax income that *cannot* be taxed by any other country. It is indeed an

196. It is in principle possible, subject to a number of preconditions, for an US enterprise to benefit

213. Indeed the FSC Replacement Act, fits uneasily with the US arrangements for avoiding double taxation. Apart from failing to relieve double taxation completely, in some circumstances, it can lead to over-compensation of 'double taxation' in other circumstances. This arises as follows:

214. The provision of the FSC Replacement Act that is presented as preventing the cumulation of the foreign tax credits and excluded income under the FSC Replacement Act two is the new section 114(d) of the IRC which generally disallows credit for foreign tax paid with respect to extraterritorial income that is excluded from gross income. However the new section 943(d) of the IRC states that, for purposes of section 114(d), any "withholding tax" shall not be treated as paid or accrued with respect to excluded income.

215. As a result, a US taxpayer will be able to claim credit against its US taxes for a foreign tax imposed on its excluded income provided that the tax is a "withholding tax."

216. The new section 943(d) of the IRC defines a "withholding tax" as "any tax which is imposed on a basis other than residence and for which credit is allowable under section 901 or 903."

217. If a US corporation is engaged in selling goods in a foreign country, one would generally expect the foreign country to subject those sales to its net income tax, not to a gross-basis withholding tax, and do so only in the case where that US corporation carried out its business through a permanent establishment situated in that foreign country. At the same time, the US corporation, while engaged in business in the foreign country, will not typically be considered a "resident" of that country and in fact normally for the purposes of double taxation treaties would not be accorded such resident status. In such a case, the foreign tax would appear to come within the definition of "withholding tax" now in new section 943(d). Thus, the US corporation would be entitled to credit for such withholding tax even though a portion of its sales income is excluded from gross income under new section 114(a).

218. 'Double' relief from 'double taxation' cannot in any circumstances be considered a means of avoiding double taxation and further demonstrates that the purpose of the FSC Replacement Act is the granting of tax benefits to US exporters.

219. Second, the FSC Replacement Act, rather than avoiding double taxation actually creates it since it requires foreign corporations that are subject to the tax jurisdiction of other countries but wish to benefit from the FSC Replacement Act to make a 'domestication election' to become subject to US tax jurisdiction as if they were US corporations and to waive all rights under treaties and in particular under bilateral tax treaties.

220. Another indication of the fact that 'avoiding of double taxation' of foreign-source income cannot be the real objective of the FSC Replacement Act is that it applies formulaic rules to calculate the excluded part of the income. In doing so the amounts excluded do not correspond to the arm's length apportionment of the profits that would be considered to relate to the part of profit which another country would seek to tax in case that there was such possibility for the other country to do so. The foreign economic processes preconditions for the applicability of the exclusion are variable and require different levels of inputs to be made outside the US, but the rules for calculating the amount of excluded income remain the same irrespective of the nature of the foreign economic processes. Anyway, none of the required foreign economic processes would imply that the country of destination of the exported goods would have the right to tax the income derived from the export transactions. They would not establish effective connection with trade and business and thereby a permanent establishment in that country.

4.6.5. Even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) because it gives exporters a choice that is not available to other operators

221. Even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) of the *SCM Agreement* because it gives exporters a *choice* that is not available to other operators. Allowing exporters the choice between two alternative methods of double taxation relief gives such companies an export-contingent advantage which is not available to other companies. This additional advantage would also be a subsidy, but would not be an "exemption, remission or deferral of tax," which is the only kind of measure that item (e) covers.[131]

222. An additional complaint that can be made against the FSC Replacement Act is that it can give rise to 'double' double taxation relief as explained in the previous section. This unwarranted *overcompensation* is also a subsidy that is contingent upon export performance and specifically related to exports.

4.6.6. Comment on the view expressed by Canada that the income exempted under the extended FSC Replacement subsidy may be foreign-source income

223. As mentioned above, the EC has one final comment to make on the double taxation defence. Canada expressed the view in its third party submission that

> the "foreign income" component of "extraterritorial income" i9(adv)3it10.eyi 1.6(T(ef a0nent).6(T(ef a0n

228. Accordingly, not even the extended FSC Replacement subsidy can in any event be considered to come within the last sentence of footnote 59 to the *SCM Agreement*.

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

229. The US response to the EC claim under Article III:4 of GATT 1994 is limited to two points. The first is again the argument that the FSC Replacement Act does not contain an affirmative requirement to use US goods. The second relates to the burden and standard of proof.

4.7.1. The "affirmative requirement" argument

230. As the Panel will know by now, the US has repeated throughout its submission that the FSC Replacement Act does not require use of US-origin goods but provides that no more than 50 per cent of the value of goods may be attributable to foreign content (articles and direct labour).

231. As explained in its first written submission[134], the EC submits that in all cases, the requirement will act as an incentive to source inputs domestically because this will enhance the chances of a US producer intending to export its goods to qualify for the tax benefit. This is sufficient to violate Article III:4 of GATT 1994, which guarantees equality of competitive opportunities and foreign markets undistorted by discriminatory internal regulations. In addition, in some cases (like the ones in the Annex to the first written submission of the EC), depending on the cost structure of a given product type, the foreign content limitation will *necessitate* use of domestic goods.[135] It will thus be even more than an *incentive* for the use of US goods, which is the standard under Article III:4.

232. In the *Canada – Automobiles* case the panel was confronted with a similar argument. Canada argued that the Canadian value added ("CVA") requirements did not provide less favourable treatment within the meaning of Article III:4 since "these requirements [did] not affect the "internal sale,… or use" of imported products because they [did] not in law or in fact require the use of domestic products and therefore play[ed] no role in the parts sourcing decisions of manufacturers."[136] However, the panel noted the broad interpretation given by the Appellate Body to the term "affecting" [137] and concluded that

> a measure which provides that an advantage can be obtained by using domestic products but not by using imported products has an impact on the conditions of competition between domestic and imported products and thus affects the "internal sale,… or use" of imported products, *even if the measure allows for other means* to obtain the advantage, such as the use of domestic services rather than products. Consequently, the CVA requirements, which confer an advantage upon the use of domestic products and deny that advantage in case of the use of imported products, must be regarded as measures which "affect" the "internal sale,… or use" of imported products, *notwithstanding the fact that the CVA requirements do not in law require* the use of domestic products. [138]

The panel report was not appealed on this point.

[134] First written submission of the EC, Section 3.7.
[135]

4.7.2. The EC has made a prima facie case which stands unchallenged

233. More fundamentally, the US response fails to undermine the EC case because it is premised on an incorrect view of the standard of proof in cases brought under Article III:4 of GATT 1994.

234. The US seems to assume[139] that in order to establish its case the EC should supply evidence that a particular class of imported goods will be accorded less favourable treatment than a class of domestic "like products".

235. All the US seems to do for the rest is to point to a "heightened burden" that it alleges to exist for cases where a measure of general application is challenged.[140]

242. For the above reasons, the US has not refuted the EC's claim that the foreign content limitation provides less favourable treatment to imported parts and materials than to domestic goods

proceeding in a more explicit way the arguments that it is now making about the need to avoid disrupting 'business operations' this would not have justified any longer period.

250. First, it is well known that tax rules are subject to revision at least every year and companies are well aware that they cannot assume that tax breaks will be available indefinitely. They therefore arrange their affairs so as to minimise the disruption that changes may cause. In the present case they had almost a full tax year in which to adjust.

251. Second, disruption to private contracts has already been rejected by the Appellate Body as well as panels as a reason for not applying WTO rules. In the Article 21.5 proceeding concerning *Brazil – Aircraft*, the Appellate Body rejected an argument that private contractual obligations could be relevant to the question of fulfilling an obligation to withdraw a prohibited export subsidy.[150] In the Article 21.5 proceedings concerning *Australia – Automotive* leather the panel ruled more generally that:

> Many situations can be envisioned, and not only in the subsidies area, in which a Member's actions to implement a ruling of the DSB might result in some interference with private rights, and result in domestic legal claims. This possibility does not, in our view, limit our interpretation of the text of the SCM Agreement.[151]

252. Finally, on this point, the EC would note that the US is perfectly capable of adopting tax legislation that interferes with private rights. As the US later states itself[152], the FSC Replacement Act was adopted on 15 November 2000 and prevented the creation of new FSCs retroactively to the 1 October 2000. There were no howls of protest, because taxpayers knew that the rules were likely to change and took their precautions.

253. The second reason given by the US why the Panel should excuse its failure to withdraw the FSC subsidies with effect from 1 October 2000 is that WTO rules should, according to it, be 'construed flexibly'.[153] It cites the Appellate Body Report in *Japan – Alcoholic Beverages*, as authority for this proposition. The US is not of course asking for rules to be 'construed flexibly' but to be

4.9. The US failed to implement the rulings and recommendations of the DSB by 1 November 2000

256. The US response to the EC's claim that the US failed to comply with the DSB recommendations and rulings within the period of time specified by the DSB and has therefore also failed to comply with Article 21 *DSU* is based on a fundamental error. The US claims in paragraph 231 of its first written submission that:

> The DSB recommended that the United States withdraw the FSC subsidies with effect from 1 October 2000, which the DSB then extended to 1 November 2000.

257. The first part of the quoted sentence is correct because the DSB adopted the Panel's ruling that the FSC subsidies must be withdrawn at the latest with effect from 1 October 2000. The second part of the sentence is not correct. The powers of the DSB under Articles 16.4 and 17.14 of the *DSU* and 4.9 of the *SCM Agreement* are only to adopt or not adopt (that is reject) panel and Appellate Body reports. It cannot modify them.

258. What the DSB did on 12 October 2000 was to modify the time period for implementing measures to be adopted, *not* the date from which they were to take effect, which was specified in the Panel Report.

259. Accordingly, the retroactive repeal of the FSC scheme with effect from the 1 October 2000 would (if it had really repealed the FSC scheme, withdrawn the FSC subsidies and not introduced measures inconsistent with the covered agreements) have implemented the Panel's ruling in paragraph 8.8 of the Panel Report but not the requirement in Article 21 of the *DSU* to do so within a reasonable period of time, which the DSB had specified would end on 1 November 2000.[155]

260. The US also argues that

> Panels typically refrain from examining measures that cease to be in existence or in effect before a panel's terms of reference are set.[156]

261. The EC would simply point out that it is not asking the Panel to examine a measure that is no longer in effect. It is asking it to find that there was a *failure* to act by a certain deadline. A finding on such an issue is necessary to ensure that in future all WTO deadlines are not *de facto* extended by the length of time necessary to have a panel established and its terms of reference set.

5. Conclusion

262. For the above reasons, the EC maintains the conclusions set out in its first written submission.

---

[155] Australia states (in paragraph 10 of its Third Party Submission) that the EC agreed to the extension to 1 November 2000. This is not correct. The EC simply supported the consensus in the DSB to grant the extension.

[156] First written submission of the US, paragraphs 232 to 233.

ANNEX

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

Section 943(1)(C) of the IRC, introduced by the

1. The Steel industry

(a) Hot-rolled coils

Hot-rolled coils are manufacturing in steel mills and are the pre-material for many types of

Cost of production - Heavy steel plate	
1999	
A. Blast furnace*	51.017.593
Raw materials	55.324.999
Total Iron	106.342.592
B. BOF plant*	57.743.638
Input coefficient (t)	0,8223
Liquid steel	164.086.230
C. Continuous casting*	36.078.324
Input coefficient (t)	1,0386
Slabs	200.164.554

A cost breakdown in a specific example of certain producers of Stainless Steel Fasteners is as follows:

ALUMINIUM HOUSEHOLD FOIL 1999

	CONVERTER
SALES TONNES	3.797
GROSS SALES	7.555
DEDUCTIONS	357
NET SALES	7.198
COST 0 Materials	**4.900**
COST 0 TONNE	1.290
CONT 0	2.298
CONT 0 TONNE	605
COST 1 Variables	1.713
COST 1 TONNE	451
CONT 1	586
CONT 1 TONNE	154
COST 2A Fixed Mftg	303
COST 2B Depreciation	447
COST 3A Selling	61
COST 3B R&D	3
COST 3C Admin	114
CONT 3 (Before Man Fee)	(343)
MANAGEMENT FEE	55
CONT 3	(397)
Other	
Profit (Loss)	**(397)**

Thus, the cost of raw materials to the firm concerned is 4900. The total cost of production (the sum of items 1,2&3) is 7596. Assuming a 10 per cent profit, the selling price is equivalent to 8356. This means that, in the case of this firm, raw materials account for 59 per cent of the final selling price.

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

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 can account for up to 70 per cent of the fair market value (normal selling price) of the final product.

A cost breakdown in a specific example involving a producer of PET Bottle Chip is as follows:

Cost of production of product concerned PET Bottle Chip

FINANCIAL YEARS	**IP 01/10/98-30/09/99**
Raw materials :	
Terephtalic Acid PTA	59 236 670
Ethylene Glycol	19 844 039
Other	3 862 167
Total raw materials	**82 942 876**
Power and electricity	5 025 906
Direct labour	2 378 949
Total direct costs (a)	90 347 731
Manufacturing overheads	
Indirect labour	9 488 430
Maintenance	1 437 219
Depreciation	7 508 704
Other	154 976

List of Exhibits

EC-10 Article: *US Treasury Official Denies FSC Repeal Signals Move to Territoriality* Tax Notes

ANNEX C-2

SECOND WRITTEN SUBMISSION OF THE UNITED STATES

(27 February 2001)

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residents."[4] This statement fails to recognize that the Act fundamentally altered the manner in which the United States treats foreign income. It is incorrect to argue that "the effect of the exclusion is to reduce . . . tax liability" because no such liability exists in the first place under the US tax system with respect to excluded extraterritorial income.

7. Third, Australia's test for subsidization apparently would condemn any tax reform that results in a contraction of a Member's tax base. According to Australia, any measure that reduces tax with respect to a category of income confers a subsidy. Taken to its logical conclusion, this argument would transform a mere reduction in tax rates into a subsidy because the revenue foregone by the rate reduction was "otherwise due" before the reduction went into effect. Such reasoning conflicts with the Appellate Body's holding in*wg2.8(d(t)-2.9( )-10.9(e)0.1(m)18.9(b)1.9(er's)10.8(av)0.1(l)8(l)-2(e U.1(l) sov)0.1(l)8(l)-)*

to raise revenue that it could ‘otherwise’ have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax all revenues."[10] Thus, the Act must be assessed against an articulated and clear standard, and not on the basis of conclusory reasoning.

(b) No Negative Inferencea5(fe(tl8as6(t)-2.r BR)679(e)1 D5(fe(er)9(a)3679wl)-331(n)4.6s)10.9froad e-6.9s-

(i) It is Irrelevant that Only Certain Categories of Extraterritorial Income are Excluded from Tax

16. Canada maintains it is inappropriate that "only certain categories of 'extraterritorial income' are excluded from tax."[16] However, nothing in the language of Article 1 suggests that the size or comprehensiveness of a tax exclusion is relevant to whether a subsidy has been provided. Many exemption systems, for example, impose complicated conditions on the non-taxation of foreign income. Canada does not explain how the scope of the exclusion is relevant to whether taxes on extraterritorial income are "otherwise due".

17. In addition to being irrelevant, Canada's assertion that the Act's exclusion is insufficiently comprehensive is false. The exclusion of extraterritorial income applies broadly to individuals, partnerships, and corporations, irrespective of whether they are located in the United States or abroad. The exclusion applies to a broad range of foreign transactions – *i.e.*, foreign sales, foreign leases, and foreign rentals.

FSC provisions. To the extent Canada really is arguing that the Act uses the same percentages as the FSC provisions, Canada is dwelling upon an irrelevant point. Neither the Panel nor the Appellate Body in *FSC* found objectionable the percentages used by the FSC provisions. Moreover, such a comparison between the provisions of the FSC and the Act is neither accurate nor meaningful. As a general matter, challenged measures can be modified to remedy WTO deficiencies. In this case, the

2. The Availability of the Exclusion of Extraterritorial Income Earned by Foreign Entities is Relevant under Article 3.1(a)

25. As discussed above, Canada focuses on export transactions in the context of the foreign-use requirement, arguing that the availability of the exclusion for income earned in foreign, non-export transactions is irrelevant.[24] However, bifurcating the Act in this way is not consistent with the way the Act operates and results in a distorted analysis under Article 3.1(a).

26. With respect to foreign sales transactions, the Act does not distinguish between export transactions and non-export transactions or between exporters and non-exporters. With one exception, there is no distinction in reporting by taxpayers, whether they be branches or subsidiaries of US corporations or foreign corporations. The only distinction in the identity of taxpayers is that foreign taxpayers must be subject to US tax on their manufacturing income in order to earn excluded income. As explained in the *First US 21.5 Submission*, this distinction merely equalizes the US tax treatment of foreign branches and corporate subsidiaries. The Act applies neutrally and broadly to income derived from foreign transactions – that is, where the goods subject to the transactions are

submission, “the proper basis for comparison must necessarily be with the tax treatment of domestic sales of domestic goods."[28]

30. This argument is not grounded in the language of Article 3.1(a) as interpreted by the

C. THE ACT'S EXCLUSION CONSTITUTES A MEASURE TO AVOID DOUBLE TAXATION WITHIN THE MEANING OF FOOTNOTE 59

33. Australia and Canada both argue that the Act does not constitute a measure to avoid double taxation pursuant to the fifth sentence of footnote 59 of the SCM Agreement.[31] In reaching this conclusion, however, they propose conditions and limitations on what constitutes a measure to avoid

no *limit* on WTO Members in fashioning double tax relief *measures.*[37] Moreover, the Appellate Body in *FSC* did not condition the sovereign right of Members to exempt a category of income on some requirement that they only do so through a unitary measure. Therefore, the United States may adopt alternative mechanisms for the avoidance of double taxation.[38]

38. The same is true with respect to US bilateral tax treaties. These treaties provide relief from double taxation in conjunction with or parallel to US domestic legal provisions, but these agreements are confined by their terms to circumstances where the two signatory governments can claim the right to tax the same income. As a general rule, bilateral tax treaties are entered into to supplement domestic legal measures designed to avoid double taxation. Almost every country entering into such a treaty has its own mechanism for avoiding double taxation, and these domestic mechanisms often differ in some way – *i.e.*, in terms of methodology or scope of application – from that of the treaty. Thus, a treaty might provide relief to taxpayers where the laws of a given treaty party otherwise would not. However, a treaty does not pgg.9(s)12.2(t (s)16 Tw[3dom)17lc Tw[3doa12.8(t(t p)127hes)10.48(d)17

does so through an example in which a taxpayer obtains a tax savings because the taxpayer's country of residence imposes a higher tax rate than the other country involved. The example assumes that (1) the total income of a taxpayer is $100,000, (2) the first $80,000 of the $100,000 is taxable only in the country of residence, (3) the other $20,000 is subject to tax in both countries, (4) the tax rate in the country of residence is 35% at $100,000 and 30% at $80,000, and (5) the foreign country's rate of taxation is 20%. Absent a measure to avoid double taxation, the taxpayer would be subjected to taxes of $35,000 on his worldwide income of $100,000 by the country of residence, plus a tax of $4,000 levied by the country of source on the $20,000 earned there – resulting in a total tax of $39,000.[39]

43. The OECD Commentary then explains that under the exemption method[40], the $20,000 in foreign-source income would not be considered for tax purposes by the country of residence. This would result in the country of residence taxing the remaining $80,000 at a 30 percent rate, yielding a tax of $24,000, while the other country would levy its tax of $4,000 on the $20,000 earned within its territory. The exemption method would thus yield a total tax of $28,000, relieving the taxpayer of $11,000 in taxes (the double tax of $39,000 minus the revised amount of $28,000).

44. The Commentary shows this example graphically as follows:

Tax in County of Residence (30% of $80,000)	$24,000
Plus Tax in Foreign Country	$4,000
Total Taxes	$28,000
Relief Given by Country of Residence	$11,000

45. To summarize these results, under the exemption method, the taxpayer would owe only $28,000 in combined taxes and $24,000 in country-of-residence taxes. This amounts to a savings of overall and country-of residence taxes of $11,000.

46. Despite the overall savings in taxes, the OECD approves of the exemption method. The EC appears to agree, having informed the *FSC* Panel that, "[t]o the extent that foreign taxes are lower than domestic taxes, resident taxpayers with exempt foreign-source income are treated more favourably than other residents."[41]

(iii) The Credit Method Does Not Offer Perfect Results

47. It is important to note that, while the credit method may in theory be better suited to calibrating the impact of double taxation and can more easily prevent a tax savings from occurring[42], tax credits in practice are not a perfect method for avoiding double taxation. Tax credits are often complicated in their application, raising substantial questions about their effect in situations where companies suffer foreign losses, roll credits over to subsequent tax years, or pay taxes in a foreign jurisdiction that are not subject to crediting (*e.g.,* payment of excise or value-added taxes instead of income taxes). Like exemption, credits may not result in an exact dollar-for dollar offset of foreign taxes paid. However, unlike exemption, credits may result in taxpayers continuing to be subject to double taxation on the same income by two nations.

[39] US-7, pages C(23)-5 to C(23)-7.
[40]

taxing authority, payment is made or issued outside the territory of the taxing authority, or economic activities giving rise to the sale occur (at least in part) outside the territory of the taxing authority. These attributes are factors that can render income subject to taxation in two jurisdictions. It is important to note that this definition includes income attributable to foreign economic processes, but the language of the fifth sentence of footnote 59 does not appear to make foreign economic processes

connected" with that trade or business is subject to US taxation. In short, the United States does not require the existence of a fixed or enduring business operation.

62. The United States is not alone in relying on a standard more flexible than something amounting to a "permanent establishment". Section 253 of the Canadian Income Tax Act provides that soliciting orders or offering items for sale in Canada through an agent or servant (whether or not the contract or transaction is to be completed inside or outside of Canada) may be deemed to be carrying on business in Canada for tax purposes.[58] Similarly, to use one EC member state as an example, UK. tax laws take into account a number of factors, including where a contract is made, in

> "The Council adopts these reports on the understanding that with respect to these cases, and in general, *economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities* in terms of Article XVI:4 of the General Agreement."[60]

The United States cited this language in support of the proposition that footnote 59 allowed WTO Members to refrain from taxing export-related income attributable to foreign economic processes and the failure to tax such income does not constitute an export subsidy.

67. The FSC Panel and Appellate Body, though, ruled that the Understanding has no relevance to the SCM Agreement in general or to footnote 59 in particular. As the Appellate Body stated, "[t]he 1981 Council action related to a different provision, Article XVI:4 of the GATT 1947, and not to the export subsidy disciplines established by Articles 1.1 and 3.1(a) of the SCM Agreement."[61]

68. As a result, the notion that "foreign source income" under footnote 59 can be directly equated to income derived from foreign economic processes, as Canada appears to contend, cannot be derived from the language of the 1981 Understanding. Such an interpretation must emanate from the language of footnote 59 itself. However, as the United States has explained in its first submission and above, the text of the fifth sentence of footnote 59 is not susceptible to such a narrow construction.

III. THE FIFTY-PER CENT RULE DOES NOT VIOLATE ARTICLE 3.1(B) OF THE SCM AGREEMENT

69. Australia argues that the Act makes the exclusion of extraterritorial income contingent on the use of domestic over imported goods and thus violates Article 3.1(b) of the SCM Agreement.[62] As discussed above, this argument is based on an erroneous description of the Act. Australia states:

> for property to constitute "qualifying foreign trade property" under the Act, at least 50 per cent of its fair market value must be attributable to articles manufactured, produced, grown or extracted *within the United States* ... . Given the tax exemption only arises on the meeting of a 50 per cent local content requirement, it is contingent upon the use of domestic over imported goods.[63]

70. However, contrary to Australia's argument, the Act does not require that any portion of the value of a final product be "attributable to articles manufactured . . . within the United States." In addition, the Act does not contain a "local content requirement."

71. The Act defines "qualifying foreign trade property" as "property not more than 50 percent of the fair market value of which is attributable to articles manufactured, produced, grown, or extracted outside the United States, and direct costs for labour . . . performed outside the United States."[64] Australia appears to be misreading this language to state that 50 percent of the fair market value of property be attributable to articles manufactured within the United States. Rather, the 50-percent rule takes into account only the value of foreign articles and foreign direct labour used in producing a finished product. The rule does not limit other foreign value. Thus, property can meet the fifty-percent rule even if 100 percent of its content is foreign.

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[60] Tax Legislation Cases, adopted December 7-8, 1981, BISD 28S/114 (1982) (emphasis added).
[61] FSC (AB), para. 119.
[62] Australia's Third Party Submission, para. 19.
[63] Id. (emphasis in original).
[64] The Act § 2, amending IRC § 943(a)(1)(C).

IV. THE UNITED STATES COMPLIED WITH THE DSB'S RECOMMENDATIONS AND RULINGS

72. Australia argues that the United States has not withdrawn the FSC subsidies by the 1 November 2000 deadline, as extended by the DSB. The United States explained in its first submission that the Act complies with the DSB's recommendations and rulings because the Act repeals the FSC provisions with effect from 30 September 2000, and provides that no FSCs may be created after that date.

73. The Act provides limited transition relief to lessen the administrative burden and impact on taxpayers' business operations that might result due to the repeal of the FSC provisions. As the United States explained in its first submission, providing limited transition rules to allow taxpayers to adjust to a new regime is customary practice in the United States and in other countries when repealing significant tax legislation. In addition, permitting limited transition rules is reasonable in this case in light of the reliance of taxpayers on the FSC rules – reliance caused, in part, by the EC's delay of thirteen years after the FSC was enacted before challenging it.

74. Australia completely ignores the arguments presented by the United States in its first submission with respect to the appropriateness of the Act's transition rules. Consequently, the United States respectfully refers the Panel to these arguments in its first submission.[65]

V. CONCLUSION

75. For the reasons set forth above and in the *First US 21.5 Submission*, the United States respectfully requests that the Panel reject the EC's claims and arguments, and make the findings requested in paragraph 239 of the *First US 21.5 Submission*.

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[65] First US 21.5 Submission, paras. 37-38, 223-39.