ANNEX D

Oral Statements of the Parties

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ANNEX D-1

ORAL STATEMENT OF THE EUROPEAN COMMUNITIES

(13-15 March 2001)

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Mr Chairman, Members of the Panel,

1. The EC knows that you have carefully studied the submissions in this case and will be brief in its introductory remarks.

2. We will endeavour to assist the Panel by highlighting what we consider to be the most

certain way; can a prohibited export subsidy be **repackaged** – or **rebundled** – so that its effects are

> taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property;[7]

18. The EC notes that a similar categorisation of different types of income is found in section 61 of the IRC.[8]

19. These are the different types of income that WTO Members have *in principle* the sovereign authority to tax or *not* to tax.

20. For example, if a Member decides not to levy taxes on the ownership of real property – or even business profits – it would not in this way be creating a subsidy.

21. But "extraterritorial income" is not such a category of income. Even less so is the truly "excluded income", "qualifying foreign trade income". In reality, the US has introduced a conditional exemption – or exclusion – from tax on some of the business profits that would otherwise be taxable under the US system.

4. He who can do more cannot always do less

22. The next fundamental error of the US is to assume that if it can exclude the whole of a category of income – in its view "extraterritorial income", in the EC's view business profits – then it must be able to exclude part of it. This leads the US to proclaim a fundamentally erroneous principle when it states

> That an exclusion is qualified or moderated, however, does not convert it into a subsidy under Article 1.[9]

23. As the EC has pointed out, 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 - or, indeed to the conditions attached to an exemption (just as it cannot justify discrimination). 14(l)-2.94e:(i)-3fiyu apply 14(What of)10.9(.2(e4.2(t cTw[(y)1r)7.3(-2.(j)rim)[(y))18.64(" m)1(t as)

26. Just as the essence of a subsidy is a difference of treatment, and it is necessary to compare one situation to a relevant benchmark, so can contingency only be understood if one situation is compared with another.

36. The Appellate Body, in *Canada-aircraft*[15], stated that benefit does not exist in the abstract. In the same way, export contingency does not exist in the abstract; it must be analysed with regard to the recipient, transaction and product concerned. The US approach would render the SCM disciplines completely ineffective.

37. The EC has cited the example of the Technology Partnerships Canada programme, the subject of the *Canada –Aircraft* proceeding, as an illustration of a case where an export contingent subsidy was included within a broader programme. The US, having ignored this argument when responding to the EC's first written submission, replied to the same argument brought by Canada saying that that the TPC was a *de facto* export contingent subsidy and asserting, wrongly, that the EC has not brought a *de facto* claim. [16] But the US argument is misconceived in any event. For one thing the Appellate Body has said that the standard of contingency is the same for both *de jure* and *de facto* cases. Further, how would the US have analysed the Technology Partnerships Canada programme if there had been a *de iure* requirement for aircraft manufacturers to export?

38. The Panel will recall that the EC gave further hypothetical examples in its first written submission to illustrate the how untenable the US position is.

7. Article 3.1(b) of the SCM Agreement must be given meaning

39. The EC's main point relative to its Article 3.1(b) claim is that Article 3.1(b) must **be given meaning in all** its constituent parts.

40. The meaning of Article 3.1(b) must be assessed having regard to the objective pursued by the drafters when they proposed to include it in the *SCM Agreement* – namely to avoid the use of subsidies to promote the substitution of domestic goods for imported goods. [17]

41. Article 3.1(b) starts from the notion of "contingency", and the EC has explained the meaning of this term.

the basis of the words of the relevant legislation or other legal instrument ".[20] Therefore, the fact that the use of US goods will be necessary in some cases is sufficient for a *de iure* violation of Article 3.1(b) to be found. Furthermore, the EC has shown with the examples in the Annex to its first written submission cases where use of US goods will indeed be necessary.

47. In addition to the cases where the cost structure for the finished products is such that use of US articles will be necessary, there are cases where, to **minimise the risk** of not meeting the foreign content limitation, for example because the price of the final product may decrease, or because the price of foreign component "articles" may increase, the foreign content limitation will make US producers prefer US "articles".

48. This "preference" is also covered by Article 3.1(b)'s prohibition, through the language "use of domestic over imported goods".

49. The EC has given a meaning to all the clauses in Article 3.1(b), as required by the *Vienna Convention on the Law(0 Tc013)1.saTn a mt4 .saTe .saT Tcand by the principle0.4f)-1.5(ef)9fec)11.6t)8iv)13.4e*

[21] *and this, in its view, is enough to rule out a can a (se u)11.0nder)7.0Art)7.1(i)-3.8c)101(l)-3.8e 3.)11.01(b)11*

55. It is true that income excluded from tax as a result of the *extended* FSC Replacement subsidy, may be liable to foreign taxation in some cases. The unprecedented aspect of the extended FSC

> The approach now generally taken by the courts is to ask whether "the operations from which the profits in substance arise" take place in the United Kingdom".

64. Thus the principle applied in the UK is that a non-resident may be liable to tax on business profits if its profits “in substance arise” in the UK. The conclusion of sales contracts in the UK may

85. The only other reply of the US to the EC's Article III:4 claim is the creation of a new standard of proof for cases involving measures of general application (as opposed to product specific measures). Contrary to the US contention, however, **there is no "heightened evidentiary burden"** for challenges of general measures under Article III:4 of GATT 1994.

86. The EC will simply refer the Panel to previous panel reports which it has relied upon in its first written submission[41] and which likewise reviewed measures of general application. These are:

- *Canada - FIRA*
- *US - Section 337*
- *EEC - Parts and Components*

87. In none of the above cases did a panel set out a different, let alone "heightened", evidentiary burden of the type advocated by the US in its first written submission. At any rate, Panels addressing claims under Article III:4 have referred indifferently to previous cases where general measures or product specific measures had been reviewed. Moreover, they have pointed out that

> the requirement of Article III:4 is addressed to 'relative competitive opportunities created by the government on the market …';
>
> and that
>
> "a determination of whether there has been a violation of Article III:4 does not require a separate consideration of whether a measure affords protection to domestic production" [42]

It is not by chance that the US has not been able to refer to any authority in support of its newly created standard of proof.

88. Even assuming, *arguendo*, that some reference to the functioning of a "requirement" of general application in respect of classes of products were to be provided, the EC has furnished evidence in its Annex as to sectors where the use of US inputs is necessary. *A fortiori* this evidence will be enough to support beyond doubt that the "requirement" under review affords less favourable treatment because it makes, all other conditions being equal, domestic inputs more attractive than foreign ones.

[41] First written submission of the EC, paragraphs 191 ff.

[42] Panel Report, *Canada – Automobiles*, paragraph 10.78; first written submission of the EC, paragraph 201 and footnote 73.

13. Confidential Exhibit US-9

89. The EC's immediate reaction to confidential Exhibit US-9 is: So what?

90. The EC does not doubt that there must be one or other company in the world that might consider domesticating, depending on the precise conditions that are eventually adopted by the US. The EC's case on Article 3.1(a) is, as the Panel well knows by now, not that no foreign company will use the extended FSC Replacement subsidy but that the basic FSC Replacement subsidy is still contingent upon exportation and that in many cases the use of the extended FSC Replacement subsidy will require the use of US articles by foreign companies.

91. If the Panel does consider the information in exhibit US-9 to be relevant to its decision in this case, the EC has a number of clarifications and questions to ask on it which it would ask the Panel to

List of Exhibits

EC-14 Extract from the BNA Daily tax report of 8 March 2001 (quoting Dirk Suringa of the International Tax Counsel's Office at the US Department of Treasury).

EC-15 Extract from the General Explanation of the Tax Reform Act of 1986 by the Staff of the US Congress' Joint Committee on Taxation.

ANNEX D-2

CLOSING STATEMENT OF THE EUROPEAN COMMUNITIES

(16 March 2001)

Mr Chairman, Members of the Panel,

1. Thank you for listening to us so carefully these last days and for your stimulating questions. We attach a written version of the answers that we have already given and will provide fuller and more refined answers by your deadline of 27 March.

2. We would like to make a number of concluding remarks to highlight a number of key issues arising out of the debate.

1. The objectives and effects of the FSC Replacement Act

3. One frustrating – yet illuminating – feature of our debate has been the extent to which the US has responded that it does not know the reasons for and the effects of many provisions of the FSC Replacement Act.

4. It is worth passing in review these US avowals of lack of justification, explanation and analysis:

- The estimated effects on tax revenue of the new legislation; [1]
- The factors that were considered to give rise to the increased tax expenditure; [2]
- The reasons certain products cannot give rise to excluded income; [3]
- The reasons why is the President allowed to exclude other categories of products in short supply; [4]
- The reasons for and anticipated effects of the so-called 50 per cent rule; [5]

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[1] [Question 2] How does the increased expenditure compared to the FSC indicated by the Congressional Budget Office arise? Answer: The US does not know.

[2] [Question 3] What part of the increased tax expenditure is attributed to a wider product coverage of the current law (defence products), and how much to other factors (e.g. transactions involving goods

- Whether and how the FSC Replacement Act applies to foreign-produced agricultural products, in

> past week, the US Joint Committee on Taxation has translated Treasury's proposal into statutory language…[9]

9. Next the exhibit we distributed this morning, an extract from the Congressional Record, House of Representatives, 14 November 2000 (Exhibit EC-19)

On page H11891, Congressman Levin explains:

> "At the same time, and I emphasize this, as it is clear from the bill itself in the committee report, this bill does not provide an incentive for US producers to move their operations overseas. It carefully defines the property that can be involved in transactions subject to the new tax regime. No more than 50 per cent of the fair market value of such property can consist of (a) non US components, plus (b) non-US direct labour. This provision has been carefully reviewed by those of us on the Committee on Ways and Means as well as the Department of Treasury, and I might add, minority leader."

On Page H11893, Congressman Rangel explains:

> "Mr Speaker, let me thank the chairman of the Committee on Ways and Means, the gentleman from Texas (Mr Archer), my fellow Democrats, and join my colleagues on the floor in asking support for this piece of legislation, which is supported by the President and which our official Secretary Stuart Eizenstat, assistant Secretary Jon Talisman, have worked on, as well as the Senate, which has made some changes."

On page H11894, Congressman English states:

> "This is a critical legislation to protect the jobs of working families who have members who work in some of our best paying export oriented jobs in America…"

On page H11896, Congressman Defazio states:

> "Apparently not bothered by the hypocrisy, immediately after the ruling by the WTO appeals panel, the Clinton Administration, a few members of Congress, and the business community openly declared the need to maintain the subsidy in some form and began meeting in secret to work out the details on how to circumvent the WTO ruling and maintain these valuable, multi-billion dollar tax incentives."

2. The Existence of a Subsidy

10. The US is asking the panel to accept the proposition that a WTO Member has an apparently unlimited right to exempt any type of income from taxation and then claim that it is not granting a subsidy because it has changed the prevailing benchmark against which the existence of a subsidy must be measured. Taken to its logical conclusion, this approach would mean that revenue would never be foregone under Article 1 of the SCM Agreement, because such revenue would never be "otherwise due", the Government in question having already moved the "outer boundary" of its tax jurisdiction to accommodate it. In these circumstances, there would be no subsidies derived from tax exemptions, which would come as quite a shock to many people in the US, notably the Import Administration of the Department of Commerce, which regularly imposes countervailing duties

[9] Exhibit EC-18 – Worldwide Tax Daily, 24 July 2000, "US Congressional taxwriters discuss FSC legislation", Goulder, Robert; Donmoyer, Ryan J; Tax Analysts.

against such measures taken by third countries. The EC has given examples of such measures in its questions to the US.

11. The US claims that by exempting extraterritorial income (or at least some of it) from US tax, it is exercising its sovereign right not tax certain income. What it is in fact doing is exercising its sovereign authority to grant a subsidy. There is nothing inherently wrong with this, except that, as explained later, these subsidies fall into the prohibited category.

3. The Export Contingency

12. The Act requires goods to be sold for ultimate us e outside the US. The US continues to overlook the obvious fact that there is only one way for the subsidy to be obtained in respect of transactions involving US goods - by exporting. In its oral statement, the US even went as far as saying that US producers are not obliged to export in order to obtain the subsidy, since they could, for example, decide to produce abroad and thus generate excluded income.

13. On the basis of this logic, all SCM Agreement disciplines would be reduced to inutility. For a start, no subsidy would ever be specific. There would be no regional specificity, since any firm could move to an eligible region. There would be no sectoral specificity, since any firm could diversify into the eligible sector. Yet the US Department of Commerce, in its CVD practice, maintains that subsidies limited to certain regions or sectors are specific. We have no reason to disagree with their approach.

14. As we have said, contingency, like benefit, does not exist in the abstract. The question of export contingency has to be determined with regard to the actual recipients of the subsidy.

15. The US, in adopting this law, knew that it was adopting a measure to promote exports – as evidenced by the statements above. This is also clear from the terms of the Act. The US has not been able to explain why products in short supply are excluded. The answer we submit is simple – because the US does not want to promote the export of such products.

4. The Foreign Content Limitation

16. We have noted above that an explanation for the foreign content limitation is contained in the legislative history - Mr Levin's statement that:

> … this bill does not provide an incentive for US producers to move their operations overseas. It carefully defines the property that can be involved in transactions subject to the new tax regime. No more than 50 per cent of the fair market value of such property can consist of (a) non US components, plus (b) non-US direct labour. This provision has been carefully reviewed by those of us on the Committee on Ways and Means as well as the Department of Treasury, and I might add, minority leader.

5. The Act mandates the granting of prohibited subsidies

17. This brings us to a more legal point. That is that the Act is inconsistent with the *SCM Agreement* because it mandates the granting of prohibited subsidies if taxpayers fulfil the conditions. The text does not preclude that these subsidies will be granted. The US tax authorities have no discretion not to allow it where, for example, the subsidy would be contrary to Article 3.1(b).

6. The Double Taxation defe Dodnted. sned in0d.

27. Contrary to the US claim that the EC in its second written submission had omitted parts of Article 5 and implied that the concept of permanent establishment in it is limited to the existence of a fixed place of business the EC, when making its second written submission, had carefully considered the full scope of Articles 5 and 7 of the Convention and concluded that the FSC Replacement Act does not in any way require the performance of such foreign activities which would constitute a permanent establishment for a US taxpayer eligible for the subsidy.

28. It is indeed of utmost importance to bear in mind that the foreign economic processes requirement in the FSC Replacement Act is based on a percentage cost test and that it can be met without undertaking any activities outside the US. In this context it is equally important to bear in mind that US taxpayers wishing to be eligible for the subsidy can outsource to independent third parties all the activities, if any, that are to be performed outside the US. It follows that foreign jurisdictions would not seek to assert any taxing rights on the excluded income as defined under the FSC Replacement Act, and that it is not meant to serve as a measure to avoid double taxation.

7. Footnote 59

29. The EC has explained that the exact status and meaning of footnote 59 does not have to be established in this case. It is sufficient to note that the FSC Replacement Act is not a measure for the avoidance of double taxation and is not limited to foreign-source income.

30. Whether one considers that this is a reference to a WTO standard or must be assessed, like revenue forgone, by reference to the tax system of the country concerned, the FSC Replacement Act does not satisfy the condition.

8. Article 3.1(b) of the *SCM Agreement* and Article III:4 of GATT 1994

31. The best way to sum up on Article 3.1(b) is to recall what you have asked the US in question 9.

32. Article 3.1(b) as we have said, prohibits conditions that give preference to domestic products in *any* cases.

33. The US itself admitted that there can be cases where use of US articles will be needed.

34. This *a fortiori* will mean that the foreign content limitation will provide an incentive to domestic products within the meaning of Article III:4.

List of Exhibits

EC-16 President Clinton Statement on signing FSC Repeal Legislation into law – The White House office of the Press Secretary, Hanoi (Vietnam), 17 November 2000.

EC-17 Government Press Release "Committee passes FSC Repeal and Extraterritorial Income Exclusion Act of 2000", 27 July 2000.

EC-18 Worldwide Tax Daily, 24 July 2000, "US Congressional taxwriters discuss FSC legislation" , Goulder, Robert; Donmoyer, Ryan J; Tax Analysts.

EC-19 Congressional Record, House of Representatives, 14 November 2000.

EC-20 US Regulation on the operation of the FSC scheme dated 6 March 2001.

ANNEX D-3

ORAL STATEMENT OF THE UNITED STATES

(13 March 2001)

I. INTRODUCTION

1. Mr. Chairman, Members of the Panel: On behalf of the US delegation, I want to thank you for the opportunity to appear before you today. We are aware of the large number of issues before the Panel, the volume of materials submitted to the Panel, and the gravity of the issues the Panel must weigh. We are grateful for your willingness to take on this considerable challenge and appreciate your service in trying to resolve this dispute and advance the aims of the multilateral system.

2. As the Panel well knows by now, the United States does not believe that the EC has met its burden of establishing that the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 – which I will hereafter refer to as "the Act"(re)11.–("th)13i9("th)13inc(lv)13.nslar to 11.th U108"th N7 to ChaiF(

enough to condemn the Act under Article 3.1(a); or (b) whether the fact that the Act does not apply to imports does condemn the Act under Article 3.1(a).

C. A MEASURE TO AVOID DOUBLE TAXATION MAY BE PREVENTIVE IN NATURE

20. Another area that demands full and reasoned analysis by the Panel is the question of what footnote 59 means when it refers to measures to avoid double taxation of foreign-source income. As is the case with regard to subsidies and export contingency, clear guidance is needed in this important area in order to secure a quick and final resolution of this dispute.

21. The EC has asked the Panel to impose a number of conditions on what constitutes a measure to avoid double taxation that cannot be found in the text of footnote 59. It has said that such measures must require taxpayers to have "permanent establishments" in foreign jurisdictions. It has claimed that such measures can only apply to income directly attributable to foreign economic processes of taxpayers. It has argued that WTO Members cannot use both exemptions and credits. It has even gone so far as to maintain that a Member must show a "necessity" for instituting such a measure and that Members must adhere to the details of the OECD Model Convention.

33. The EC claims that the United States "fails to comment at all" on the EC's argument that the 50-per cent rule makes the tax exclusion for foreign manufacturers export contingent. However, the United States, in footnote 102 of its First Submission, directly responded to this point by stating that

enacted different, WTO-consistent tax legislation in its place, the United States does not dispute the argument that the Act "replaces the FSC." Stated more simply, the United States replaced a measure found to be an export subsidy with a tax exclusion that is not an export subsidy. Indeed, if the United States had in fact enacted "essentially the same subsidy", no transition rules would have been necessary.

B. THE ACT FUNDAMENTALLY CHANGES THE US TAX SYSTEM

41. The EC also challenges the US position that the Act makes a "fundamental change" to US [illegible] laws by amending the definition of the key term "gross income" to exclude extraterritorial in[illegible] support of this allegation, the EC states that the United States continues to maintain a "f[illegible] worldwide" approach to taxation and excludes, subject to certain conditio[illegible] extraterritorial income.

42. First, the United States has not argued that it now has a territori[illegible] US position is that it has incorporated elements of the territorial syste[illegible] fundamental change embodied by the Act was the incorporation of territorial l[illegible] worldwide taxing authority where essentially none previously existed. As the [illegible] explained in its First Submission, the US Congress made clear in two legislative [illegible] imposition of territorial limitations constituted "fundamental" changes to US taxing [illegible]

43. Second, whether an exclusion is partial and [illegible] is subject to certain conditions is irrelevant to whether the exclusion itself represents a [illegible]l change in the US tax system. As we will discuss later, a limited or conditional exclus[illegible] nder that exclusion a subsidy.

44. In addition, the EC cites to an article ap[illegible] *rnational* to support its claim that the Act's exclusion "is a narrow exceptio[illegible] odel based on reaching the worldwide income of each tax payer, reg[illegible]."[9] The EC's reliance on this selected quotation is misplace[illegible]

45. First, the quotation provided by the [illegible] tio[illegible] not a quotation of the US Treasury represe[illegible] ever [illegible] Second, the EC takes the quotation out of c[illegible] rticle no[illegible] question was in the process of dispelling [illegible] t the new law [illegible] corporation tax regime should be inte[illegible] t the United States [illegible] global tax structure and move to a *p*[illegible] s, the Treasury representative [illegible] stating that the United States do[illegible] foreign tax credi(a)0(9(esa na)11(epUe)0(n-2.

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47. The EC also contests the US statement that all foreign sales are treated alike and believes that the US confuses terms like “foreign transactions ”, “foreign sales”, “foreign goods”, “exports”, and “foreign source income”. To the contrary, it is the EC that seeks to inject an element of confusion.

48. The United States has made clear that the exclusion of extraterritorial income applies to income earned in a wide range of foreign transactions, regardless of where the goods involved are manufactured. The Act treats all US taxpayers earning such income alike. The Act applies equally to individuals, partnerships, and corporations that earn excluded extraterritorial income. The Act applies to these taxpayers irrespective of whether they are located in the United States or abroad, the only requirements being that these persons be subject to US taxation and earn extraterritorial income.[11]

49. With regard to the EC’s statement that the United States attempts to blur the distinction between “extraterritorial income” and “excluded” income, the United States has explained that all

V. BURDEN OF PROOF

58. Third, the EC implicitly asserts that, whether or not it has made its *prima facie* case, the Panel may draw adverse inferences against the United States to the extent it has failed to furnish information requested by the Panel. It did so in paragraph 56 of its Second Submission, where it discusses such a negative inference drawn in the *Canada Aircraft* case. However, to date, this Panel has not requested any information from the United States. Therefore, it is wholly improper for the EC to suggest that the Panel draw adverse inferences against the United States.

59. Finally, the EC erroneously claims that the United States has "accepted . . . the burden to establish its defence under footnote 59."[17] That statement is patently incorrect. There are instances where a responding party may have to bear the burden of establishing an affirmative defense – for example, under GATT Article XX. However, the relationship between violations under other provisions of the GATT and Article XX of the GATT is fundamentally different from the relationship between footnote 59 and Article 3.1(a) of the SCM Agreement. Footnote 59 "simply excludes from its scope of application the kinds of situations covered by [Article 3.1(a)] of that Agreement."[18] Even if footnote 59 were characterized as an "exception", such characterization would not shift the burden of proof or dictate a narrower or stricter approach to treaty interpretation.[19] In addition, footnote 59 merely "recognizes the autonomous right of a Member"[20] to take measures to avoid double taxation of foreign-source income. Therefore, unlike GATT Article XX, which is implicated only after a violation under another GATT article is established, footnote 59 narrows the scope of SCM Article 3.1(a), as opposed to providing a justification for a violation. Thus, the EC continues to bear

indeed, to have benefitted from the historical accident of having commenced income taxation using the exemption method.

71. What the EC ignores is that the Appellate Body chose "the tax rules applied by the Member in question" as the basis for determining the existence of a subsidy. The EC is in effect asking the Panel not only to make the tax-raising exception the general rule, it also is asking the Panel to apply the US concept of "gross income" without an integral part of its definition.

C. THE EC IDENTIFIES AN ERRONEOUS BENCHMARK

72. Alternatively, the EC appears to be arguing that the appropriate benchmark in this case is that "corporate income from a commercial activity . . . may be taxed if it is earned by a US corporation or is 'effectively connected' with a US trade or business."[22] The "benchmark " the EC is asking the Panel to rely on is a combination of two distinct concepts – the taxation of US corporations and the taxation of income effectively connected with a US trade or business, neither of which applies here.

73. The reference to income earned by US corporations from commercial activity reflects the EC's reliance on the US worldwide tax system as it existed prior to the Act. Prior to the Act, the worldwide income of US corporations was generally subject to US tax regardless of whether the source of income was foreign or domestic. The Act, however, imposes limitations on the US worldwide tax system. Under the Act, extraterritorial income earned by US corporations is not

77. The EC attempts to back up its specificity argument by claiming that extraterritorial income is an arbitrarily defined category of income. The EC asserts that only categories of excluded income

the ordinary meaning of the term "export" is "not of much help."[24] Likewise, the EC has not cited any WTO panel or Appellate Body reports that interpret Article 3.1(a) in the manner proposed by the EC.

83. The language of Article 3.1(a) focuses its attention on whether a WTO Member makes the availability of a subsidy *contingent*

89. The EC attempts to deflect this argument by saying that, even if US manufacturers have a choice in where to manufacture and thus need not export to rely on the Act, this is not the case where parties have goods in the United States to sell. This argument, though, suffers from the same defect. Parties that sell goods in the United States can choose to source their goods from outside the United States and can choose to engage in wholly non-US transactions. Moreover, as the Appellate Body explained in the *United States - Lead Bar* case, subsidies are provided to natural or legal persons and not to productive operations or, we assume, the goods resulting from such operations.[26]

90. Thus, the relevant issue here is whether there is a condition imposed under the Act on US persons or businesses to export in order to earn excluded extraterritorial income. We submit that there is not. The Act does not require any taxpayer to export in order to invoke its exclusion for extraterritorial income.

95. In paragraphs 117 through 125, the EC produces a list of factors supposedly indicating that US companies would rarely, if ever, choose to operate through branches, as opposed to subsidiaries. The EC admits that "[u]ndoubtedly, the choice of the legal form for the foreign manufacturing

jurisdiction in branch form for US tax purposes while retaining limited liability protection offered through local law.

100. The EC claims that transfer pricing presents a greater problem for branches than for corporations. This statement is untrue. Transfer pricing is just as significant an issue between incorporated entities as between a corporation and its branch. With respect to incentives, branch form also carries certain tax advantages. For example, French branches of US corporations generally may deduct their allocable share of the expenses of the home office against their French income, while French subsidiaries of US corporations cannot take this deduction.

101. In sum, the EC's list of reasons why US businesses would prefer operating through subsidiaries rather than branches is oversimplified and, in some respects, just plain wrong.

2. Foreign Subsidiaries

102. The EC now agrees with the United States that foreign corporations can and will elect to become US taxpayers. While the EC maintains that such situations will be "rare"[31], the United States is pleased that the EC now recognizes that foreign corporations are a legitimate class of taxpayers that may exclude extraterritorial income. Of course, whether in fact it is rare or common remains to be seen, and the EC provides absolutely no evidence either way to support its al se10.9(al)1.0017e.9(ats.)]TJ0 -2.2935 TD

104. he EC's alalnt that it cannot be expected to provide the Pnel with evidence in support of its *de fct* theory is unavailing. If it does not have or cannot obtain sufficient evidence to back up what otherwise appears to be (al)16(e)-0.2(re su)12.5(ppos)10.30ition and prediction, then it ought not to have asrted claials. As the Ape108(p)12..0010(l)7.9(l)C3(a)d0.9(a)-3(f ,B)5.1 .0r...

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plain meaning of the word "including" is to be contained within, to take into account in an inclusive way, or to incorporate. All of these definitions suggest just what the United States has maintained all along – that the Illustrative List provides examples of subsidies that satisfy the standard of Article 3.1(a)..

107. Despite recognizing this, the EC continues to hold to the notion that paragraph (e) provides "a separate source of prohibition of export subsidy".[32] To the extent that the EC is suggesting that a measure can come within paragraph (e), but not Article 3.1(a), and constitute a prohibited export subsidy, the United States disagrees. If that were the case, then the Illustrative List would do far more than *illustrate* subsidies contingent upon export performance.

income, calls for double tax avoidance on a form of passive income – that is, income for which there are no directly related foreign economic processes. Like interest income and other forms of passive income, dividend income may be exempted to avoid double taxation under Articles 10.5 (and 23.2) of the Convention even though the party earning such income performs no economic activities in relation to such income – whether foreign or domestic. What can make dividend and other types of passive income "foreign" is that it is received from a foreign company or bank. In other words, the source of payment is foreign. The OECD Convention does not specify where the business activities of a company paying dividends must occur.

135. The same is true with respect to the OECD's treatment of "business profits" pursuant to Article 7 of the Convention. It applies to essentially all profits of an enterprise, not merely to profits directly attributable to economic processes of the enterprise itself that take place outside the country of residence of that enterprise.

136. Accordingly, the OECD provisions the EC cites do not support the EC's proposition that only income attributable to foreign economic processes can be "foreign source income" under footnote 59.

D. THE US CONGRESS DID INTEND FOR THE ACT TO SERVE AS A MEASURE TO AVOID DOUBLE TAXATION

137. In its zeal to see the Act struck down, the EC does not confine itself to rewriting provisions of the Act, WTO rules, and Articles of the OECD Convention. The EC goes so far as to substitute its opinion for that of the United States Congress as to the legislative intent underlying the Act. The EC not once, but twice, asserts that the US Congress did not intend for the Act to serve as a measure to avoid double taxation.[54]

138. The United States recognizes that ascertaining the specific intent of a legislative body is not always easy, but in this case there is strong and unmistakable evidence on the point in question. Each of the two congressional committees responsible for reviewing US tax policy and for drafting US tax laws stated unequivocally that the Act was intended and designed to serve as a measure to avoid double taxation. The report of the Ways and Means Committee of the US House of Representatives, which has been submitted to the Panel as US-3, states, on pages 10, 19, and 21, that "the exclusion of . . . extraterritorial income is a means of avoiding double taxation." The report also includes a discussion on page 11 noting that the Act's exclusion is to some extent designed to move the United States away from its predominant reliance on tax credits as a means for avoiding double taxation and toward the European model of exemption. Likewise, the report of the Finance Committee of the US Senate, which has been submitted as US-2, states, on pages 2, 6, and 8, that the Act's exclusion serves to avoid double taxation.

139. Furthermore, the structure of the Act demonstrates how it serves as a measure to avoid double taxation. The Act, at section 114(d), disallows tax credits on excluded income in order to avoid what the EC refers to as "'double relief' from 'double taxation'".[55] In this way, the exclusion provides the only method of double tax avoidance that is available under US law for excluded extraterritorial income. If the Act did not disallow tax credits, then US taxpayers could rely on the exclusion and credits for the same income, which might result in too much relief. To the same end, the United States limits the amount of foreign tax credits that US taxpayers may apply with respect to non-excluded income under the Act through its sourcing rules in section 943. This prevents what the EC terms "over-compensation" of taxpayers.[56] While it is true that application of such rules may result in less than full relief for double taxation under the credit method, the United States has explained that credits typically result in only partial relief of double taxation.

[54] *Id.,* paras. 41 and 209.
[55] *Id.,* para. 218.
[56] *Id.,* para. 213.

E. IT IS IRRELEVANT THAT THE UNITED STATES ALSO RELIES ON TAX CREDITS

140. In yet another effort to create a rule that cannot be found in the WTO agreements, the EC claims that the United States may not rely on an exclusion as a method to avoid double taxation because it also uses tax credits. This is one more contention that is completely divorced from the relevant language of the SCM Agreement and from common international tax practice.

141. As the United States has previously explained, it is widely accepted that relief from double taxation generally may be provided through an exemption of foreign income, through a credit for foreign taxes paid, or through an income tax convention pursuant to which participating countries cede taxing rights over particular categories of income. As the EC has recognized, most if not all Members employ all three of these mechanisms, in varying degrees, to avoid double taxation.[57] This is reflected in the fact that the Commentary to Article 23 of the OECD Convention provides with respect to alternative use of exemption and credits, "Contracting States may use a combination of the two methods."[58] The Commentary even goes further, stating that there are instances in which credits should be used even though exemption is the general rule of a given tax system.[59]

142. The OECD Commentary is relevant only in that it reflects the fact that many countries are like the United States and offer a mix of exemptions and exclusions as well as foreign tax credits. Even France, which is reputedly the most territorial of EC tax systems, offers its taxpayers a choice of a territorial exemption or foreign tax credits. If offering such a choice constituted an independent basis for violating Article 3.1(a), as the EC alleges, then many choices available under tax laws around the world would be improper.

143. However, this is not the case, because nothing in the SCM Agreement prohibits Members from using this type of alternative mechanism for the relief of double taxation. Footnote 59 leaves the choice of mechanism to WTO Members, stating that the ban against export-specific direct tax exemptions, remissions, or deferrals set forth in paragraph (e) of the Illustrative List of Export Subsidies "is *not intended to limit* Members from taking *measures* to avoid . . . double taxation". (Emphasis added). This language is particularly flexible, imposing no *limit* on WTO Members in fashioning double tax relief *measures*.

144. In contrast to what the EC asserts, footnote 59 does not allow Members to institute a measure to avoid double taxation only where such a measure is "necessary".[60] Footnote 59 in no way conditions the right to avoid double taxation on the basis of necessity. It is not a provision, like GATT Article XX, that makes certain practices allowable only upon a showing that a measure is "necessary". Footnote 59 makes clear that this right is not limited and that the method of achieving this permissible end is left to each Member to decide.

F. THE EC'S ARM'S-LENGTH PRINCIPLE ARGUMENT IS MISPLACED

145. There is one additional point that the EC makes with respect to the double taxation issue that calls for a response. The EC argues that the Act is improper because, according to the EC, it does not rely on the arm's-length principle in calculating taxes on non-qualifying foreign trade income. The EC confuses two distinct concepts.

146. The arm's-length principle is relevant for WTO purposes only in attributing income between related parties in export transactions. This derives from the second sentence of footnote 59, which

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[57]

152. Turning to the EC's arguments regarding Article 3.1(b) of the SCM Agreement, Article 3.1(b) is relevant only if the Panel first finds: (a) that the Act's exclusion constitutes a subsidy; and (b) that the Act does not constitute a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59. The United States respectfully submits that, for the reasons previously

in certain sectors" within the European Union.[70] Not only is there no evidence to support these conclusions, the data provided by the EC reflect only costs within the European Union, rather than costs within the United States or in other countries in which qualifying foreign trade property may be produced. Such data has little or no value in this case.

173. The absence of adequate factual support for the EC's Article III:4 claim should be viewed by this Panel with a high degree of scepticism and, without more, the EC' s claim should be rejected.

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

174. As this Panel is aware, the measures contested by the EC in the *FSC* case no longer exist. The US explained in its First Submission, however, that the Act does provide limited transition relief by providing one tax year for those FSCs in existence as of 30 September 2000 to continue in operation.

180. The cases cited by the EC do not limit this Panel's authority to uphold the Act's transition rules. These cases involved narrow legal provisions that impacted only a few private parties. The overall impact of repealing those provisions was relatively small.

181. That situation does not exist in this proceeding. The scope of the FSC regime was broad, and a quite large number of businesses were impacted by its repeal. Therefore, the cases cited by the EC should not control the Panel's actions in assessing whether the United States has properly implemented the DSB's recommendations.

182. Finally, it is worth recalling that the FSC provisions had been in place for a long time and the EC waited thirteen years before challenging it. During that time, US taxpayers came to rely on the FSC provisions in structuring their foreign transactions. Furthermore, the United States promulgated and maintained the FSC tax provisions in reliance on the 1981 Understanding adopted by the GATT Council. Such reliance was not unjustified.

B. THE UNITED STATES COMPLIED WITH THE TIME PERIOD SPECIFIED BY THE DSB

183. The EC also argues that the United States failed to comply with the DSB's recommendations in the *FSC* case because the Act was not signed until 15 November 2000. The EC's argument fails for two reasons.

184. First, the DSB did not recommend that the United States enact legislation by 1 October 2000. Instead, 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. The Act's provisions apply retroactively and repeal the FSC provisions before 1 November 2000. The Act in fact provides that the "amendments made by this Act shall apply to transactions after 30 September 2000."[74] Thus, the United States complied with the DSB's recommendation by repealing the FSC with effect from 1 October 2000. None of the EC's arguments to the contrary support an alternative conclusion.

185. Second, the EC's arguments with respect to whether the United States complied with the DSB's recommendations and rulings within a reasonable period of time are moot. As reflected in Article 19.1 of the DSU, the WTO does not provide retroactive relief for alleged past wrongs.

186. In this case, the EC alleges that the United States failed to act by 1 November 2000. However, once the United States signed the Act into law on 15 November 2000, the allegation that the United States "failed to act" ceased to exist. In other words, by the time the EC made its panel request to commence this Article 21.5 proceeding, the violation – that is, the purported "failure to act" – 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.[75] Therefore, the EC's claim that the United States has failed to properly comply with the DSB's time line should be rejected.

XII. CONCLUSION

187. In closing, the United States thanks the Panel for its patience in listening to a rather detailed discussion of the issues. The United States would like to end this statement where it began: focusing on the most important issues before the Panel.

[74] The Act § 5(a).
[75] *See, e.g., Argentina Textiles*, paras. 6.13-15.

12. The third main issue in this dispute involves the principle, articulated in footnote 59 of the SCM Agreement, that paragraph (e) of the Annex to Article 3.1(a) is "not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income." This issue, which was not addressed in the prior proceeding regarding the FSC, is clearly before this Panel. It is at issue because this was an explicit, stated objective of the Congress in adopting the new US measure.

13. The EC would have the Panel decree that this was not the purpose of the US Congress in adopting its new legislation, a proposition that would be arguable had the Congress been silent with respect to its intent, but an extraordinary proposition in the face of a clearly expressed Congressional purpose. The EC further contends that even if this were the purpose, that purpose was unnecessary because there are other means available to avoid double taxation, a proposition better suited for a policy debate than for an analysis of footnote 59. And the EC finally argues that a measure to avoid double taxation can be justified only through country-by-country determinations of whether there is an applicable foreign tax, a proposition that would be laughable were anyone to similarly suggest that territorial limits found in tax systems of EC member states should be permissible vis-a-vis certain foreign countries, but not others.

14. In fact, an exclusion is a widely recognized means of avoiding double taxation. OECD principles make clear that exclusions or exemptions need not provide dollar-for-dollar or pound-for-pound protection from double taxation, as European exemption systems demonstrate. The text of footnote 59, which does not limit measures to just offsets and does not use the term "permanent establishment", authorizes measures designed to avoid double taxation on "foreign-source income", a broader term on which the exclusion in the Act is based.

15. As a factual matter, it is clear that the income covered by the Act's exclusion is income that faces the legitimate possibility of taxation outside the United States. Foreign taxes will apply to the excluded income of foreign producers who take advantage of the new US exclusion, both in cases where there is a foreign permanent establishment and where there is foreign economic activity that does not meet the strict standard of a permanent establishment. Many countries do not limit their taxing authority to "permanent establishments", among them the United States, Canada, certain European countries, and a wide variety of developing nations. Income from electronic commerce transactions is just one recent example of income that may be subject to tax without regard to the "permanent establishment" standard. Nor does the fact that a country has tax treaties with certain other countries nullify the final sentence of footnote 59, as again, European exemption systems show.

16. For all of these reasons, the new US exclusion is a legitimate, indeed conventional, measure "to avoid the double taxation of foreign-source income," as the text of footnote 59 allows.

17. With respect to all three of the core issues in this case, there is an underlying question of the general applicability of rulings that this dispute generates. It is, of course, true that European tax systems are not at issue here; they are not within the terms of reference of this Panel. It also is true that the existence of a corresponding subsidy in a European tax system is not a defense in a challenge to a United States measure. At the same time, though, it is equally true that any WTO principles articulated in this case are equally applicable to all WTO Members, European countries included. It is also true that European tax systems that incorporate territorial limits confer, without question, a tax benefit on exporters who realize both domestic and offshore income from export sales. And it is true that with the new exclusion, the United States has incorporated a measure that is similar to, albeit not identical to, features found in European tax systems.

18. It is not the intent of the United States to condemn European tax systems or to justify its own by pointing to similar practices in other countries. It *is* our intent, however, to suggest that this

to invalidate all of those systems. The ordinary meaning of the text they drafted does not support that result.

19. In conclusion, the United States submits that this measure, like its predecessor, should be measured by the ordinary meaning of the text of the provisions that apply to it. Such an analysis, we believe, leads to the conclusion that in its central respects the United States measure is not inconsistent with the SCM Agreement.

20. The United States recognizes that it has voluntarily assumed the obligations of the WTO Agreement. At the same time, the United States understands, as this Panel undoubtedly also understands, that neither it nor the other proponents of the SCM Agreement contemplated that their obligations under the SCM Agreement would sharply circumscribe their ability to make their own tax policy decisions or to maintain rough tax parity with respect to the competitive advantages and disadvantages that different national tax systems confer. Thank you.