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UNITED STATES - TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS"

Recourse to Article 21.5 of the DSU
by the European Communities

Report of the Panel

The report of the Panel on *United States - Tax Treatment for "Foreign Sales Corporations"- Recourse to Article 21.5 of the DSU by the European Communities* is being circulated to all Members, pursuant to the *DSU*. The report is being circulated as an unrestricted document from 20 August 2001 pursuant to the Procedures for the Circulation and Derestriction of WTO Documents (WT/L/160/Rev.1). Members are reminded that in accordance with the *DSU* only parties to the dispute may appeal a panel

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I. PROCEDURAL BACKGROUND

1.1 On 20 March 2000, the Dispute Settlement Body (the "DSB") adopted the Appellate Body Report in WT/DS108/AB/R and the Panel Report in WT/DS108/R as modified by the Appellate Body Report in the *United States - Tax Treatment for "Foreign Sales Corporations"* dispute. In its recommendations and rulings, the DSB requested the United States to bring the FSC measure that was found, in the Appellate Body Report and in the Panel Report as modified by that Report, to be inconsistent with its obligations under Articles 3.1(a) and 3.2 of the *Agreement on Subsidies and Countervailing Measures* (the "*SCM Agreement*") and under Articles 10.1 and 8 of the *Agreement on Agriculture*, into conformity with its obligations under those Agreements.[1] The DSB specified that the FSC subsidies had to be withdrawn "at the latest with effect from 1 October 2000".[2]

1.2 In its Report, the Appellate Body, *inter alia*, upheld the Panel's finding, in paragraph 7.130 of the original Panel Report, that the FSC measure constitutes a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*; reversed the Panel's finding, in paragraph 7.159 of the original Panel Report, that the FSC measure involves "the provision of subsidies to reduce the costs of marketing exports" of agricultural products under Article 9.1(d) of the *Agreement on Agriculture* and, in consequence, reversed the Panel's findings, in paragraphs 7.165 and 7.176 of the original Panel Report, that the United States has acted inconsistently with its obligations under Article 3.3 of the *Agreement on Agriculture*; and found that the United States acts inconsistently with its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture* by applying export subsidies, through the FSC measure, in a manner which results in, or which threatens to lead to, circumvention of its export subsidy commitments with respect to both scheduled and unscheduled agricultural products.[3]

1.3 On 29 September 2000, the Chairman of the DSB received a communication from the United States in which the United States "propose[d] that the DSB modify the time-period in this dispute so as to expire on 1 November 2000".[4] The United States asked "that the DSB approve this proposal and, to that end, request[ed] a meeting of the DSB on 12 October 2000 to consider this matter."[5] On 12 October 2000, the DSB, given that there was no opposition to the US request, agreed to accede to the request of the United States as formulated in its letter of 29 September 2000 and

1.6 On 17 November 2000, the European Communities requested the United States to enter into consultations under Articles 4 and 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "*DSU*"), Article 4 of the *SCM Agreement*, Article 19 of the *Agreement on Agriculture* and Article XXIII:1 of the *GATT 1994* with respect to the Act. The European Communities considered that the United States had failed to comply with the DSB recommendations and rulings by 1 November 2000. Furthermore, the European Communities alleged that the Act "appears to replicate the violations of the WTO Agreement found in the original dispute rather than remove them."[10]

1.7 Consultations were held between the parties on 4 December 2000 in Geneva, but the consultations failed to settle the dispute.

1.8 On 7 December 2000, the European Communities requested the establishment of a panel as "there is a disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings" of the DSB. The European Communities made the request pursuant to Article 6 and Article 21.5 of the *DSU*, Article 4 of the *SCM Agreement*, Article 19 of the *Agreement on Agriculture* and Article XXIII of the *GATT 1994*, and as envisaged in the "Agreed procedures under Articles 21 and 22 of the Dispute Settlement Understanding and Article 4 of the SCM Agreement applicable in the follow-up to the *United States - Tax Treatment for 'Foreign Sales Corporations*' WTO dispute" between the European Communities and the United States of 29 September 2000".[11]

1.9

9 July 2001, each party submitted written comments on the other party's written request. The Panel submitted its final report to the parties on 23 July 2001.

II. FACTUAL ASPECTS

2.1 On 15 November 2000, the United States enacted the Act[14], which repeals the provisions in the United States Internal Revenue Code ("IRC") relating to taxation of foreign sales corporations[15], subject to certain transitional provisions. In particular, the Act specifies that, in general, the amendments made by the Act "shall apply to transactions after September 30, 2000".[16] In addition, no new FSCs may be created after that date.[17] However, in the case of a FSC in existence on 30 September 2000, the amendments made by the Act shall not apply to any transaction in the ordinary course of trade or business involving a FSC which occurs: (A) before 1 January 2002; or (B) after 31 December 2001, pursuant to a binding contract between the FSC (or any related person) and any unrelated person that is in effect on 30 September 2000.[18] The original FSC scheme is described in paras. 2.1-2.8 of our original Panel Report.[19]

2.2 The Act amends the IRC by, *inter alia*, inserting a new section 114, entitled "extraterritorial income". Under the heading "exclusion", the Act[20] provides that "gross income does not include extraterritorial income". Under the heading "exception", the Act[21] provides that this exclusion "shall not apply to extraterritorial income which is not qualifying foreign trade income…".

2.3 Under the Act, certain income of a United States "taxpayer"[22] may be excluded from taxation. Such income -- "extraterritorial income" that is "qualifying foreign trade income" -- may be earned with respect to goods only in transactions involving qualifying foreign trade property.[23]

2.4 The Act defines "extraterritorial income" as the gross income of a taxpayer attributable to foreign trading gross receipts, i.e. gross receipts generated by certain qualifying transactions involving the sale or lease of "qualifying foreign trade property" not for use in the United States.[24]

2.5 "Qualifying foreign trade income" means, with respect to any transaction, the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest of:

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[14] *FSC Repeal and Extraterritorial Exclusion Act of 2000*, United States Public Law 106-519, 114 Stat. 2423 (2000), Exhibit EC-5; Exhibit US-1.

[15] See section 2 of the Act, repealing subpart C of part III of subchapter N of chapter 1 of the IRC.

[16] Act, section 5(a).

[17] Act, section 5(b)(1).

[18] Act, section 5(c)(1).

[19] See *supra*, note 2.

[20] Act, section 3; section 114(a) IRC.

[21] Act, section 3; section 114(b) IRC.

[22] Including a foreign corporation that has elected to be treated as a US corporation for the purposes of the Act. See Act, section 3; section 943(e) IRC.

[23] And, outside the goods area, such income may be earned in relation to services which are: related and subsidiary to (i) any sale, exchange, or other disposition of qualifying foreign trade property, or (ii) any lease or rental of certain qualifying foreign trade property; for engineering or architectural services for

- 30 per cent of the foreign sale and leasing income[25] derived by the taxpayer from such transaction,
- 1.2 per cent of the foreign trading gross receipts[26] derived by the taxpayer from the transaction, or
- 15 per cent of the foreign trade income[27] derived by the taxpayer from the transaction.[28]

2.6 Qualifying foreign trade property means property –

> "(A) manufactured, produced, grown or extracted within or outside the United States,
>
> (B) held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and

(d) Consequently, the FSC Replacement scheme grants and maintains subsidies contrary to Article 3.2 of the *SCM Agreement*.

(e) The FSC Replacement scheme accords more favourable treatment to US than to like imported products in relation to the usp18.9(ee2,(odu)1p)18.6(1s5(cts)1hp)18.6(1p2 92au7em)18e2r

IV. ARGUMENTS OF THE PARTIES

4.1 The arguments of the parties are set out in their submissions to the Panel. The parties' submissions are attached to this Report as Annexes (see List of Annexes, page iii).

V. ARGUMENTS OF THE THIRD PARTIES

5.1 The arguments of the third parties, Australia, Canada, India and Japan, are set out in their submissions to the Panel and are attached to this Report as Annexes (see List of Annexes, page iii). One third party, Jamaica, made no written or oral submissions to the Panel.

VI. PROCEDURAL MATTERS

A. THIRD PARTY ACCESS TO REBUTTj/TT12 1 Tfn70 TD(T)Tj9 0 0 9OBMISSIT12 11n 20 9 11E11n 20D(T)9 T04.00247.401 gs0T

4. In reaching our decision, we took note of the weight placed by the EC argument on the text of Article 10.3 *DSU*[3], as well as on certain perceived considerations in the *DSU*.[4] We were mindful also of the *Vienna Convention* rules on treaty interpretation, including the need to avoid isolating the words of a treaty from their context.[5]

5. We note, to begin with, the express reference in Article 10.3 to the "first" meeting of the panel. In our view, this reference in Article 10.3 to "submissions … to the *first* meeting of the panel" (emphasis added) cannot be interpreted in such a way as to render the word "first" devoid of meaning. Its use clearly presupposes a context where there is more than one meeting of a Panel. This reflects the fact that the reference at issue is made in the context of standard panel procedures.

6. Under such procedures, a panel ordinarily holds two meetings. Documentation is submitted prior to each of these meetings.[6] Third parties ordinarily do not have a right to hear the oral statements of the parties at any panel meeting (including the first meeting). Rather, they attend a single special third party session set aside for this purpose and held subsequent to the first panel meeting with the parties.[7] In that context, it should be emphasized, the manifest effect of Article 10.3 *DSU* is to limit third party rights to receive only the parties' first written submissions (submitted to the first meeting); not the parties' written rebuttals (presented to the second meeting).

7. A panel under Article 21.5 must follow *DSU* panel procedures. But it must do so in a particular context, namely in the context of a much stricter timeframe. As a result, this Panel decided to hold only one meeting, rather than two, as would usually be the case (i.e. in the context of a proceeding with a lengthier timeframe). Our working procedures maintained the practice of obtaining from the parties two sets of

prior to the first meeting, but not rebuttals or other subsequent submissions. Thus, in a more frequent procedure, third parties would be in precisely the same position as

argued that the European Communities has the opportunity to file two written submission, while the United States was limited to one.

6.5 On 14 February 2001, the European Communities sent a written communication to the Panel, asking that we "reject this request" and expressing surprise that the United States was trying to reopen this matter at this late stage in the proceeding, after the deadline for requesting preliminary rulings. The European Communities asserted that "[s]imultaneous rebuttals are required by Article 12.6 DSU" and that this rule had also been followed in previous panel proceedings under Article 21.5 *DSU*. The European Communities stated that these considerations had presumably led the Panel to reject the United States request at the organizational meeting with the parties in December 2000.

6.6 On 21 February 2001, the Panel issued the following decision to the parties:

> Panel decision concerning the request by the United States
> relating to the timing of rebuttal submissions
>
> 1. We have carefully considered the request by the United States of 12 February 2001 that the Panel provide for consecutive, rather than simultaneous, filing of the parties' second written submissions, as well as the responding communication of the European Communities dated 14 February 2001.
>
> 2. We recall that we adopted our working procedures after having heard the views of the parties, including their views on the issue of the timing of the filing of their rebuttal submissions. We do not believe that any development or consideration has since arisen that would require us to reconsider this aspect of our working procedures, particularly given the current advanced stage of the proceedings and the difficulties inherent in adjusting other aspects of the Panel's schedule that such a change would necessitate.
>
> 3. We therefore deny this request by the United States to chw[(3.)ye.5(e1r)-22.9(d)-22.91red0.8(suc

7.4 The **European Communities** further argues that the formulation that originally appeared in paragraph 8.164 suggested that the DSB had changed an adopted panel report, by referring to a date contained in the our original Report and then stating that the DSB had subsequently extended that date. In the EC view, the DSB agreed to accede to the request of the United States as formulated in document WT/DS108/11, which referred to a time-period set (implicitly) by the DSB for the "necessary measures" to be *adopted* by the United States; the DSB did not affect the explicit recommendation that the FSC subsidies "must be withdrawn at the latest with effect from 1 October 2000." The European Communities submits that paragraph 8.171 was also inaccurate as to

7.7 The **United States** submits that paragraph 2.3 is inaccurate as it states that certain income "may be" rather thannaci "ilidrfom axactioannac ndr thcti(rag)2891(r)1.8(ath)12.9h 27 hvan lbsitti titi

has inserted the finding requested by the United States in paragraph 3.3. In order to maintain consistency, we have also inserted, in paragraph 3.2, the procedural finding requested by the European Communities.

7.12 The **United States** objects to our citation, in paragraph 8.38, of section 941(a)(1) IRC as support for our conclusion that the text of the Act is inconclusive on the question of whether extraterritorial income is excluded from gross income. In the US view, this citation is inaccurate and, as the United States submits it had explained during the proceedings[48], the rule set forth in this provision functions as a computational mechanism for determining the amount of the gross income exclusion. The **European Communities** considers that no change need be made to this paragraph, and that even if section 941(a)(1) IRC includes a "computational mechanism", the presence of such mechanism confirms that it is not the "extraterritorial income" as such that is excluded, but only a portion of it (and then only upon fulfilment of certain conditions). The European Communities submits that the reference to section 941(a)(1) IRC merely confirms the conclusion already drawn by referring to section 114 IRC, a provision making clear that only a fraction of the "category" "extraterritorial income" -- qualifying foreign trade income -- can actually be "excluded" (if the relevant conditions are met). The **Panel** takes note of these comments and has maintained the reference to the provision in question. It is the structure of the provision, read in conjunction with the other relevant provisions of the Act, that provides the basis for our analysis in paragraph 8.38.

7.13 The **United States**

products – constitutes export contingency within the meaning of Article 3.1(a) of the *SCM Agreement*. In the view of the United States, our discussion of this point fails to connect the rule we articulate to the actual text of Article 3.1(a). In the view of the United States, we should fill in this gap in our analysis in order to add clarity to our resolution of a critical issue in this dispute. In the **European Communities'** view, the reference to "differentiation in treatment" is easily "connected" to the actual text of Article 3.1(a), contrary to the US suggestion. According to the European Communities, we make this perfectly clear in paragraph 8.72. The European Communities submits that if we wish to make the text of paragraph 8.67 even clearer for the United States, we could insert language clarifying that the differentiation in treatment is as regards eligibility or non-eligibility for the tax exemption. The **Panel** does not concur with the US view that we fail to connect the rule we articulate to the text of Article 3.1(a) of the *SCM Agreement*. In this context, we recall that an examination of *de jure* contingency under Article 3.1(a) calls for an examination of whether export contingency is apparent from the words of the Act, or can be derived by necessary implication (*infra*, paras.8.55-8.56). We then find that the words of the Act make clear that the subsidy is not available in relation to goods produced within the United States sold for use within the United States (*infra*, para. 8.60). It is the differential treatment provided for in the Act -- that is, if US-produced goods are exported, the subsidy is available, while if they are sold in the domestic market, it is not -- that renders the Act contingent upon export performance within the meaning of Article 3.1(a).

7.15 With respect to paragraphs 8.76-8.108, the **United States** submits that the parties disagreed during the proceedings as to which party bore the burden of proof with respect to footnote 59. 51in(i D7uf11.595r)nlona3ttrT/TT4 Tf4f19]348664yrdst -01t, paap 8raph ading33.9783nf1.57sst D.4e 0.4e 0 (

that, in our view the United States bears the burden of proof in this context. In any event, we consider that the evidence and argumentation adduced by both parties was sufficient to enable us properly to weigh this evidence and argumentation in reaching our finding. Moreover, even if the European Communities bore the burden of proving that the Act was not within the scope of the last sentence of footnote 59, we consider that the European Communities discharged this burden.

7.16 The **United States** submits that the last sentence in paragraph 8.102 appeared to have disregarded the first element of the "foreign sales and leasing income" prong of the Act, which excludes income attributable to foreign economic processes.[52] In the view of the United States, the last sentence of paragraph 8.102, as well as our analysis related thereto, was inaccurate and incomplete to the extent that it failed to take this element of the "foreign sales and leasing income " prong into account. According to the **European Communities**, these US comments appear to be a rather artificial attempt to have us include in the Report consideration of an argument that the United States raised for the first time in its comments on the European Communities' answers to the Panel's questions (and that did not appear to bear any real connection therewith) and which had not been debated during the proceeding. The European Communities submits that the United States appears to argue that there may be a relationship between the extent of "foreign economic processes" conducted and the amount of the excluded income where qualifying foreign trade income is calculated on the basis of foreign sale and leasing income in accordance with Act, section 3; section 941(c)(1)(A) IRC. While the European Communities is of the view that it cannot be expected to deal with this complex issue at this stage of the proceedings, it made several brief points to demonstrate that the arguments are unmeritorious. The European Communities asserts that Act, section 3; section 941(c)(1)(A) IRC constitutes only one of two ways of calculating "foreign sales and leasing income" which in turn is only one out of three ways of calculating "qualifying foreign trade income". The alternative way of calculating "foreign sales and leasing income" is set out in Act, section 3; section 941(c)(1)(B) IRC, from which the "attributable" or "properly allocable" language on which the United States appears to rely is absent. According to the European Communities, the method for calculating qualifying foreign trade income based on "foreign sale and leasing income" in

7.17 The

narrowness -- in other respects, in conjunction with the other aspects of the Act's structure and design that we examine lead us to find that the relationship between the measure and its asserted purpose is not reasonably discernable. We have therefore maintained our original language while making an insertion in footnote 197.

7.18 We have also made certain technical revisions and clarifications in paragraphs 1.13, 8.60,

8.5 In the EC view, section 114(a) of the IRC is a "limited exclusion or exemption" that confirms the general rule of world-wide taxation of income of US natural or legal persons.[59] With respect to "corporate income from a commercial activity"[60], the European Communities asserts that the US "prevailing domestic standard" is that such income may be taxed, if it is earned by a US corporation, under section 11, in conjunction with section 61, IRC. If such income is earned by a foreign corporation, it may be taxed under section 881 IRC if it is US-source income; or under section 882 IRC if it is "effectively connected" with a US trade or business.[61] The European Communities also argues that the "benchmark" for assessing the "extended"[62] FSC Replacement scheme under

extraterritorial income that is not qualifying foreign trade income is a revenue-raising exception, i.e. without it, all extraterritorial income would be excluded from gross income and revenues would be less.[68] The United States contends that the exclusion of extraterritorial income from US taxation represents a shift in US taxing jurisdiction and the "normative benchmark" for US taxation of "foreign income".[69]

8.7 The United States submits that section 61 IRC can be understood only in light of the other

choose a particular kind of tax system; this is not so. A Member, in principle, has the sovereign authority to tax any particular categories of revenue it wishes. It is also free *not*

equivalent narrow and formalistic manner, the practical consequence would be precisely the same. It would effectively ensure that any Member that was careful enough to sever any self-evident formal

requirements relating to use outside the United States[81] and the foreign articles/labour limitation.[82] In addition, the Act stipulates, for example, that certain property is "excluded property"[83], and not

US corporate taxpayer in transactions not involving foreign trading gross receipts or qualifying foreign trade property would ordinarily be subject to taxation, under section 11 of the IRC, in conjunction with sections 61 and 63 of the IRC. [90] Foreign corporations pay tax in the United States on income "from sources within the United States" under section 881 of the IRC and on income "effectively connected with a United States trade or business" under section 882 of the IRC**.**

8.26 By treating as "non-taxable" certain income on the basis of highly selective qualitative conditions and quantitative requirements, the Act effectively carves such income out from another situation. The Act's demarcation -- in a negative manner through a number of qualitative (and quantitative) conditions -- of income that may be eligible for "exclusion" from "gross income" cannot be rationally understood as a self-standing autonomous construct, but rather only by comparison with another situation to which the Act itself explicitly refers. This other situation is the one that prevails where the Act's conditions for obtaining the "exclusion" are *not* fulfilled, most particularly, for example, where goods are for use *within* the United States or where they do not satisfy the foreign articles/labour limitation. That leads us to the conclusion that this is to be rightly characterized as the foregoing of revenue otherwise due.

8.27 Moreover, we do not see any other, countervailing, features that could reasonably lead us to conclude otherwise. Even if one seeks to discern some kind of overall rationale and coherence to the “extraterritorial income” “exclusion” that might even hypothetically (and we make no presumption that it would) lead one to modify the view that this is revenue that is “otherwise due”, no such rationale is apparent here.

8.28 For instance – and without prejudice to what the status of such a measure might be under the *SCM Agreement* – the Act manifestly does not represent a coherent approach to corporate earnings derived from offshore activities only. The conditionality is such that the eligibility is, in fact, circumscribed carefully to render it only effective, for example, with respect to goods, only with respect to *certain* goods -- i.e. *certain* "qualifying foreign trade property" -- produced within or

8.30 In light of these considerations**,** we are of the view that, through the tax "exclusion" provided by the Act, the United States government foregoes revenue that is otherwise due within the meaning of Article 1.1(a)(1)(ii). In our view, a "financial contribution" thereby arises within the meaning of Article 1.1 *SCM Agreement*.

8.31 We recall that in its Report in the original dispute, the Appellate Body referred on several occasions to the concept of "categories" of revenue and indicated that a Member is "free *not* to tax any partic13.3(udo)2(c)0.1(t43(r)-1.7( )-10.8(c.1(t43(teg)13.1(o)2.2(r)9.1(i)-2.6(es of rev)13.1(e)0.4(nues)10.9(")-2.6(.)]

8.35 In our view, although the terminology of “categories” is particular, we see no reason why the

8.44 Having found that the tax "exclusion" under the Act gives rise to a financial contribution within the meaning of Article 1.1(a) of the *SCM Agreement*, we must also examine whether a benefit is thereby conferred within the meaning of Article 1.1(b) of the *SCM Agreement*.

8.45

8.51 The United States argues that, in order to be inconsistent with Article 3.1(a) of the *SCM Agreement*, export performance must be a condition that must be satisfied in order to obtain the subsidy.[118]

> granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.
>
> [5] Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement."

8.54 In examining whether the exclusion of qualifying foreign trade income from gross income is "contingent … upon export performance" within the meaning of Article 3.1(a), we recall that the meaning of "contingent" in that provision is "conditional" or "dependent for its existence upon".[127] We further recall that the legal standard expressed by the word 'contingent' is the same for both *de jure* or *de facto* contingency.[128] There is a difference, however, in what evidence may be employed to establish that a subsidy is export-contingent.[129] We understand the European Communities to be making a claim of *de jure* contingency, challenging the legislation "as such".[130] We will conduct our examination accordingly.

8.55 We recall the Appellate Body's statement that "*de jure* export contingency" is demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument[131], as opposed to the "total configuration of the facts constituting and surrounding the grant of the subsidy."[132] The Appellate Body has also recently stated,

> "that a subsidy is also properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be

taxpayer from a transaction if the qualifying foreign trade property (or services) are for ultimate use in the United States.[137] The Act defines the term 'qualifying foreign trade property' to mean property:

> "(A) manufactured, produced, grown or extracted within or outside the United States,
>
> (B) held primarily for sale, lease or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and
>
> (C) not more than 50 per cent of the fair market value of which is attributable to -
>
> > (i) articles manufactured, produced, grown, or extracted outside the United States, and
> >
> > (ii) direct costs for labour (determined under the principles of Section 263A) performed outside the United States."[138]

8.58 We observe that the text of the Act limits the definitions of "foreign trading gross receipts" and "qualifying foreign trade property" -- which determine what income will qualify as "extraterritorial income", "foreign trade income" and "qualifying foreign trade income" -- to property that is for ultimate use *outside the United States*. The subsidy is therefore only available in respect of income derived from transactions relating to such property.

8.59 The definition of qualifying foreign trade property applies to goods manufactured, produced, grown or extracted *within* or *outside* the United States. The fact that the definition of the term "qualifying foreign trade property" refers to property manufactured, produced, grown or extracted within *or outside the United States*

goods. In relation to US-produced goods, the existence of such income is clearly conditional, or dependent upon, the exportation of such goods from the United States. We are therefore of the view that by necessary implication the scheme is *de jure* dependent or contingent upon export in relation to US-produced goods.

8.61 We take note of the US argument that US manufacturers may earn extraterritorial income without exporting, as they have the option to produce and sell outside the United States.[141] That entities effecting transactions relating to goods in the United States could opt to source their goods from outside the United States and to engage in wholly non-US transactions does not, in our view, alter the fundamental reality that for US-produced goods, export is a necessary precondition for benefitting from the subsidy under the Act due to the requirement of "use outside the United States".

8.62 The United States emphasizes that the subsidy is also available under the scheme with respect to goods produced outside the United States, provided the transactions involve qualifying foreign trade property, and asserts that the subsidy is not export-contingent because it is available to other than exporters. By contrast, the European Communities argues that it is not necessary to show that all subsidies under the Act are export-dependent[142], and that a subsidy that is export-contingent in some

exist in the context of a broader subsidies scheme in the reasoning of the Appellate Body in *Canada-Aircraft*. There, the Appellate Body stated that,

> "the fact that some of TPC's contributions, in some industry sectors, are *not* contingent upon export performance, does not necessarily mean that the same is true for all of TPC's contributions. It is enough to show that one or some of TPC's contributions do constitute subsidies "contingent ... in fact … upon export performance".[146]

There, the export-contingency of the subsidy *vis-à-vis* regional aircraft was not vitiated by the fact that it did not depend on exports *vis-à-vis* other products/sectors.

8.65 We recall that, in response to Panel questioning, the United States drew an analogy between export contingency and specificity under the *SCM Agreement*, arguing that just as "the conventional way of making a specific subsidy non-specific is to expand the universe of users or beneficiaries"[147], "the way to cure an export subsidy is to ensure that the benefit is provided to a larger group than just exporters; that is, to a non-specific group".[148]

are themselves not produced within the territory of the Member itself.[150] In effect, the United States seems to argue that a subsidy to economic activity that is entirely irrelevant to export activity -- indeed, is precluded from involving such exports -- can effectively remove export contingency. This seems to be a manifestly unreasonable interpretation. Be that as it may, it would also have the

subsidy upon export, and thus does not cure the inconsistency with Article 3.1(a) of the *SCM Agreement*.[152]

8.73 We also take note of the US argument that the tax exclusion is even available for certain domestic transactions (domestic sales of products that are to be used outside of the United States).[153] In response to questioning from the Panel, the United States submits that "[a] manufacturer of goods can earn excluded income by sales to domestic buyers, provided that the goods in question are used outside the United States".[154] The United States contends, further, that:

> "Use outside the United States could occur, for example, if the good in question is a fishing boat sold to a United States person for use outside the territorial waters of the United States. In that case, income from the sale of the boat could qualify notwithstanding that the boat was not "consumed" within a foreign jurisdiction. Use outside the United States also could occur in certain circumstances if the article is incorporated into a good that is sold for use outside the United States. Thus, for example, extraterritorial income could be earned if a US manufacturer sells an aircraft engine to a US aircraft manufacturer for incorporation into a finished aircraft to be used outside the United States."[155]

8.74 These US statements do not change our view of the nature of the scheme in relation to US-produced goods. Since, in order for a transaction involving US-produced goods to qualify for the tax exclusion under the Act, the goods must not be "for use in the United States", it follows that these goods must be sent across the US border and moved outside US territory, generally, and in the usual case not involving questions of territorial waters, into another country. In our view, this means that,

8.80 In order for the United States to prevail, on the basis of footnotes 59 and 5 of the *SCM Agreement*, with respect to the claims of the European Communities under Article 3.1(a), we must determine that:

- the Act is a measure to avoid the double taxation of foreign-source income within the meaning of the fifth sentence of footnote 59 of the *SCM Agreement*, and

- the fifth sentence of footnote 59 falls within the scope of footnote 5 of the *SCM Agreement.*[165]

(b) whether the Act is a measure to avoid the double taxation of foreign-source income under footnote 59 of the *SCM Agreement*

8.81 We first turn to an examination of the United States argument that the Act is a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59 of the *SCM Agreement*.

8.82 The United States contends that the language in the fifth sentence of footnote 59 is

taxation outside the United States.[172] In the US view, the issue that arises is whether the Act does *not* constitute a measure to avoid double taxation under footnote 59 because it does not limit its exclusion to the amount of foreign taxes paid.[173]

8.85 The United States submits that the exemption (non-taxation) of foreign-source income is a widely accepted method of avoiding double taxation (along with foreign tax credits).[174] While the United States continues to use foreign tax credits, it asserts that nothing prevents it from using alternative means (tax credits and exclusions) to avoid double taxation.[175] The United States relies on the

income within the meaning of US law.[184] In the EC view, the scheme allows what is claimed to be double taxation relief on both foreign-source income and domestic-source income. The availability of double taxation relief on domestic-source income under the FSC Replacement scheme is also not covered by the last sentence of footnote 59.[185]

8.89 Finally, the European Communities argues that the United States has no need of the Act to relieve double taxation, because it has a comprehensive system of foreign tax credits. Nor does the Act solve the problem of double taxation because, the amount of excluded income being limited, companies may still need to claim foreign tax credits to avoid double taxation. On the other hand, the Act in some cases permits an enterprise to take a foreign tax credit with respect to excluded income,

8.93 We turn first to the term “foreign-source income". We recognize that this term in footnote 59 refers to a taxation concept. However, it is not clear to us that the term has obtained a universally agreed upon special meaning. Even if such a definition or special meaning existed, no such definition or meaning has been included in the *SCM Agreement* as a common understanding among WTO Members. Therefore, in our examination of the Act under footnote 59, we do not impose a single rigid definition or interpretation of the term “foreign-source income”, as that term is used in footnote 59, nor do we import into the *WTO Agreement* any definition of the term that may exist in other international instruments or fora.[189] Nor are we of the view that the meaning of the term "foreign-source" as used in footnote 59 need necessarily be determined purely by reference to the domestic laws of the Member invoking the footnote, in this case, the United States.[190] We note,
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8.95 We have a degree of sympathy for the US statement that “precision” in the relief of double taxation is "“probably impossible” given the many differences in taxation systems from one country to another and the many different ways that international commerce can be structured.”[194] Indeed, we do not view footnote 59 as requiring that a measure "to avoid" the double taxation of foreign-source income must avoid double taxation entirely, exclusively or precisely.[195] However, we consider that the relationship between the measure and its asserted purpose -- i.e. "to avoid the double taxation of foreign-source income …" -- must be reasonably discernable.[196] We seek to ascertain whether the Act

establishment" principle or on an analogous basis. In fact, we note that the bilateral tax treaties of the United States and a number of other countries largely rely on this approach.[201] Thus, in cases where the United States maintains either a bilateral tax treaty reflecting the "permanent establishment" approach or the country in question has incorporated the concept of "permanent establishment" in its legislation, there is no potential for double taxation in the absence of a permanent establishment. The Act, however, contains no requirement that excluded income be derived from a permanent establishment. It may thus be anticipated that the Act will, in a range of situations, exclude from taxation income that could not, in any event, be taxed in the foreign jurisdiction in question.

8.101 We note the United States' contention that the foreign economic processes requirement in section 942(b) IRC is an indication that extraterritorial income must involve some foreign economic activity, as well as the US statement that "the Act requires that transactions giving rise to extraterritorial income must have a variety of foreign attributes that can result in a sufficient nexus to a foreign taxing regime so as to render US taxpayers subject to foreign taxation".[202] We further note that, while the foreign economic processes referred to and required by the Act must be performed outside the United States, the Act allows the solicitation or negotiation of a given contract to be conducted by the taxpayer or any person acting under a contract with such a taxpayer and that a taxpayer is treated as meeting the requirements with respect to activities relating to qualifying foreign trade property if any related person has met the requirements in a given transaction.[203] We take these as further indications that the Act does not require that excluded income be derived from a permanent establishment, and this indicates that the Act would exclude from taxation income that could not, in any event, be taxed in many of the foreign jurisdictions in question. Moreover, the foreign economic

8.103 We do not mean to suggest that the absence of a permanent establishment requirement in the Act in itself means that the Act is not a measure to avoid double taxation within the meaning of footnote 59. We are conscious of the fact that "there are differing views and practices among countries as to what brings a non-resident enterprise within a country's taxing authority".[205] While we believe that the Act probably pushes close to the outer limit of the income that might be subject somewhere by some other jurisdiction to taxation, we do not preclude that the broad scope of the Act might nevertheless be justified as a "prophylactic", "preventive" measure to avoid double taxation.[206] We find it difficult, however, to reconcile the asserted desire of the United States to take such a prophylactic, preventive approach with the fact that the Act is in key respects quite narrow, excluding from "extraterritorial income" a wide range of income that could be subject to double taxation. It is to this issue that we now turn.

8.104 It is in our view striking that "extraterritorial income" does not include a range of income which is potentially subject to taxation in other jurisdictions. In this respect, we first note that the Act excludes entirely from "extraterritorial income" income related to sales *within* the United States or to sales outside the United States not meeting the foreign articles/labour limitation.[207] Furthermore, the Act makes access to the special tax treatment subject to several highly selective conditions. These are the conditions relating to ultimate use outside the United States[208] and the foreign articles/labour limitation. In addition, for example, Section 943(a)(3) of the Act stipulates that certain property is

8.116 In line with the decision of the Appellate Body in the original dispute concerning the scope and application of Article 10.1 of the *Agreement on Agriculture*[220], we consider that our reasoning and conclusions with respect to Articles 1.1 and 3.1(a) of the *SCM Agreement*[221], are also applicable as regards whether the Act gives rise to subsidies contingent upon export performance within the meaning of Article 1(e) of the *Agreement on Agriculture* for the purposes of Article 10.1 of the *Agreement on Agriculture*. Consequently, we find in the circumstances of the present case that the Act also involves subsidies contingent upon export performance within the meaning of Article 1(e) of the *Agreement on Agriculture* for the purposes of Article 10.1 of the *Agreement on Agriculture*. [222]

8.117 Turning to the issue of whether the export subsidies are "applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments" within the meaning of Article 10.1 of the *Agreement on Agriculture*, we derive guidance from the approach of the Appellate Body in the original dispute and consider the structure and other characteristics of the measure.[223] We recall that the term "export subsidy commitments", defining the obligations that are to be protected under Article 10.1 of the *Agreement on Agriculture*, "… covers commitments and obligations relating to *both* scheduled and unscheduled agricultural products".[224]

8.118 We note that the Act creates a legal entitlement for recipients to receive export subsidies, not listed in Article 9.1[225], with respect to both scheduled and unscheduled agricultural products. Upon fulfilment by the taxpayer of the conditions stipulated in the Act, the United States government must provide the tax exclusion. As there is no limitation on the amount of extraterritorial income, and thus

confer upon goods any quality that makes them, by definition, "unlike" any imported goods.[232] The European Communities cites the *European Communities – Parts and Components*[233] panel report for the proposition that it need not, in respect of a measure of general application, compare a certain class of domestic products with the same class of imported products.[234]

8.131 The United States contends that there must be evidence that any particular class of imported goods will be accorded less favourable treatment than a class of domestic like products, and that, as this case involves a generally applicable measure, there is a greater evidentiary burden than in the case of a measure of specific application and evidence must be introduced to establish a "meaningful nexus" between the measure and adverse effects on competitive conditions for a like class of imported goods.[235]

8.132 We view the principal purpose of the "like product" inquiry under Article III:4 of the *GATT 1994* as ascertaining whether any formal differentiation in treatment between an imported and a domestic product could be based upon the fact that the products are different -- i.e. not like -- rather than on the origin of the products involved. We find support for this view in the recent statement by the Appellate Body that under "Article III:4 of the *GATT 1994*, the term "like products" is concerned with competitive relationships between and among products."[236]

8.133 On this basis, we note that the distinction made between imported and domestic products in the Act's foreign articles/labour limitation concerning the limitation on fair market value attributable

applicability have, at most, an indirect impact on imported products and thus engender a greater evidentiary burden than laws of specific application.[239]

8.135 For these reasons, we consider that the "like product" element of Article III:4 is satisfied in this case.

(ii) whether the Act is a "law, regulation or requirement affecting the internal … use" of imported and like domestic products by reason of the foreign articles/labour limitation

8.136 The parties disagree on whether or not, by reason of the foreign articles/labour limitation, the

believe that the three separate elements identified in this phrase in Article III:4 deal with the *form* rather than the *content* of the measure under examination. We observe that the foreign articles/labour limitation is a statutory provision, that is, a requirement included in the Act, which is a generally applicable "law". At any rate, regardless of whether the measure at issue is a "law" or a "requirement", we agree with the view expressed by the European Communities that the "standard laid down in Article III:4 of GATT 1994 is the same both for "laws" and "requirements"".[248]

8.141 We recall the European Communities' statement that its claim under Article III:4 of *GATT 1994* is focusing on the "foreign content limitation, which affects the sale or use of products on the US market and discriminates against foreign products".[249] The European Communities clarifies that it is not claiming that the "tax exemption" as such is a "requirement affecting internal sale" within the meaning of Article III:4 of the *GATT 1994*.[250] In this regard, we note that the measure in question in an Article III:4 examination may condition access to an advantage or incentive bestowed by the government. We consider that the nature of the "advantage" ultimately sought from (or "incentive"

GATT and the *WTO Agreement* (including the "elimination of discriminatory treatment" in international trade[252]) and can hardly have been what the drafters intended. On the basis of the text and context of Article III:4 in light of the object and purpose of the *GATT* and the *WTO Agreement*,

not covered by Article III:2, but may infringe Article III:4 to the extent that they are linked to other conditions which favour the use, purchase, etc. of domestic products."[258] We also note that provisions relating to eligibility for an import duty exemption (an area also referred to in the preparatory work cited by the United States as not falling within the scope of Article 18 of the Havana Charter) were at issue in the Article III:4 inquiry by the panel in *Canada-Autos.*[259]

8.147 We next examine whether the measure at issue is one "affecting" the internal sale or use of the products concerned. We recall here the Appellate Body's observation that the ordinary meaning of the word "affecting" implies a measure that has "an effect on" and thus indicates a broad scope of application.[260] Further, we observe that the term "affecting" in Article III:4 of the *GATT 1994* has been interpreted to cover not only laws and regulations which directly govern the conditions of sale or purchase but also any laws or regulations which might adversely modify the conditions of competition between domestic and imported products.[261]

8.148 We consider that a measure pursuant to which the use of domestic -- but not imported -- products contributes to obtaining an advantage has an impact on the conditions of competition between domestic and imported products and thus "affects" the internal "use" of imported products, *even if*

product must be treated no less favourably than a like domestic product -- and this in all cases, for all transactions".[265]

8.152 The core of the US response to this claim hinges on its argument that no less favourable treatment is afforded to imported goods because the foreign articles/labour limitation does not change or affect the conditions of competition. According to the United States, taxpayers are under no obligation to use domestic content.[266] The United States contends that the Act does not require the use of any US-origin goods for a transaction to earn excluded extraterritorial income[267], but rather provides that up to 50 per cent of the fair market value of the goods involved in a transaction may be attributable to articles produced outside the United States and direct labour costs inccome

8.166 In the US view, the "limited transition relief" available under the Act provides foreign and domestic businesses with an opportunity to adjust and protect people who might have altered their conduct in reliance on the tax treatment provided by the earlier law, and is reasonable in the particular circumstances of this case. The United States contends that WTO panels have excused procedural violations in the absence of prejudice to the complaining party, essentially taking into account equitable considerations in issuing their decisions. According to the United States, a limited adjustment period is particularly appropriate given the EC's 13-year delay in challenging the FSC and the United States' reasonable reliance on the 1981 decision and understanding of the GATT 1947 Council.[281] Thus, the United States argues that the Act's limited transition rules constitute "reasonable implementation of the DSB's recommendations".[282]

8.167 We recall that the Act provides that "amendments made by this Act shall apply to transactions after 30 September 2000"[283]

IX. CONCLUSION

9.1 In light of the findings contained in Section VIII above, we therefore conclude that:

(a) the Act is inconsistent with Article 3.1(a) of the *SCM Agreement* as it involves subsidies "contingent… upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement* by reason of the requirement of “use outside the United States” and fails to fall within the scope of the fifth sentence of footnote 59 of the *SCM Agreement* because it is not a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59 of the *SCM Agr3Mt*

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