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UNITED STATES - TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS"

Second recourse to Article 21.5 of the DSU
by the European Communities

Report of the Panel

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I. PROCEDURAL BACKGROUND

1.1 The original Panel and Appellate Body Reports in this dispute were adopted by the Dispute Settlement Body (the "DSB") on 20 March 2000. In its recommendations and rulings, the DSB requested the United States to bring the FSC measure that was found, in the Panel and Appellate Body Reports, 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] Adopting the recommendation of the original Panel made under Article 4.7 of the *SCM Agreement*, the DSB specified that the prohibited FSC subsidies had to be withdrawn "at the latest with effect from 1 October 2000". On 12 October 2000, at a special session, the DSB agreed to the United States' request to allow it a time period expiring on 1 November 2000 to implement the DSB recommendations and rulings.[2]

1.2 On 15 November 2000, the United States enacted the "*FSC Repeal and Extraterritorial Income Exclusion Act of 2000*"[3] (the "ETI Act"). With the enactment of this legislation, the United States considered that it had implemented the DSB's recommendations and rulings in the dispute and that the legislation was consistent with the United States' WTO obligations.[4]

1.3 Following consultations requested by the European Communities on 17 November 2000, the DSB, acting under Article 21.5 of the *DSU*, referred the matter back to the original Panel on 20 December 2000. On 29 January 2002, the DSB adopted the Article 21.5 Panel and Appellate Body reports. The Article 21.5 Panel found the ETI Act to be inconsistent with Articles 3.1(a), 3.2 of the *SCM Agreement*, 10.1 and 8 of the *Agreement on Agriculture* and III:4 of the GATT 1994. It further found:

> "the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies inconsistent with Article 3.1(a) of the *SCM Agreement* and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 *SCM Agreement*."

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[1] Original Panel and Appellate Body Reports, *US – FSC*, para. 178. The original Panel concluded that the FSC scheme was inconsistent with the obligations of the United States under Article 3.1(a) of the *SCM Agreement* and under Articles 3.3 and 8 of the *Agreement on Agriculture*. The original Panel recommended at paras. 8.3-8.4:

> "With respect to our conclusions regarding the SCM Agreement, we *recommend*, pursuant to Article 4.7 of that Agreement, that the DSB request the United States to withdraw the FSC subsidies without delay." [i.e. by 1 October 2000 – see para. 8.8].
>
> "With respect to our conclusions regarding the Agreement on Agriculture, we *recommend* that the United States bring the FSC scheme into conformity with its obligations in respect of export subsidies under that Agreement....".

The Appellate Body upheld the Panel's *SCM Agreement* finding and modified the Panel's findings under the *Agreement on Agriculture* to find a violation of Articles 10.1 and 8. The original Appellate Body recommendation read:

> "The Appellate Body *recommends* that the DSB request the United States to bring the FSC measure that has been found, in this Report and in the Panel Report as modified by this

1.4 The 2002 Article 21.5 Panel Report contained no explicit new "withdrawal without delay" recommendation pursuant to Article 4.7 of the *SCM Agreement*, opining that the original DSB recommendation "remained operative".[5]

1.5 The Appellate Body upheld the 2002 Article 21.5

1.9 At its meeting on 17 February 2005, the DSB referred this dispute, if possible, to the original Panel in accordance with Article 21.5 of the *DSU* to examine the matter referred to the DSB by the European Communities in document WT/DS108/29. At that DSB meeting, it also was agreed that the Panel should have standard terms of reference, as follows:[10]

> "To examine, in the light of the relevant provisions of the covered agreements cited by the European Communities in document WT/DS108/29 the matter referred by the European Communities to the DSB in that document, and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements."

1.10 The Panel was composed on 2 May 2005 as follows:[11]

Chairman: Mr. Germain Denis

Members: Mr. Didier Chambovey
Professor Seung Wha Chang

1.11 Australia, Brazil and China reserved their rights to participate in the Panel proceedings as third parties.

1.12 The Panel met with the parties on 30 June-1 July 2005 and with third parties on 1 July 2005.

1.13 The Panel submitted its interim report to the parties on 22 July 2005. On 1 August 2005, both parties submitted written requests that the Panel review certain specific aspects of the interim report. On 5 August 2005, each party submitted written comments on the other party's written request. The Panel submitted its final report to the parties on 10 August 2005.

II. FACTUAL ASPECTS

A. INTRODUCTION

2.1 These proceedings of this Article 21.5 compliance panel follow the United States enactment of the Jobs Act in late 2004.

2.2 Before briefly describing the Jobs Act, we recall the relevant provisions of the original FSC and ETI subsidy measures.

B. THE ORIGINAL FSC SCHEME

2.3 A detailed description of the original FSC scheme was contained in paragraphs 2.1-2.8 of the original Panel Report.[12]

2.4 Briefly, Sections 921-927 of the US Internal Revenue Code provided for a US tax exemption on a portion of a FSC's earnings. This was "foreign trade income", the gross income of a FSC attributable to "foreign trading gross receipts". Foreign trading gross receipts meant the gross receipts of any FSC generated by qualifying transactions, which generally involved the sale or lease of certain

[10] See document WT/DS108/30.
[11] *Ibid.*
[12] Original Panel Report, *US – FSC*, paras. 2.1-2.8.

"export property".[13] A FSC had to meet certain requirements of foreign presence and foreign economic processes.[14]

2.5 A portion of the "foreign trade income" was deemed to be "foreign source income not effectively connected with a trade or business in the United States" and was therefore not taxed in the United States.[15] This untaxed portion was "exempt foreign trade income".[16] The remaining portion was taxable to the FSC. Dividends paid by the FSC out of exempt and non-exempt income to the shareholder (ordinarily, the "related supplier") generally qualified for a full dividends-received deduction.[17] Special rules applied for agricultural cooperatives.[18] The FSC scheme also contained certain income allocation (including two administrative pricing) rules in the case of a sale of export property to a FSC by a person described in Section 482 of the Internal Revenue Code (*i.e.*, by a related supplier). There were also certain requirements relating to distribution activities attributable to the export transaction.[19]

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transactions;[23] (ii) involving "qualifying foreign trade property";[24] and (iii) if the "foreign economic process requirement" was fulfilled.[25]

2.10 Section 114(a) of the Internal Revenue Code provided that a taxpayer's gross income "does not include extraterritorial income". Section 114(b) added that this exclusion of extraterritorial income from gross income "shall not apply" to that portion of extraterritorial income which is not "qualifying foreign trade income". Accordingly, the portion of extraterritorial income which was excluded from gross income – and, thereby, from United States taxation – was an amount which would result in a reduction of the taxable income of the taxpayer from the qualifying transaction.[26]

2.11 Section 2 of the ETI Act repealed the provisions of the Internal Revenue Code relating to FSCs.[27] Section 5(b) prohibited foreign corporations from electing to be treated as FSCs after 30 September 2000 and provided for the termination of inactive FSCs.

2.12 However, section 5(c) created a “transition period” and a “grandfathering clause” for certain transactions of existing FSCs. Specifically, section 5(c)(1) of the ETI Act stipulated that the repeal of the provisions of the Internal Revenue Code rela

2.15 However, pursuant to the "transition provision" in section 101(d) of the Jobs Act, for certain transactions in the period between 1 January 2005 and 31 December 2006, the ETI scheme remains available on a reduced basis. That is, a percentage

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 iv).

V. ARGUMENTS OF THE THIRD PARTIES

5.1 The arguments of the third parties -- Australia, Brazil and China -- are set out in their submissions to the Panel and are attached to this Report as Annexes (see List of Annexes, page iv).

VI. INTERIM REVIEW

6.1 The Panel submitted its interim report to the parties on 22 July 2005. On 1 August 2005, both parties submitted written requests that the Panel review certain specific aspects of the interim report. On 5 August 2005, each party submitted written comments on the other party's written request.

A. COMMENTS BY THE EUROPEAN COMMUNITIES

6.2 The

which says nothing about consistency with "the relevant recommendations and rulings." DSB recommendations and rulings are themselves required to be consistent with the covered agreements. DSB recommendations and rulings do not – indeed cannot – amend the covered agreements nor can they "add to or diminish" the rights and obligations under the covered agreements. Accordingly, the question of "consistency" remains a question of consistency with the covered agreements, not with recommendations and rulings.

6.7 In considering the parties' comments, the **Panel** has remained mindful that: Article 19.1 of the *DSU* states that a panel "shall recommend"; Article 4.7 of the *SCM Agreement* states that "the panel shall recommend..."; and a panel report must be adopted by the DSB to produce operative DSB rulings and recommendations. We have made certain changes in paragraphs 1.4 and 7.43. For greater clarity, and noting that we address the issue of whether Article 21.5 *requires* a new *recommendation*, we have made certain changes in paragraph 7.35 and in paragraph 7.37 (footnote 65). Mindful of thot

> from the *object and purpose of the treaty as a whole* may usefully be sought."[37] (emphasis added)

6.13 We believe that Article 3.2 of the *DSU* articulates a fundamental tenet relating to the object and purpose of the *DSU*, including its special and additional provisions, such as Article 4.7 of the *SCM Agreement*: "The dispute settlement system of the WTO is a central element in providing security and predictability to the multilateral trading system." The *DSU* aims to achieve the fair, prompt and effective resolution of trade disputes.[38] In respect of our interpretation of the terms of the *SCM Agreement*, we further recall and endorse the view of the 2002 Article 21.5 Panel that we must avoid an interpretation that "... is inherently contradictory to what may be viewed as the object and purpose of the *SCM Agreement* in terms of disciplining trade-distorting subsidies in a way that provides legally binding security of expectations to Members." (para. 8.39) In our view, our interpretation of the text of the relevant treaty provisions, in their context, is reflective of their object and purpose. Moreover, this interpretation is entirely consistent with, reflective of, and confirmed by, the object and purpose of the *DSU* (and the *SCM Agreement*), as a whole. We have slightly altered paragraphs 7.42 and 7.46, by, among other things, inserting footnotes 66 and 69.

6.14 The **United States** asserts that the European Communities made three primary claims in this proceeding: under Article 4.7 of the *SCM Agreement* and Articles 19.1 and 21.1 of the *DSU*. The EC also made some "consequential" claims that flowed from the supposed breaches of these three articles. According to the United States, none of these three articles appropriately serves as the basis for claims in this proceeding. As a result, those primary claims fail and, because they are "consequential," the EC's consequential claims fail as well. According to the United States, the US arguments need to be viewed in this context, but the interim report does not appear to reflect this. For example, continues the United States, paragraph 7.37 misstates the US argument and makes it broader than it is. The US argument is that the EC erred in claiming that the United States had breached Article 4.7 of the *SCM Agreement* with respect to the ETI Act. There was no Article 4.7 recommendation, nor, for the reasons found by the Panel, would it have been appropriate for there to have been one. The United

"consequential". The United States does not further clarify what would be in its view the "consequential" claims of the European Communities. Given that the United States designates as "primary" the claims relating to Article 4.7 of the *SCM Agreement* and to Articles 19.1 and 21.1 of the *DSU*, the European Communities infers that the "consequential claims" would be the other claims contained in its request for establishment of a panel. According to the European Communities, this would however be a gross misrepresentation of the European Communities' position (and one that the United States is making for the first time). There is no basis in the European Communities' request for the establishment of the Panel for this contention by the United States. The European Communities asserts that the word "consequential" is put by the United States in quotation marks but with no indication of from where it is quoted. And for good reason because the claims of violation of Articles 3.1(a) and 3.2 of the *SCM Agreement*, Articles 10.1, 8 and 3.3 of the

statement.[41] We note that the United States did not specifically identify any perceived inaccuracy in our description of its arguments in Section VII.B.2 of this Report. We have nevertheless clarified the US arguments in paragraphs 7.37 - 7.39 and 7.51 for

Communities disagrees that there is necessarily a difference in standards between "existence" and "consistency" of a measure taken to comply. According to the European Communities, in the case of partial compliance such as exists in this case the situation can be described as inconsistency or partial non-existence of the measure taken to comply. Where, as in the present case, a measure "taken to comply" has been adopted and the measure achieves partial compliance, there is a measure taken to comply for the part for which compliance is achieved; for the remainder, there is no measure. For the European Communities, there is no reason why the formulation that is chosen to describe the situation (non-existence or inconsistency) should lead to a difference in outcome. **We** have made certain changes in footnote 77 to better reflect our view.

6.23 In response to the **United States** request that we clarify the "alternative" to which we referred in paragraph 7.69, and noting the **European Communities** suggestion that this is, in fact, "in addition" rather than "in the alternative", **we** have modified that paragraph.

6.24 The **United States** submits that the second sentence of paragraph 7.80 is inaccurate in describing the scope of section 101 of the Jobs Act. The **European Communities** suggests a certain re-formulation of this paragraph. **We** have made clarifying changes in paragraph 7.80.

VII. FINDINGS

A. INTRODUCTION

7.1 This is the second time that the European Communities has asked a Panel to rule on the WTO-consistency of measures taken by the United States to comply with DSB recommendations and rulings in this dispute.

7.2 The original WTO dispute settlement proceedings resulted in DSB recommendations and rulings, in 2000, that the United States withdraw the prohibited FSC subsidies and bring itself into conformity with its obligations under the relevant covered agreements. The time period for withdrawal of the prohibited subsidies pursuant to Article 4.7 of the *SCM Agreement* expired on 1 November 2000.

7.3 Subsequently, the 2002 Article 21.5 *DSU* compliance proceedings established that the ETI Act[42] had failed to withdraw completely the prohibited FSC subsidy and to bring the United States fully into conformity with its WTO obligations.

7.4 Since that time, the United States has enacted the Jobs Act.[43]

7.5 We now turn to the parties' main claims and arguments before this Article 21.5 *DSU* compliance Panel.

B. ARGUMENTS OF THE PARTIES

1. European Communities

7.6 Before this Article 21.5 compliance Panel, the European Communities asserts that two provisions of the Jobs Act continue inconsistencies with the United States' WTO obligations. These two provisions are:

- the "transition provision"[44], which provides for a two-year continuation of a percentage of ETI benefits (80 per cent in 2005 and 60 per cent in 2006); and

[42] Text of the ETI Act is in Exhibit EC-2.
[43] Text of the Jobs Act is in Exhibit EC-1.

- the "grandfathering provision"[45]

C. ARGUMENTS OF THE THIRD PARTIES

1. Australia

7.12 **Australia** submits that the pertinent Article 21.5 of the *DSU* "recommendations and rulings" are those made by the original Panel and Appellate Body, as adopted by the DSB in 2000. Hence, the purpose of the current Article 21.5 proceeding is to decide whether certain measures that the United States has taken to comply with these recommendations and rulings are consistent with the covered agreements.

7.13

conferring prohibited export subsidies. China questions how transition period and grandfathering provisions for another prohibited subsidy measure can be justified.

D. EVALUATION BY THE PANEL

1. Introduction

7.20

7.24 For the purposes of this case, we see three relevant textual elements in Article 21.5 of the *DSU*: i) "the existence or consistency with a covered agreement of..."; ii) "measures taken to comply with"; and iii) "the recommendations and rulings". We examine each in turn.

(b) "existence or consistency with a covered agreement"

7.25 An Article 21.5 panel adjudicates on disputes "as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings ...".[48] Article 21.5 panels may assess whether "measures taken to comply" implement specific "recommendations and rulings" adopted by the DSB in the original dispute[49],but must also examine either the "existence" of "measures taken to comply" or the "consistency with a covered agreement" of implementing measures.[50]

7.26 We also note that the expedited procedure in Article 21.5 of the *DSU* reinforces the principle of "withdrawal" of an inconsistent measure[51] and the requirement of "prompt compliance"[52] with recommendations and rulings, made under Article 19 of the *DSU*, as well as recommendations of "withdrawal" of prohibited subsidies under Article 4.7 of the *SCM Agreement.*[53]

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[48] As already mentioned, this is also informed by the Panel's terms of reference, which we discuss below.

[49] Appellate Body Report, *Canada – Aircraft (Article 21.5 – Brazil),* para. 40.

[50] *Ibid.*, paras. 40-41. The panels in *EC – Bananas III (Article 21.5 – Ecuador)* (paras. 6.8-6.9) and *Australia – Salmon (Article 21.5 – Canada)* (para. 7.10, subparagraph 9) reached essentially the same conclusion.

[51] See, e.g., Article 3.7 of the *DSU*, which states:

> "In the absence of a mutually agreed solution, the first objective of the dispute settlement mechanism is usually to secure the withdrawal of the measures concerned if these are found to be inconsistent with the provisions of any of the covered agreements. The provision of compensation should be resorted to only if the immediate withdrawal of the measure is impracticable and as a temporary measure pending the withdrawal of the measure which is inconsistent with a covered agreement."

[52] This is expressed in both Article 3.3 and Article 21.1 of the *DSU*. Article 3.3 of the *DSU* states:

> "The prompt settlement of situations in which a Member considers that any benefits accruing to it directly or indirectly under the covered agreements are being impaired by measures taken by another Member is essential to the effective functioning of the WTO and the maintenance of a proper balance between the rights and obligations of Members."

Article 21.1 provides:

> "Prompt compliance with recommendations or rulings of the DSB is essential in order to ensure effective resolution of disputes to the benefit of all Members."

See, for example, Panel Report, *Australia – Salmon (Article 21.5 – Canada),* paragraph 7.10, subparagraph 9.

[53] That special and additional dispute settlement rule reads:

(c) "measures taken to comply"

7.27 We turn to the second textual element in Article 21.5 of the *DSU*: "measures taken to comply".

7.28 Article 21.5 of the *DSU* does not refer to just *any* measure[54] of a WTO Member, but rather to a "measure taken to comply". However, it does not further define what a "measure taken to comply" may be.

7.29 Read in its context, this term "measure taken to comply" is clearly informed by the particular "recommendations and rulhe ses wh9TJ18.( )]TJ(rm)

7.36 Article 21.5 compliance proceedings form part of a continuum of events[62] flowing from the

explicit reference to the "recommendation" provisions of Article 19 of the *DSU*, or to Article 4.7 of the *SCM Agreement*. We see no express requirement in the text of Article 21.5 of the *DSU* that a compliance panel must formulate recommendations upon finding an inconsistency with a covered agreement, including a recommendation under Article 4.7 upon a finding of inconsistency with Article 3 of the *SCM Agreement*.

7.41 In particular, we see nothing in Article 21.5 of the *DSU* requiring a panel to make a recommendation under Article 19 of the *DSU* or Article 4.7 of the *SCM Agreement*.

7.42 This flows from both the text and context of Article 21.5, in view of the object and purpose of the *DSU*.[66] In particular, Article 21.5 comes after the "recommendation" provision in Article 19 of the *DSU*, and the principle of "prompt compliance" in Article 21.1, as part of the WTO dispute settlement process. The title of Article 21 -- "Surveillance of recommendations and rulings"-- is telling. It informs us that the proceedings are to follow the implementation of recommendations and rulings that have been made. This finds further support in the particular nature and purpose of *compliance* panel proceedings.

7.43 In this respect, an Article 21.5 compliance procedure occurs *after* the DSB has already made recommendations and rulings based on Article 19.1 of the *DSU* (and/or Article 4.7 of the *SCM Agreement*). It is linked to the post-recommendation implementation period envisaged in Articles 21.1 and 21.3 of the *DSU*. This necessarily implies that th

7.45 This would mean that Article 21.5 compliance proceedings should result in *adding* to the "non-implementing" Member's rights under the covered agreements through an extension of the time-period for implementation. The Article 21.5 proceeding would thus risk undermining the recommendations and rulings adopted by the DSB, by revisiting an issue already addressed and definitively resolved by the DSB. We are also mindful that a compliance panel must take what has been decided by the DSB as a given.

7.46 Nowhere do we find any indication in the text or context of Article 21.1/21.5 of the *DSU* or of Article 4.7 of the *SCM Agreement*, nor in the object or purpose of the *DSU* (nor, for that matter, the *SCM Agreement*)[69] that would require repeated extensions of the implementation period in Article 21.5 *DSU* compliance proceedings. Indeed, such an interpretation would reduce the textual treaty terms "prompt compliance" and "without delay" to redundancy and inutility. We are not permitted to adopt such an interpretation. Such an approach might lead to a potentially never-ending cycle, whereby a Member continues to adopt non-compliant measures in order to win more time to comply with adopted DSB recommendations and rulings. This would entirely undermine the effective operation of the WTO dispute settlement system.[70]

3. Panel's application of guiding principles

(a) Panel's task under Article 21.5 of the *DSU*

7.47 The task of this Article 21.5 compliance Panel is to examine whether measures that the United States has taken to comply with the recommendations and rulings are consistent with the relevant covered agreements.[71] For this purpose, we first identify the "measures taken to comply" and the "recommendations and rulings" at issue.

(b) "measures taken to comply with" "the recommendations and rulings"

7.48

transactions.[73] Furthermore, Section 101 of the Jobs Act does not repeal section 5(c)(1) of the ETI Act, indefinitely grandfathering FSC subsidies in respect of certain transactions.

(c) Article 4.7 of the *SCM Agreement* in the 2002 Article 21.5 proceedings

7.51 We recall our understanding of the United States argument: in order for the European Communities' Article 4.7 claim to prevail, and/or for the United States to be under any obligation to withdraw the prohibited ETI scheme, it would have been necessary for the 2002 Article 21.5 Panel to make a new recommendation under Article 4.7 of the *SCM Agreement* that the United States withdraw the ETI Act.[74]

7.52 We disagree with the United States. This is simply because the operative "recommendations and rulings" remain those adopted by the DSB in the original proceedings in 2000. The purpose of the 2002 Article 21.5 compliance proceeding was to decide whether the measures taken by the United States to comply with these recommendations and rulings did, in fact, bring the United States into a situation of consistency with its WTO obligations. The DSB found, *inter alia*, that the United States had not fully withdrawn the prohibited subsidies.

7.53 This Panel is of the view that the United States' obligation to withdraw the ETI scheme arises from the fact that the original recommendations and rulings adopted by the DSB recommended withdrawal without delay of the prohibited subsidies pursuant to Article 4.7 of the *SCM Agreement*; and the 2002 Article 21.5 Panel and Appellate Body reports, as adopted by the DSB, found that the ETI scheme was WTO-inconsistent in that, *inter alia*, it failed to fully withdraw the prohibited subsidies.

7.54 Article 21.5 of the *DSU* indicates that there is a procedure to decide a disagreement as to whether a Member has implemented DSB recommendations and rulings and "fixed the problem". It seems to us that an Article 21.5 compliance panel in a prohibited subsidies dispute may basically find one of two things. It may find that a Member has indeed "fixed the problem", as it has withdrawn the prohibited subsidy. Or, it may decide that the Member has not withdrawn, or fully withdrawn, the prohibited subsidy. We believe that either of these findings mark the completion of the task of an Article 21.5 panel.

7.55 Thus, we see no material significance in the purported lack of an explicit "new" Panel recommendation under Article 4.7 of the *SCM Agreement* in the first compliance proceeding.

7.56 In any event, the 2002 Article 21.5 Panel expressly indicated the view that the original Article 4.7 recommendation "remain[ed] operative". For its part, the Appellate Body recommended "that the DSB request the United States to implement fully the recommendations and rulings of the DSB in *US – FSC*, made pursuant to Article 4.7 of the *SCM Agreement*."[75] Furthermore, the Appellate Body recommended that the United States bring the ETI measure into conformity with its obligations under the relevant covered agreements, *including the SCM Agreement*.[76] These adopted recommendations and rulings recognize the continuing non-withdrawal of the prohibited subsidies and the continuing obligation on the United States to withdraw them fully pursuant to Article 4.7 of the *SCM Agreement* and to bring itself into conformity with the relevant covered agreements, including the *SCM Agreement*. Thus, with our finding that Article 21.5 proceedings need not produce new recommendations and rulings, we observe that operative recommendations nonetheless persist.

[73] We recall and incorporate our description of the factual aspects of these measures, *supra*.

[74] We recall and incorporate our discussion of the US arguments, *supra*, paras. 7.37-7.39. We further recall our view *supra*, note 65, that it is difficult to reconcile this United States argument with the United States argument that the Article 21.5 panel had no mandate to make such a recommendation.

[75] 2002 Article 21.5 Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para.257.

[76] 2002 Article 21.5 Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para.257.

In light of the Panel's clear expression in the first compliance proceedings that the original recommendation remained operative, the United States could not reasonably have been unaware that operative withdrawal recommendations persisted.

7.57 The United States also asserts that the Appellate Body recommendations in the first compliance proceeding relating to Article 4.7 do not pertain to the ETI Act, as the Appellate Body in the first compliance report referenced the recommendations and rulings in the original proceedings, which were made before the ETI Ac

7.62 It is clear that continuing to grant subsidies found to be prohibited is not consistent with the obligation to "withdraw" prohibited export subsidies, in the sense of "removing" or "taking away".[82]

7.63 As stated in the prior Article 21.5 proceedings in this dispute[83], this WTO obligation to withdraw prohibited subsidies is unaffected by contractual obligations that the Member itself may have assumed under its applicable domestic legislation or regulation. Similarly, this obligation cannot be affected by contractual arrangements which private parties may have made in reliance on laws conferring prohibited export subsidies.

7.64 Therefore, the United States obligation to implement the operative DSB recommendations and rulings to withdraw fully the prohibited subsidies under Article 4.7 of the *SCM Agreement* and to bring its measures fully into conformity with the obligations under the relevant covered agreements remains.[84]

7.65 Accordingly, we find that, to the extent that the United States, by enacting Section 101 of the Jobs Act, maintains prohibited FSC and ETI subsidies through these transitional and grandfathering measures, it continues to fail to implement fully the operative DSB recommendations and rulings to withdraw the prohibited subsidies and to bring its measures into conformity with its obligations under the relevant covered agreements.

4. Panel's terms of reference

7.66 The United States alleges that Section 5 of the ETI Act, indefinitely grandfathering the *original* FSC scheme in respect of certain transactions, is not within this Panel's terms of reference. The European Communities disagrees.

7.67 We recall that the terms of reference dictate the scope of a panel's mandate and determine its task. This obviously holds true in these Article 21.5 compliance proceedings.[85]

7.68 We first observe that, irrespective of whether or not section 5 of the ETI Act is within our terms of reference, it is a matter of fact that the Jobs Act neither repeals nor explicitly or implicitly affects the operation of section 5 of the ETI Act in any way. The United States remains under an

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obligation to withdraw the prohibited subsidies without delay as a result of the original recommendations and rulings and the first compliance proceedings in this dispute.

7.69 In addition, and in any event, we examine whether or not section 5 of the ETI Act, grandfathering the original FSC subsidies, is within our terms of reference.

7.70 It is well established that a panel's terms of reference are governed by a complainant's panel request, and that a panel request must satisfy Article 6.2 of the *DSU*. Article 6.2 of the *DSU* reads:

> "The request for the establishment of a panel shall be made in writing. It shall indicate whether consultations were held, identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly. In case the applicant requests the establishment of a panel with other than standard terms of reference, the written request shall include the proposed text of special terms of reference."

7.71 There are two distinct requirements in this provision, namely identification of *the specific measures at issue*, and the provision of a *brief summary of the legal basis of the complaint*. Together, they comprise the "matter referred to the DSB", which forms the basis for a panel's terms of reference under Article 7.1 of the *DSU*.

7.72 The issue before us does not involve the omission of a legal basis for a claim. Rather, it concerns an alleged failure to identify a *measure at issue* (Section 5 of the ETI Act, grandfathering original FSC subsidies).

7.73 This measure would be within our terms of reference to the extent that it is *adequately identified* in the EC request for the establishment of the Panel, as required by Article 6.2 of the *DSU*.

7.74 In general, when faced with a question relating to the scope of its terms of reference, a panel must "examine the request for the establishment of the panel very carefully to ensure its compliance with both the letter and the spirit of Article 6.2 of the *DSU*."[86] The task of assessing the sufficiency of a panel request for the purpose of Article 6.2 may be undertaken on a case-by-case basis, in consideration of the panel request as a whole, and in the light of the attendant circumstances.[87] There

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7.77 It begins with an overview of developments in this dispute since the original panel proceedings (including the DSB recommendations and rulings arising from the original proceedings and the 2002 Article 21.5 proceedings, and the enactment of the Jobs Act). This includes the following statements:

> "On 15 November 2000, the President of the United States signed into law the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, US Public law No 106-519 (the "ETI Act")."
>
> "On 20 December 2000, the matter was referred back to the Panel under Article 21.5 of the *DSU* and on 29 January 2002 the DSB adopted the Panel [WT/DS108/RW] and Appellate Body [WT/DS108/AB/RW] reports declaring that the ETI Act violates Articles 3.1(a), 3.2 and 4.7 of the *SCM Agreement*, Articles 8, 10.1 and 3.3 of the Agreement on Agriculture and Article III:4 of the General Agreement on Tariffs and Trade 1994 (the "GATT 1994"), so that the US had failed to fully withdraw its prohibited subsidy scheme and failed to implement DSB recommendations and rulings in this dispute."

7.78 Therefore, the text of the Panel request refers to the ETI Act in its entirety, and to the original DSB recommendations and rulings and the DSB adoption of the 2002 Article 21.5 panel and Appellate Body reports containing, *inter alia*, findings of inconsistency of Article 5 of the ETI Act.

7.79 As to the subject of the dispute, the EC Panel request states:

> "Section 101 of the JOBS Act purports to repeal the ETI Act (Section 101 (a)). However, at the same time, it effectively maintains part of the ETI Act tax exemptions for a transitional period up to the end of 2006 (Section 101 (d)). Furthermore, the repeal of the ETI Act does not apply to certain contracts, without any time limits (Section 101(f))."

It continues:

> "In the light of the above, the European Communities considers that Section 101 of the JOBS Act contains provisions which will allow US exporters to continue benefiting from the tax exemptions already found to be WTO incompatible (a) in the years 2005 and 2006 with respect to all transactions, and (b) for an indefinite period with respect to certain contracts. Thus, the United States has failed to implement the DSB's recommendations and rulings by failing to withdraw without delay schemes found to be prohibited subsidies under the *SCM Agreement* and to bring its legislation into conformity with its obligations under the

FSC subsidies are before us for a *second* Article 21.5 Panel proceedings as part of a *continuum of events* flowing from the original and subsequent compliance proceedings. Consequently, we do not believe that the United States has been prejudiced in its ability to defend itself before us.

7.87 For these reasons, we find that section 5 of the ETI Act, grandfathering prohibited FSC subsidies, is within the terms of reference of this *second* Article 21.5 compliance Panel.

VIII. CONCLUSION

8.1 In light of the findings contained in Section VII above, we conclude that, to the extent that the United States, by enacting Section 101 of the Jobs Act, maintains prohibited FSC and ETI subsidies through the transition and grandfathering measures at issue, it continues to fail to implement fully the operative DSB recommendations and rulings to withdraw the prohibited subsidies and to bring its measures into conformity with its obligations under the relevant covered agreements.

8.2 Since the original DSB recommendations and rulings in 2000 remain operative through the results of the compliance proceedings in 2002, we make no new recommendation.