WORLD TRADE ORGANIZATION

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UNITED STATES – TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS"

AB-1999-9

Report of the Appellate Body

WORLD TRADE ORGANIZATION

APPELLATE BODY

United States – Tax Treatment for "Foreign Sales Corporations"

United States, *Appellant/Appellee*

European Communities, *Appellant/Appellee*

Canada, Japan, *Third Participants*

AB-1999-9

Present:

Lacarte-Muró, Presiding Member
Bacchus, Member
Feliciano, Member

I. Introduction

1. The United States and the European Communities appeal certain issues of law and legal interpretations in the Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations"* (the "Panel Report").[1] The Panel was established to consider a complaint by the European Communities with respect to "Sections 921-927 of the Internal Revenue Code and related measures establishing special tax treatment for 'Foreign Sales Corporations' ('FSCs')".[2] Pertinent aspects of this "FSC measure"[3] are described in Section II below.[4]

2. In the Panel Report, circulated on 8 October 1999, the Panel concluded that, through the FSC measure:

> (a) the United States has, except as provided in the Agreement on Agriculture, acted inconsistently with its obligations under Article 3.1(a) of the SCM Agreement by granting or maintaining export subsidies prohibited by that provision;
>
> (b) the United States has acted inconsistently with its obligations under Article 3.3 of the Agreement on Agriculture (and consequently with its obligations under Article 8 of that Agreement):
>
> - by providing export subsidies listed in Article 9.1(d) of the Agreement on Agriculture in excess of the quantity commitment levels specified in the United States' Schedule in respect of wheat;

[1]WT/DS108/R, 8 October 1999.

[2]The Panel's terms of reference, WT/DS108/3, 11 November 1998, refer to the European Communities' request for consultations, WT/DS108/1, 28 November 1997.

[3]In paragraph 7.34 and footnote 602 thereto of the Panel Report, the Panel identified sections 245(c), 921 through 927, and 951(e) of the United States Internal Revenue Code as the "primary" legal provisions constituting the FSC measure. This finding has not been appealed.

[4]The Panel describes the FSC measure in paragraphs 2.1 to 2.8 of the Panel Report.

- by providing export subsidies listed in Article 9.1(d) of the Agreement on Agriculture in respect of all unscheduled products.[5]

3. With respect to its conclusion regarding the *Agreement on Subsidies and Countervailing Measures* (the "*SCM Agreement*"), the Panel recommended that the Dispute Settlement Body (the "DSB") request the United States "to withdraw the FSC subsidies without delay".[6] With respect to its conclusions regarding the *Agreement on Agriculture*, the Panel recommended that the DSB request the United States to bring the FSC measure into conformity with its obligations in respect of export subsidies under that Agreement.[7]

4. On 28 October 1999, the United States notified the DSB of its intention to appeal certain issues of law covered in the Panel Report and certain legal interpretations developed by the Panel, pursuant to paragraph 4 of Article 16 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), and filed a Notice of Appeal pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*"). For scheduling reasons, and pursuant to an agreement it had reached with the European Communities, on 2 November 1999 the United States notified the Chairman of the Appellate Body and the Chairman of the DSB of its decision to withdraw its 28 October 1999 notice of appeal. This withdrawal was made pursuant to Rule 30(1) of the *Working Procedures*, and was conditional upon the right of the United States to file a new notice of appeal pursuant to Rule 20 of the *Working Procedures*. On 26 November 1999, the United States once again notified the DSB of its intention to appeal certain issues of law covered in the Panel Report and certain legal interpretations developed by the Panel, pursuant to paragraph 4 of Article 16 of the DSU, and filed a Notice of Appeal pursuant to Rule 20 of the *Working Procedures*. On 2 December 1999, the United States filed its appellant's submission.[8] On 7 December 1999, the European Communities filed its own appellant's submission.[9] On 17 December 1999, the United States[10] and the European Communities[11] each filed an appellee's submission. On the same day, Canada and Japan each filed a third participant's submission.[12]

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[5]Panel Report, para. 8.1.

[6]*Ibid.*, para. 8.3.

[7]*Ibid.*, para. 8.4.

[8]Pursuant to Rule 21(1) of the *Working Procedures*.

[9]Pursuant to Rule 23(1) of the *Working Procedures*.

[10]Pursuant to Rule 23(3) of the *Working Procedures*.

[11]Pursuant to Rule 22 of the *Working Procedures*.

[12]Pursuant to Rule 24 of the *Working Procedures*.

9. The United States has also adopted a series of "anti-deferral" regimes that depart from the principle of deferral and that, in general, respond to specific policy concerns about potential tax avoidance by United States corporations through foreign affiliates. One of these regimes is Subpart F of the United States Internal Revenue Code (the "IRC"), which limits the availability of deferral for certain types of income earned by certain controlled foreign subsidiaries of United States corporations.[20] Under Subpart F, certain income earned by a foreign subsidiary can be imputed to its United States parent corporation even though it has not yet been repatriated to the parent in the form of a dividend.[21] The effect of Subpart F is that a United States parent corporation is immediately subject to United States taxation on such imputed income even while the income remains with the foreign subsidiary.

10. These generally prevailing United States tax rules are altered for FSCs by the FSC measure.

B. *The FSC Measure*

11. FSCs are foreign corporations responsible for certain sales-related activities in connection with the sale or lease of goods produced in the United States for export outside the United States. The FSC measure essentially exempts a portion of an FSC's export-related foreign-source income from United States income tax.[22] The relevant tax regime is comprised of three separate elements, which affect the tax liability under United States law of an FSC as well as of the United States corporation that supplies goods for export. These three exemptions are described in detail below, as well as in paragraphs 7.95, 7.96 and 7.97 of the Panel Report.[23]

12. A corporation must satisfy several conditions to qualify as an FSC.[24] To qualify, a corporation must be a foreign corporation organized under the laws of a country that shares tax information with the United States, or under the laws of a United States possession other than

[20]Section 951 IRC; United States' appellant's submission, para. 24.

[21]With respect to such deferred income, the United States parent may be eligible for an indirect foreign tax credit on some foreign income taxes paid by the foreign subsidiary. See United States' appellant's submission, para. 24.

[22]This characterization of the FSC measure is not disputed by the participants. See Panel Report, para. 7.112.

[23]During the oral hearing, the United States accepted, in response to a question from the Division hearing this appeal, that paragraphs 7.95-7.97 of the Panel Report accurately describe the FSC exemptions.

[24]The description set forth here is intended to outline the main elements of the FSC measure which relate to this appeal. A comprehensive explanation of all the rules applicable to FSCs should be obtained from the text of the statutory provisions themselves or from specialized tax treatises, e.g., J. Isenbergh, *International Taxation*, 2nd ed. (Aspen Publishers Inc., 1999). We note here that special rules apply *inter alia* in the case of agricultural cooperatives, small FSCs, shared FSCs, FSCs owned by individual rather than corporate shareholders, and transactions involving military property.

Puerto Rico.[25] The corporation must satisfy additional requirements relating to its foreign presence, to the keeping of records, and to its shareholders and directors.[26] The corporation must also elect to be an FSC for a given fiscal year.[27] There is no statutory requirement that an FSC be affiliated with or controlled by a United States corporation. The FSC measure is, however, such that the benefit to both FSCs and the United States corporations that supply goods for export will, as a practical matter, often be greater if the United States supplier is related to the FSC. As a result, many FSCs are controlled foreign subsidiaries of United States corporations.

13. The foreign-source income of an FSC may be broadly divided into "foreign trade income"[28] and all other foreign-source income. "Foreign trade income" is essentially the foreign-source income attributable to an FSC from qualifying transactions involving the export of goods from the United States. An FSC's other foreign-source income may include *inter alia* "investment income", such as interest, dividends and royalties, and active business income not deriving from qualifying export transactions. This appeal raises a number of issues with respect to the taxation of an FSC's *foreign trade income*. Foreign trade income is in turn divided into *exempt* foreign trade income and *non-exempt* foreign trade income.[29] As explained below, the United States tax treatment of an FSC's *exempt* foreign trade income differs from the United States tax treatment of an FSC's *non-exempt* foreign trade income.

14. An FSC's foreign trade income is its "foreign trading gross receipts" generated in qualifying transactions.[30] Qualifying transactions involve the sale or lease of "export property" or the performance of services "related and subsidiary" to such sale or lease. "Export property" is property manufactured or produced in the United States by a person other than an FSC, sold or leased by or to an FSC for use, consumption or disposition outside the United States, and of which no more than 50 per cent of its fair market value is attributable to imports.[31] In addition, for FSC income to be foreign trade income, certain economic processes relating to qualifying transactions must take place outside the United States[32], and the FSC must be managed outside the United States.[33]

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[25]Sections 922(a)(1) and 927(d)(3) IRC. Typically an FSC is organized in a non-United States jurisdiction that does not tax, or applies a low tax rate to, corporate income.

[26]Section 922(a)(1) IRC.

[27]Section 922(a)(2) IRC.

[28]Section 923(b) IRC.

[29]Section 923(a) IRC.

[30]Section 924 IRC.

[31]Section 927(a) IRC; Panel Report, para. 2.1.

[32]Section 924(b)(1)(B) IRC.

[33]Sections 924(b)(1)(A) and 927(d)(3) IRC.

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within the United

that footnote 2 addressed key elements of the

25. The United States considers that footnote 59 permits tax exemptions for foreign-source income even if it is "specifically in relation to exports".[47] Item (e) of the Illustrative List identifies certain tax practices as export subsidies, and the text of footnote 59 qualifies this characterization of some of such practices. The second sentence of footnote 59, in which Members "reaffirm" the principle of arm's length pricing, imposes parameters on the prices that may be charged between related parties in export transactions. According to the United States, the second sentence of footnote 59 *assumes* that foreign-source income *may* be exempted from tax or taxed to a lesser extent than domestic-source income, and would have no meaning if foreign-source income could *not* be exempted from tax.

26. The United States submits that the FSC measure is also not an export subsidy by virtue of the fifth sentence of footnote 59, which excludes from the scope of item (e) of the Illustrative List measures to prevent foreign-source income from being subjected to double taxation. The Panel erred by failing to find that, as a tax exemption measure to avoid the double taxation of foreign-source income, the FSC measure is permitted by footnote 59. The Panel erroneously stated that the United States had not asserted that the fifth sentence of footnote 59 applied to the FSC. In its first submission to the Panel, the United States asserted that "the FSC is designed to prevent double taxation of export income earned outside the United States ... ."[48]

27. The United States argues that the Panel's interpretation of Article 1.1(a)(1)(ii), as well as of Article 3.1(a), also failed to take into account the 1981 "understanding". The "understanding"

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"understanding", which accepted the principles codified in footnote [redacted] *o Round Subsidies Code*.[49]

29. The United States further argues that the 1981 "understanding" satisfies all of the criteria to constitute a "decision" under paragraph 1(b)(iv) of the language in Annex 1A incorporating the GATT 1994 into the *WTO Agreement.* Accordingly, the 1981 "understanding" has the same legal force as any other provision of the GATT 1994. In finding that the 1981 "understanding" is not an "other decision" within the meaning of paragraph 1(b)(iv), the Panel wrongly imposed a requirement – that such decisions must be a "legal instrument" – that is inconsistent with paragraph 1(b)(iv). Furthermore, the Panel misapplied this standard by declaring the phrase "in general" in the 1981 "understanding" to be ambiguous, and then misinterpreted the circumstances surrounding the adoption of the "understanding" to override the text itself. The Panel failed to appreciate that the Council took two separate actions, with independent significance: a *decision* to adopt the *Tax Legislation Cases* reports and an accompanying "*understanding*". Although the Chairman stated that the *decision* does not affect the interpretation of the *Tokyo Round Subsidies Code*, the Chairman did not make the same statement as regards the "*understanding*". To the contrary, the United States alleges that the third sentence of the "understanding" shows that it would affect future interpretations of the *Tokyo Round Subsidies Code*, and that this guidance has been carried forward into the WTO.

30. Even if the 1981 "understanding" were not a part of the GATT 1994, the United States subm3srFhe eand GAlesscisions1.1334 Tw (decision" within theArticle XVI:1e not a in the 1981) Tj Tj 3 0

excess of the quantity commitment levels specified in the United States Schedule in respect of wheat; and by providing export subsidies listed in Article 9.1(d) in respect of all unscheduled products.

(a) Article 9.1(d) of the *Agreement on Agriculture*

32. According to the United States, the Panel wrongly interpreted the phrase "to reduce the costs of marketing" in Article 9.1(d) of the *Agreement on Agriculture* and, as a consequence, erred in finding the FSC tax exemption to be an Article 9.1(d) export subsidy. The Panel defined an Article 9.1(d) subsidy in terms of the nature of the activities performed by the entity receiving the subsidy rather than the nature of the subsidy itself. In the view of the United States, the Panel's analysis suffers from a "fundamental flaw"[51], namely the conclusion that subsidies which benefit export entities generally should be deemed specifically to "reduce the costs of marketing".

33. The United States considers the ordinary meaning of the phrase "costs of marketing" to refer to "marketing costs" – which would not include income taxes – and finds support for this meaning in the specific examples listed in Article 9.1. The Panel's interpretation of Article 9.1(d) ignores the context of that sub-paragraph and is so broad that it subsumes all but one of the other subparagraphs of Article 9.1 and renders them redundant. Additional relevant context to demonstrate the error in the Panel's analysis can, in the view of the United States, be found in paragraph 13 of Annex 3 of the *Agreement on Agriculture* (which sets out a calculation methodology for "marketing-cost reduction measures" that could not work if an income tax exemption were a marketing cost), the *SCM Agreement's* Illustrative List (which distinguishes tax-related subsidies from other types of subsidies), as well as footnote 59 to the *SCM Agreement* and the 1981 "understanding". The United States adds that the Panel's interpretation is inconsistent with the object and purpose of the *SCM Agreement*, in particular because it appears to assume that Article 9.1 is intended to cover *all* export subsidies to agricultural products, even though Article 10.1 makes it clearw (and tfw2-he Unitedfh2-dy. The

35. The United States contends that the Panel wrongly relied upon one dictionary definition of "provide", namely "make available", rather than upon the more common meaning of the term, namely "supply or furnish for use" or, in other words, to "grant or pay". That the latter definition of "provide" is the correct one under Article 3.3 is confirmed by reference to the equivalent verbs used in the French ("accorder") and Spanish ("otorgar") versions of Article 3.3. Further context supporting this meaning is found elsewhere in the *Agreement on Agriculture*. In Article 9.2(b), "provide" can only mean to "grant or pay". Articles 9.4 and 10.1 refer to Article 9.1 subsidies being "*applied*"; Articles 9.2(a)(ii) and 10.3 refer to an export subsidy being "*granted*"; and Article 11 of the *Agreement on Agriculture* refers to an export subsidy "*paid*". Moreover, the United States considers that the Appellate Body has itself effectively defined "provided" as synonymous with "granted".[52] The United States adds that the Panel's analysis means that the word "provide" has a different meaning in the first clause of Article 3.3 than in the second clause, and that this reading "flies in the face of the basic interpretive principle that a word is presumed to mean the same thing when used in different parts of an agreement."[53]

3. Article 4.2 of the *SCM Agreement*

36. The United States requests the Appellate Body to reverse the Panel's refusal to dismiss the

38. The United States alleges that the Panel erred in refusing to rule on whether evidence subsequently submitted by the European Communities was "available" at the time of the requests for consultations. The Panel further erred in indicating that the European Communities' consultation requests, which simply identified the relevant provisions of the IRC, could satisfy Article 4.2. The Panel justified this conclusion based on its characterization of the European Communities' claims as involving a *de jure* export subsidy. This approach ignores the distinction between law and fact, and between arguments and evidence. In any event, the United States argues, this is not a *de jure* case, but a dispute that has been fact-intensive from the outset.

39. In the view of the United States, the Panel's determination that it lacked authority to dismiss the European Communities' Article 3 claims even if the European Communities violated Article 4.2 is inconsistent with the governing WTO provisions, previous WTO practice, and the significance accorded to consultations in the dispute settlement process. The failure of a complaining party to

42. The United States contends that the Panel misconstrued the meaning of the relevant portion of footnote 59, which directs Members to resort to appropriate tax fora before invoking WTO dispute settlement. According to the United States, "shall normally" should be read to mean that WTO Members raising transfer pricing issues are under a duty, in the absence of unusual, abnormal, or extraordinary circumstances, to invoke the assistance of a tax forum. In support of this interpretation, the United States refers to a previous interpretation of the term "shall normally" in Article 5.1 of the *Tokyo Round Agreement on Implementation of Article VI of the GATT 1947*[57], as well as to the Appellate Body's interpretation of the word "should".[58]

43. The United States believes that the Panel's interpretation renders the fourth sentence of footnote 59 essentially unenforceable. There are compelling reasons for resorting to an appropriate tax forum, in particular because the application of the

use non-arm's length pricing may give rise to an export subsidy when this is done in connection with export-related measures. The fifth sentence is not properly before the Appellate Body, and in any case, the European Communities adds, the FSC regime is not intended "to avoid double taxation".

49. The European Communities asks the Appellate Body to uphold the Panel's findings that the 1981 "understanding" is not an "other decision" within the meaning of paragraph (1)(b)(iv) of the introductory language to GATT 1994. The European Communities rejects the United States' argument that the *decision* to adopt the *Tax Legislation Cases* reports and the "*understanding*" are

the *Agreement on Agriculture*."[62] In this regard, the European Communities also observes that the Panel's interpretation of Article 9.1(d) is much narrower than the characterization of it by the United States would imply. Only because the FSC measure is so intrinsically linked with the

55. Finally, the European Communities presents a further alternative argument. Article 8 of the *Agreement on Agriculture* is a "fundamental general provision"[66] that makes clear that Members must not grant export subsidies otherwise than in conformity with that Agreement. Since Article 9 is the principal provision of the *Agreement on Agriculture* that allows export subsidies, the European Communities argues that if the FSC subsidies are not covered by Article 9.1(d), then their availability for agricultural products is a violation of Article 8 of the *Agreement on Agriculture*.

(b) Article 3.3 of the *Agreement on Agriculture*

56. The European Communities asks the Appellate Body to uphold the Panel's finding that, with respect to unscheduled agricultural products, the United States has acted inconsistently with its obligations under the second clause of Article 3.3 (and Article 8) of the *Agreement on Agriculture* by "providing" subsidies listed in paragraph 9.1(d).

57. In the view of the European Communities, the Panel correctly found that the term "to provide" in the second clause of Article 3.3 *Agreement on Agriculture* includes "the notion of making something available *as well as* that of actually granting or paying that thing."[67] The European Communities does not believe that the French and Spanish texts of Article 3.3 of the *Agreement on Agriculture* differ in any way from the English text. The European Communities also refers to the context and the grammatical setting of the phrase "to provide" in support of the Panel's interpretation. The European Communities finds further support for its argument that the existence and availability of the FSC measure *itself* can be a ground for a violation of Article 3.3 of the *Agreement on Agriculture* in certain statements made and reasoning employed by panels[68] and by the Appellate Body.[69]

58. If the Appellate Body should find that the FSC subsidies are not subsidies listed in paragraph 9.1(d), the European Communities argues, in the alternative, that the availability of the FSC measure with respect to unscheduled agricultural products nevertheless violates Article 8, because the *Agreement on Agriculture* contains no explicit or implicit provision which *allows* Members to provide export subsidies of the kind involved in this case for unscheduled products.

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[66]European Communities' appellee's submission, para. 273, citing the Panel Report in *Canada – Milk*, *supra*, footnote 63, para. 7.27.

[67]Panel Report, para. 7.170 (all emphasis added by the European Communities).

[68]The European Communities refers to the Panel reports, *Australia - Leather*, *supra*, footnote 54, paras. 9.38 and 9.41; and *Canada – Aircraft*, WT/DS70/R, adopted 20 August 1999, as modified by the Appellate Body Report, *supra*, footnote 58.

[69]The European Communities refers to the Appellate Body Reports, *Brazil – Aircraft*, *supra*, footnote 52, para. 158; and *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*, WT/DS56/AB/R, adopted 22 April 1998, para. 55.

3. Article 4.2 of the *SCM Agreement*

59. The European Communities argues that the Panel correctly interpreted Article 4.2 of the *SCM Agreement*, and correctly held that even if there had been non-compliance with the requirements of Article 4.2, this would not require dismissal of any of the European Communities' claims. In the view of the European Communities, Article 4.2 of the *SCM Agreement* is a specific application to subsidy cases of the general requirements contained in the second sentence of Article 4.4 of the DSU. The European Communities underlines, however, that while both the panel and the consultation stages are important elements of dispute resolution, the procedural rules applicable to consultations are intended to be effective *only at the consultation stage.*

60. The European Communities believes that the Panel correctly determined the meaning of a statement of available evidence, and correctly found that the European Communities' request for consultations constituted "evidence" within the meaning of Article 4.2 of the *SCM Agreement.* Since the FSC measure is a case where the nature and existence of the subsidy derives from the law, no "evidence" is required other than the law itself. The European Communities further argues that the Panel correctly held that even non-compliance with the requirements of Article 4.2 of the *SCM Agreement* does not require the dismissal of any of the claims of the European Communities. The consequences, if any, for such non-compliance should be found at the consultation stage rather than the panel stage. The European Communities submits that the jurisprudence of the Appellate Body supports this approach.[70]

61. Finally, the European Communities does not accept that the United States' due process rights have been violated because: (1) the request for consultations did contain a statement of available evidence and the United States never argued otherwise during consultations; (2) the United States was well aware of the features of the FSC measure; and (3) although the United States had ample opportunity, it did not ask for further evidence during three rounds of consultations.

4. Appropriate Forum

62. The European Communities requests the Appellate Body to uphold the Panel's findings on the fourth sentence of footnote 59 to the *SCM Agreement.* The WTO is the appropriate forum for these proceedings *because they involve export subsidies prohibited by the SCM Agreement*, and the "alternatives" suggested by the United States are in any case inappropriate.

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[70]The European Communities cites the Appellate Body Reports, *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, adopted 16 January 1998; *Brazil – Aircraft*, *supra*, footnote 52; and *Korea – Taxes on Alcoholic Beverages*, WT/DS75/AB/R, WT/DS84/AB/R, adopted 17 February 1999.

choose transaction by transaction whether to use the administrative pricing rules when these are available, as well as which of the two administrative pricing rules to use, it is clear that the *availability* of the administrative pricing rules increases the tax advantage that may be obtained.

2. Article 3.1(b) of the *SCM Agreement*

66. The European Communities requests that, *if* the Appellate Body concludes that the United States could bring the FSC measure into consistency with the Panel's recommendations *without* eliminating the provision that FSC subsidies are only available in respect of goods no more than 50 per cent of the fair market value of which is attributable to imports, the Appellate Body reverse the Panel's finding that there was no need to make a finding on the European Communities' claim under Article 3.1(b) of the *SCM Agreement*. In that event, the European Communities asks the Appellate Body to find that the FSC measure violates Article 3.1(b) of the *SCM Agreement*.

67. The European Communities explains that one of the conditions for obtaining the FSC subsidies is that foreign trade income must derive from transactions involving "export property". Subparagraph (C) of Section 927(a)(1) of the IRC imposes a requirement that not more than 50 per cent of the fair market value of "export property" be attributable to articles imported into the United States. This, the European Communities argues, makes the FSC subsidies contingent in law upon the use of domestic over imported goods, in violation of Article 3.1(b) of the *SCM Agreement*.

68. The European Communities observes that, if the United States could make the FSC measure consistent with Article 3.1(a) of the *SCM Agreement* by removing only the export contingency, for example by making the FSC measure available also to sales of goods by FSCs to domestic purchasers, then FSC subsidies would remain conditional on the sale of goods with no more than 50 per cent of their fair market value attributable to imports. In that case, the Panel's finding on Article 3.1(a) alone would not ensure that the United States complies with its obligations under the *SCM Agreement*, since the violation of Article 3.1(b) would persist.

D. *Arguments by the United States – Appellee*

1. The FSC Administrative Pricing Rules

69. If the Appellate Body reverses the findings of the Panel under Article 3.1(a) of the *SCM Agreement*, the United States submits, the Appellate Body may complete the Panel's legal analysis "to the extent possible on the basis of the factual findings of the Panel and/or of undisputed

facts in the Panel record ... ".[73] In that case, the United States believes that the factual findings of the Panel and/or the undisputed facts in the Panel record would require the Appellate Body to conclude that the European Communities has failed to satisfy its burden of proof, as complainant, of demonstrating that the FSC administrative pricing rules are inconsistent with the

protected by footnote 5 of the *SCM Agreement* and that one or both measures constitutes a subsidy, the United States argues that in any case neither measure is contingent upon the use of domestic over imported goods. The requirement in section 927(a)(1)(C) applies to the overall *value* of the exported product, not to the domestic versus foreign content of its component parts. Therefore, a product could qualify under section 927(a)(1)(C) even if it consisted *entirely* of imported components, provided those components comprise no more than 50 per cent of the fair market value of the product. Since the European Communities has provided *no* evidence to support its assertion that section 927(a)(1)(C) forces a producer to make decisions on the sourcing of parts that would not be made in the absence of the 50 per cent requirement, the United States requests the Appellate Body to find that this requirement is not inconsistent with Article 3.1(b) of the *SCM Agreement.*

E. *Arguments by the Third Participants*

1. Canada

74. Canada disagrees with the United States' assertion that taxation of foreign-source income is not "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement* since, absent the FSC measure, income generated by export performance would be subject to United States

IV. Issues Raised in This Appeal

76. This appeal raises the following issues:

(a) whether the Panel erred in finding that the FSC measure constitutes a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*, including whether the Panel erred in finding that the FSC measure involves a "subsidy" under Article 1.1 of the *SCM Agreement*;

(b) whether the Panel erred in its interpretation and application of Article 3.3 of the *Agreement on Agriculture*, in particular:

i) in its interpretation and application of the term "costs of marketing" in Article 9.1(d) of the *Agreement on Agriculture*; and

ii) in its interpretation and application of the words "shall not provide such subsidies" in Article 3.3 of the *Agreement on Agriculture*.

(c) whether the Panel erred in its interpretation and application of Article 4.2 of the *SCM Agreement*;

(d) whether the Panel erred in its interpretation and application of footnote 59 of the *SCM Agreement* by declining to dismiss or defer the European Communities' claims regarding the FSC administrative pricing rules until the European Communities had attempted to resolve this matter through the facilities of existing bilateral tax treaties or other specific international instruments;

(e) whether the Panel erred in finding that it was neither necessary nor appropriate to make findings with respect to the European Communities' claims under Article 3.1(a) of the *SCM Agreement* relating to the FSC administrative pricing rules;

(f) whether the Panel erred in finding that it was neither necessary nor appropriate to make findings with respect to the European Communities' claims under Article 3.1(b) of the *SCM Agreement.*

V. Article 3.1 of the *SCM Agreement*

77. At the outset, the Panel stated that it would begin its examination of the dispute with the European Communities' claims under Article 3.1(a) of the *SCM Agreement*, rather than with the United States' arguments under footnote 59 of that Agreement. Under Article 3.1(a), the Panel determined, first, whether the FSC measure involved a "subsidy" as that term is defined in Article 1.1

of the *SCM*

> … even assuming for the sake of argument that footnote 59 is predicated on the assumption that income arising from foreign economic processes is not as a general matter "otherwise due" within the meaning of Article 1.1(a)(1)(ii), we could at most conclude that a decision by a Member not to tax any income arising from foreign economic processes would not represent the foregoing of revenue "otherwise due". There is in our view however nothing in footnote 59 which would lead us to conclude that a Member that decides that it will tax income arising from foreign economic processes does not forego revenue "otherwise due" if it decides in a selective manner to exclude certain limited categories of such income from taxation.[80]

81. The Panel, therefore, dismissed the United States argument that footnote 59 altered the interpretation of the term "otherwise due". Thereafter, the Panel examined whether the FSC measure involves the foregoing of government revenue "otherwise due". The Panel found:

> Viewed as an integrated whole, the exemptions provided by the FSC scheme represent a systematic effort by the United States to exempt certain types of income which would be taxable in the absence of the FSC scheme. Thus, application of special source rules for FSCs serves to protect a certain proportion of the foreign trade income of a FSC from direct taxation, whether or not that income would be taxable under the source rules provided for in Section 864 of the US Internal Revenue Code. The exemption from the anti-deferral rules of Subpart F of the US Internal Revenue Code ensure that the undistributed foreign trade income of a FSC is not immediately taxable to the US parent of a FSC, even though such income might otherwise be subject to the anti-deferral rules. Finally, the 100 per cent dividends-received deduction ensures that, even when the FSC distributes earnings attributable to foreign trade income to the US parent company, the US parent will not be subject to US income taxes on that income. Taken together, it is clear that the various exemptions under the FSC scheme result in a situation where certain types of income are shielded from taxes that would be due in the absence of the FSC scheme.[81]

82. The Panel, therefore, concluded that "the various exemptions under the FSC scheme, taken together, result in the foregoing of revenue which is otherwise due and thus give rise to a financial contribution within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement."[82] Having also found that the FSC measure involves a "benefit" to the recipients of the FSC tax exemptions[83], the Panel

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[80]Panel Report, para. 7.92.

[81]*Ibid*., para. 7.100.

[82]*Ibid*., para. 7.102.

[83]*Ibid*., para. 7.103.

concluded that the FSC tax exemptions "represent a subsidy within the meaning of Article 1 of the SCM Agreement."[84]

83. The Panel then considered whether the FSC subsidies are "contingent upon export performance" under Article 3.1(a) of the *SCM Agreement.* The Panel examined the provisions of the IRC, notably those relating to the "foreign trading gross receipts" of an FSC[85] and the definition of "export property".[86] In light of these provisions, the Panel concluded that the FSC tax exemptions are "contingent upon export performance" under Article 3.1(a) of the *SCM Agreement.* The Panel then

United States appeals against the Panel's finding that the 1981 Council action is not part of the GATT 1994 and, in any event, has no relevance to this dispute. The United States contends that the 1981 Council action was a "decision" of the CONTRACTING PARTIES which entered into force before the *WTO Agreement* and which had a binding effect in determining the rights and obligations of all contracting parties to the GATT 1947. The United States concludes, accordingly, that the 1981 Council action *is* a "decision" under paragraph 1(b)(iv) of the language incorporating the GATT 1994 into the *WTO Agreement* and, therefore, may be relevant in dispute settlement proceedings.

86. The United States' appeal from the Panel's specific findings under Article

agree with the Panel that the term "otherwise due" implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question. To accept the argument of the United States that the comparator in determining what is "otherwise due" should be something other than the prevailing domestic standard of the Member in question would be to imply that WTO obligations somehow compel Members to 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* to tax any particular categories of revenues. But, in both instances, the Member must respect its WTO obligations.[100] What is "otherwise due", therefore, depends on the rules of taxation that each Member, by its own choice, establishes for itself.

91. The Panel found that the term "otherwise due" establishes a "but for" test, in terms of which the appropriate basis of comparison for determining whether revenues are "otherwise due" is "the situation that would prevail but for the measures in question".[101] In the present case, this legal standard provides a sound basis for comparison because it is not difficult to establish in what way the foreign-source income of an FSC would be taxed "but for" the contested measure. However, we have certain abiding reservations about applying any legal standard, such as this "but for" test, in the place of the actual treaty language. Moreover, we would have particular misgivings about using a "but for" test if its application were limited to situations where there actually existed an alternative measure, under which the revenues in question would be taxed, absent the contested measure. It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be *no* general rule that applied formally to the revenues in question, absent the contested measures. We observe, therefore, that, although the Panel's "but for" test works in this case, it may not work in other cases. We note, however, that, in this dispute, the European Communities does not contest either the Panel's interpretation of the term "otherwise due" or the Panel's application of that term to the facts of this case.[102] The United States also accepts the Panel's interpretation of that term as a general proposition.

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[100]See

92. The United States does, however, argue that the Panel erred because the general interpretation

United States' belief that its interpretation of footnote 59 is "confirmed" by the 1981 Council action. These arguments will be examined below when we consider Article

97. We need to examine footnote 59 sentence by sentence. The first sentence of footnote 59 is specifically related to the statement in item (e) of the Illustrative List that the "full or partial exemption remission, or deferral specifically related to exports, of direct taxes" is an export subsidy. The first sentence of footnote 59 qualifies this by stating that "deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected." Since the FSC measure does not involve the *deferral* of direct taxes, we do not believe that this sentence of footnote 59 bears upon the characterization of the FSC measure as constituting, or not, an "export subsidy".

98. The second sentence of footnote 59 "reaffirms" that, in allocating export sales revenues, for

makes as to *which* categories of foreign-source income, if any, it will not tax, or will tax less. Likewise, the operation of the arm's length principle is unaffected by the choice a Member might make to grant exemptions from the generally applicable rules of taxation of foreign-source income that it has selected for itself. In short, the requirement to use the arm's length principle does not address the issue that arises here, nor does it authorize the type of export contingent tax exemption that we have just described. Thus, this sentence of footnote 59 does not mean that the FSC subsidies are not export subsidies within the meaning of Article 3.1(a) of the *SCM Agreement*.

100. The third and fourth sentences of footnote 59 set forth rules that relate to remedies. In our view, these rules have no bearing on the substantive obligations of Members under Articles 1.1 and 3.1 of the *SCM Agreement*. So, we turn to the fifth and final sentence of footnote 59. That sentence provides:

> Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

101. On appeal, the United States maintains that the FSC measure is a measure "to avoid double taxation of foreign-source income" *under footnote 59*.[108] As a consequence, the United States further contends that the FSC measure is excluded from the prohibition against export subsidies in Article 3.1(a) of the *SCM Agreement*. During the oral hearing, we asked the United States to identify where it had asserted before the Panel that the FSC measure is a measure "to avoid double taxation of foreign-source income" under footnote 59. That is, we asked the United States to tell us specifically where it had invoked the fifth sentence of footnote 59 as a means of justifying the FSC measure. In reply, the United States pointed to its first written submission to the Panel. In that submission, in describing the FSC measure and before setting forth its legal arguments, the United States stated that "the FSC is designed to prevent double taxation of export income earned outside the United States by exempting a portion of the FSC's income from taxation."[109] The United States pointed also to certain general arguments it made before the Panel concerning the fifth sentence of footnote 59. However, the United States did not indicate that, in its substantive arguments to the Panel, it had justified the FSC measure as a measure "to avoid double taxation" under footnote 59. Nor do we find any indication in the Panel Record that the United States ever invoked this justification. We, therefore, conclude that the United States did not assert, far less argue, before the Panel that the FSC measure is a measure "to avoid double taxation of foreign-source income" under footnote 59. Our conclusion is confirmed by the Panel's statement, in footnote 682 of the Panel Report, that the United States had not

[108]United States' appellant's submission, para. 268.

[109]United States' first submission to the Panel, para. 54, reproduced at para. 4.348 of the Panel Report.

asserted that the fifth sentence of footnote 59 was "relevant to this dispute".[110] It follows, therefore, that this issue was not properly litigated before the Panel and that the Panel was not asked to examine whether the FSC measure is a measure "to avoid double taxation of foreign-source income" under footnote 59.

102. We said, in our Report in *Canada – Aircraft*, that "new arguments are not *per se* excluded from the scope of appellate review, simply because they are new."[111] However, that statement should not be read as allowing *any* new argument to be raised for the first time on appeal. Our ability to consider new arguments is circumscribed by our mandate under Article 17 of the DSU. In *Canada – Aircraft*, for example, we declined to examine a new argument that would have required us "to solicit, receive and review new facts", which we cannot do under Article 17.6 of the DSU.[112]

103. Our mandate under Article 17.6 is to address "*issues of law* covered in the panel report and *legal interpretations* developed by the panel". The argument which the United States asks us to

footnote 59.[114] For that reason, the United States also appeals from the Panel's finding that, although the 1981 Council action provides "guidance" to the WTO as a "decision" under Article XVI:1 of the *WTO Agreement*, it has no relevance to this dispute.[115]

105. The 1981

> Following the adoption of these reports the Chairman noted that the Council's decision and understanding does not mean that the parties adhering to Article XVI:4 are forbidden from taxing the profits on transactions beyond their borders, it only means that they are not required to do so. *He noted further that the decision does not modify the existing GATT rules in Article XVI:4 as they relate to the taxation of exported goods. He noted also that this decision does not affect and is not affected by the Agreement on the Interpretation and Application of Articles VI, XVI and XXIII. Finally, he noted that the adoption of these reports together with the understanding does not affect the rights and obligations of contracting parties under the General Agreement.*[118] (emphasis added)

107. The first issue relating to the 1981 Council action is whether it forms part of the GATT 1994 as an "other decision" under paragraph 1(b)(iv) of the language incorporating the GATT 1947 into the *WTO Agreement.* Paragraph 1(b) stipulates that the GATT 1994 includes certain "legal instruments … that entered into force under the GATT 1947", such as "other decisions of the CONTRACTING PARTIES to the GATT 1947" under sub-paragraph (b)(iv). As the Panel said, in terms of Article II:2 of the *WTO Agreement*, these various "legal instruments" are, in themselves, "integral parts" of the *WTO Agreement* and are "binding on all Members". The inclusion of these "legal instruments" in the GATT 1994 recognizes that the legal character of the rights and obligations of the contracting parties under the GATT 1994 is not fully reflected by the text of the GATT 1994 because those rights and obligations are conditioned by the "protocols", "decisions" and other "legal instruments" to which paragraph 1(b) refers.

108. In our Report in *Japan – Alcoholic Beverages*, we stated that not *every* decision of the CONTRACTING PARTIES to the GATT 1947 is an "other decision" within the meaning of paragraph 1(b)(iv) of the language incorporating the GATT 1994 into the *WTO Agreement.* In that respect, we disagreed with the view that "adopted panel reports in themselves constitute '*other decisions* of the CONTRACTING PARTIES to GATT 1947' for the purposes of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the *WTO Agreement.*"[119] (emphasis added) The reason for this conclusion was that adopted panel reports "are *not binding, except with*

109. The opening clause of the 1981 Council action states: "The Council adopts *these reports* on the understanding that *with respect to these cases, and in general…*". The 1981 Council action is, therefore, somewhat equivocal in tenor. On the one hand, it is clear from the text that the 1981 Council action relates specifically to the *Tax Legislation Cases* and is an integral part of the resolution of those disputes. This would suggest that, consistently with our Report in *Japan – Alcoholic Beverages*, the Council action is binding only on the parties to those disputes, and only for the purposes of those disputes.

110. On the other hand, we note that the opening clause of the 1981 Council action also prefaces the substance of the statement with the words "*in general*". The United States argues that these words indicate that the 1981 Council action was an "authoritative interpretation" of Article XVI:4 of the GATT 1947 that has "general" application and that, therefore, bound all the contracting parties. The European Communities counters that the 1981 Council action formed part of the resolution of the *Tax Legislation Cases* and that, in adopting that decision, the GATT 1947 Council was acting in dispute settlement "mode".[122] The European Communities contends further that disputes are resolved on the basis of the generally applicable rules that are, first, interpreted "in general" and then applied to the facts of a specific dispute. It is in this limited sense that the European Communities contends that the GATT 1947 Council meant the term "in general".[123]

111. The remainder of the text of the 1981 Council action embodies the substantive statement of the GATT 1947 Council on Article XVI:4 of the GATT 1947 and does not, in our view, shed any additional light on whether that statement bound *all* the contracting parties or only the parties to the *Tax Legislation Cases*.[124] We, therefore, share the Panel's view that the text of the 1981 Council action alone does not resolve the ambiguity highlighted by the conflicting arguments of the United States and the European Communities.[125] Thus, we consider that the Panel was correct to examine the circumstances surrounding the 1981 Council action.

112. When the 1981 Council action was adopted, the Chairman of the GATT 1947 Council stated, *inter alia*, that "the adoption of these reports together with the understanding *does not affect the rights and obligations of contracting parties under the General Agreement.*" In our view, if the contracting parties had intended to make an *authoritative* interpretation of Article XVI:4 of the GATT 1947, binding on all contracting parties, they would have said so in reasonably recognizable terms.

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[122]European Communities' appellee's submission, para. 154.

[123]*Ibid*., para. 158.

[124]We note, in that respect, that we do not share the Panel's misgivings regarding the use of the word "should" in a "legal instrument" (Panel Report, para. 7.65). In our view, many binding legal texts employ the word "should" and, depending on the context, the word may imply either an exhortation or express an obligation (see, further, *Canada – Aircraft*, *supra*, footnote 58, para. 187).

[125]Panel Report, para. 7.65.

We think it most unlikely that the Chairman would have stated that the action did "*not affect the rights and obligations of contracting parties*", if it represented an authoritative interpretation of Article XVI:4 of the GATT 1947.[126] In our view, an authoritative, and generally binding, interpretation of Article XVI:4 would, in all probability, have been perceived by the contracting parties as affecting their rights and obligations and would not, therefore, have been accompanied by such a statement.[127] Thus, we are of the view that the statement of the GATT 1947 Council Chairman is consistent with a reading of the 1981

116. Although we have not previously had an opportunity to examine the relationship between these two particular provisions, we have in the past examined the relationship between the provisions of the GATT 1994 and certain other Multilateral Agreements on Trade in Goods.[129] In *Brazil – Desiccated Coconut*, we observed that the "relationship between the GATT 1994 and the other goods agreements in Annex 1A is complex and must be examined on a case-by-case basis."

disciplines that "go well beyond merely applying and interpreting Articles VI, XVI and XXIII of the GATT 1947".[136] Next, Article XVI:4 prohibits export subsidies only when they result in the export sale of a product at a price lower than the "comparable price charged for the like product to buyers in the domestic market." In contrast, the *SCM Agreement* establishes a much broader prohibition against *any* subsidy which is "contingent upon export performance". To say the least, the rule contained in Article 3.1(a) of the *SCM Agreement* that all subsidies which are "contingent upon export performance" are prohibited is significantly different from a rule that prohibits only those subsidies which result in a lower price for the exported product than the comparable price for that product when sold in the domestic market. Thus, whether or not a measure is an export subsidy under Article XVI:4 of the GATT 1947 provides no guidance in determining whether that measure is a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*. Also, and significantly, Article XVI:4 of the GATT 1994 does not apply to "primary products", which include agricultural products. Unquestionably, the explicit export subsidy disciplines, relating to agricultural products, contained in Articles 3, 8, 9 and 10 of the *Agreement on Agriculture* must clearly take precedence over the *exemption* of primary products from export subsidy disciplines in Article XVI:4 of the GATT 1994.

118. Furthermore, as the Panel observed, the text of the 1981 Council action itself contains reference only to Article XVI:4, and the Chairman of the GATT 1947 Council stated expressly that the 1981 Council action did *not* affect the *Tokyo Round Subsidies Code*. We share the Panel's view that, in these circumstances, it would be incongruous to extend the scope of the action, beyond that intended, to the *SCM Agreement*.[137] If the 1981 Council action did not affect the *Tokyo Round Subsidies Code*, which existed in 1981, it is difficult to see how that action could be seen to affect the *SCM Agreement*, which did not.

119. Against this background, we agree with the Panel that the 1981 Council action does not dispose of the issue before us, in particular, with respect to the determination of what constitutes an "export subsidy" under Article 3.1(a) of the *SCM Agreement*. The 1981 Council action related to a different provision, Article XVI:4 of the GATT 1947, and not to the export subsidy disciplines established by Articles 1.1 and 3.1(a) of the *SCM Agreement*.

[136] *Brazil – Desiccated Coconut*, *supra*, footnote 50, p. 17.

[137] Panel Report, para. 7.85.

120. In any event, even if the United States had been correct that the 1981

123. The Panel stated that:

> … as a practical commercial matter and in ordinary parlance, *income taxes are a cost of doing business*. Because FSC subsidies reduce an exporter's income tax liability with respect to marketing activities, they *effectively reduce the cost of marketing agricultural products*.[141] (emphasis added)

124. The Panel added:

> In any event, *a subsidy such as the FSC, which is provided to offset costs of marketing agricultural products, should be considered to reduce the costs of marketing agricultural products*.[142] (emphasis added)

125. Thus, focusing on the "purpose and role of the subsidies", the Panel concluded that the FSC measure involved export subsidies as listed in Article

130. The text of Article 9.1(d) lists "handling, upgrading and other processing costs, and the costs of international transport and freight" as examples of "costs of marketing". The text also states that "export promotion and advisory services" are covered by Article 9.1(d), provided that they are not "widely available". These are not examples of just *any* "cost of doing business" that "effectively reduce[s] the cost of marketing" products.[150] Rather, they are specific types of costs that are incurred *as part of* and *during* the process of selling a product. They differ from general business costs, such as administrative overhead and debt financing costs, which are not specific to the process of putting a product on the market, and which are, therefore, related to the marketing of exports only in the broadest sense.

131. It seems to us that income tax liability under the FSC measure can also be viewed as related to the business of marketing exports only in the very broadest sense. Income tax liability under the FSC measure arises only when goods are actually sold for export, that is, *when they have been the subject of successful marketing.* Such liability arises *because* goods have, in fact, been sold, and not as *part of the process* of marketing them. Furthermore, at the time goods are sold, the costs associated with putting them on the market – costs such as handling, promotion and distribution costs – have already been incurred and the amount of these costs is not altered by the income tax, the amount of which is calculated by reference to the sale price of the goods. In our view, if income tax liability arising from export sales can be viewed as among the "costs of marketing exports", then so too can virtually any other cost incurred by a business engaged in exporting. This cannot be what was intended by Article 9.1(d). We, therefore, hold that income tax liability arising from export sales is not part of the "costs of marketing" a product.

132. Accordingly, we do not agree with the Panel that the FSC measure is a subsidy "to reduce the costs of marketing exports of agricultural products" under Article 9.1(d), and we, therefore, reverse the Panel's finding, in paragraph 7.159 of the Panel Report, that the FSC measure involves export subsidies listed in Article 9.1(d) of the *Agreement on Agriculture.* A finding of inconsistency with Article 3.3 of the *Agreement on Agriculture* is dependent on the Member having provided export subsidies *listed in Article 9.1*. As we have reversed the Panel's finding that the FSC measure involves export subsidies listed in Article 9.1(d), and as the European Communities has not claimed that the FSC measure involves export subsidies listed in any other sub-paragraph of Article 9.1, we also reverse the Panel's finding that the United States has acted inconsistently with Article 3.3 of the *Agreement on Agriculture* by providing export subsidies as listed in Article 9.1 of that Agreement. Having reversed the Panel's finding under Article 3.3, we do not find it necessary to examine the United States' appeal that the Panel erred in its interpretation of the word "provide" in the second clause of Article 3.3 of the *Agreement on Agriculture.* As we have found that the FSC measure does

[150]See Panel Report, para. 7.155.

not involve an export subsidy as listed in Article 9.1, and that, consequently, there is no inconsistency with Article 3.3, the Panel's interpretation of the word "provide" in the second clause of Article 3.3 is moot and of no legal effect.

133. As an alternative to its claims under Articles 3.3 and 9.1 of the *Agreement on Agriculture*, the European Communities claims that the FSC measure is inconsistent with Article 10.1, as read together with Article 8 of that Agreement. As we have reversed the Panel's findings under Articles 9.1 and 3.3 of the *Agreement on Agriculture*, it is necessary for us to examine this alternative claim under Articles 10.1 and 8 of that Agreement.

134. Article 8 of the *Agreement on Agriculture* stipulates:

> Each Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member's Schedule.

135. Article 10.1 of the *Agreement on Agriculture* reads:

> Export subsidies not listed in paragraph 1 of Article 9 shall not be *applied in a manner which results in, d is inc8threatens to lead to, circumvention of export subsidy commitments*; … (emphasis added)

136. We observe that Article 1(e) of the *Agreement on Agriculture* states that the term "export subsidies" "refers to subsidies contingent upon export performance". However, we note also that the *Agreement on Agriculture* does not contain a definition of the terms "subsidy" d i"subsidies". In our Report in *Canada – Milk*, a case that involved "export subsidies" under the *Agreement on Agriculture*, we stated that "a 'subsidy' involves a transfer of economic resources from the grantd ito the recipient for less than full consideration."[151] In making this statement, we drew, as context, upon the definition of a "subsidy" in Article 1.1 of the *SCM Agreement*:

> … a "subsidy", within the meaning of Article 1.1 of the *SCM Agreement*, arisesis ere the grantd imakes a "financial contribution" s inc8confers a "benefit" on the recipient, as compared with what would have been otherwise available to the recipient in the marketplace.[152]

[151] Appellate Body Report, *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products* ("*Canada – Milk*"), WT/DS103/AB/R, WT/DS113/AB/R, adopted 27 October 1999, para. 87.

[152] *Ibid*.

137. Therefore, in this case, we will consider, first, whether the FSC measure involves a transfer of economic resources by the grantor, which in this dispute is the government of the United States, and, second, whether any transfer of economic resources involves a benefit to the recipient.

138. The alleged subsidy here involves a transfer of resources through the foregoing of revenue. We held, in *Canada – Milk*, that "export subsidies" under the *Agreement on Agriculture* may involve, not only direct payments, but also "*revenue foregone*".[153] We believe, however, that in disputes brought under the *Agreement on Agriculture*, just as in cases under Article 1.1(a)(1)(ii) of the *SCM Agreement*, it is only where a government foregoes revenues that are "*otherwise due*" that a "subsidy" may arise.

139. In our examination of the Panel's findings under Article 1.1 of the *SCM Agreement*, we concluded that the FSC measure involves the foregoing of fiscal revenues that are "otherwise due" under that Agreement. We see no reason to reach any different conclusion under the *Agreement on Agriculture*. Under the FSC measure, the fiscal treatment of agricultural products is not materially different, for present purposes, from the fiscal treatment of products falling within the scope of application of the *SCM Agreement*.

140. As to whether there is a benefit, the United States did not contest that if the FSC measure involved a "financial contribution" under Article 1.1 of the *SCM Agreement*, it also involved a "benefit" under Article 1.1(b) of that Agreement.[154] The tax exemptions provided by the FSC measure, whether provided for agricultural or other products, confer upon the recipient the obvious benefit of reduced tax liability and, therefore, reduced tax payments. We find, therefore, that the FSC measure involves a "subsidy" under the *Agreement on Agriculture*.

141. We turn next to the requirement that "export subsidies" under Article 1(e) of the *Agreement on Agriculture* be "contingent upon export performance". We see no reason, and none has been pointed out to us, to read the requirement of "contingent upon export performance" in the *Agreement on Agriculture* differently from the same requirement imposed by the *SCM Agreement*. The two Agreements use precisely the same words to define "export subsidies". Although there are differences between the export subsidy disciplines established under the two Agreements, those differences do not, in our view, affect the common substantive requirement relating to export contingency. Therefore, we think it appropriate to apply the interpretation of export contingency that we have adopted under the *SCM Agreement* to the interpretation of export contingency under the *Agreement*

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[153] *Canada – Milk*, *supra*, footnote 151, para. 112. In reaching this conclusion, we observed that, under Article 1(c) of the *Agreement on Agriculture*, the terms "budgetary outlays" and "outlays" may include "*revenue foregone*".

[154] Panel Report, para. 7.103.

on Agriculture.[155] We also recall that we have upheld the Panel's finding that the FSC measure involves subsidies contingent upon export performance under Article 3.1(a) of the *SCM Agreement.* In making that finding, the Panel stated:

> The subsidy is only available with respect to "foreign trading income"; foreign trading income arises from the sale or lease of "export property" or the provision of services relating to the sale or lease of export property; and export property is limited in effect to

145. Under Article 3, Members have undertaken two different types of "export subsidy commitments". Under the first clause of Article 3.3, Members have made a commitment that they will not "provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitments levels specified therein". This is the commitment for *scheduled* agricultural products. Article 3.1 confirms that:

> The domestic support and *export subsidy commitments in Part IV of each Member's Schedule constitute commitments limiting subsidization* and are hereby made an integral part of GATT 1994. (emphasis added)

146. Under the second clause of Article 3.3, Members have committed *not* to provide *any* export subsidies, *listed in Article 9.1*, with respect to *unscheduled* agricultural products. This clause clearly also involves "export subsidy commitments" within the meaning of Article 10.1. Our

148. We turn next to whether the subsidies under the FSC measure are "applied in a manner which *results in*, or which *threatens to lead to*, *circumvention* of export subsidy commitments". (emphasis added) The verb "circumvent" means, *inter alia*, "find a way round, evade…".[160] Article 10.1 is designed to prevent Members from circumventing or "evading" their "export subsidy commitments". This may arise in many different ways. We note, moreover, that, under Article 10.1, it is not necessary to demonstrate *actual* "circumvention" of "export subsidy commitments". It suffices that "export subsidies" are "applied in a manner which … *threatens to lead to circumvention* of export subsidy commitments".

149. In determining whether the FSC measure in this case is "applied in a manner which … threatens to lead to circumvention of export subsidy commitments", it is important to consider the structure and other characteristics of that measure. The FSC measure creates, in itself, a *legal entitlement* for recipients to receive export subsidies, not listed in Article 9.1, with respect to agricultural products, both scheduled and unscheduled. As we understand it, that legal entitlement arises in the recipient when it complies with the statutory requirements and, at that point, the government of the United States must grant the FSC tax exemptions. There is, therefore, no discretionary element in the provision by the government of the FSC export subsidies. If the statutory eligibility requirements are met, then an FSC is entitled by law to the statutorily established tax exemption. Furthermore, there is no limitation on the amount of exempt foreign trade income that may be earned by an FSC. Therefore, the legal entitlement that the FSC measure establishes is unqualified as to the *amount* of export subsidies that may be claimed by FSCs. There is, in other words, no mechanism in the measure for stemming, or otherwise controlling, the flow of FSC subsidies that may be claimed with respect to any agricultural products. In this respect, the FSC measure is unlimited.

150. With respect to *unscheduled* agricultural products, Members are *prohibited* under Article 3.3 from providing *any* export subsidies as ./if3s", s ./ii in a"R0.17sj 0 -19.5 T7sj 0 -19.5 T7sj 0 -19.5 Tdies, trad.12

151. With respect to *scheduled*

VII. Section 4.2 of the *SCM Agreement*

155. Before the Panel, the United States entered a preliminary objection that the claim by the European Communities under Article 3 of the *SCM Agreement* should be dismissed because the request for consultations by the European Communities did not include a "statement of available evidence", as required by Article 4.2 of the *SCM Agreement*.[161] The Panel denied this preliminary objection. The Panel explained in the Panel Report that "it may well be that the European Communities' request for consultations does contain a statement of available evidence", in part because "the primary evidence on which the European Communities relies is Sections 921

158. Article 4.2 of the *SCM Agreement* provides:

> A request for consultations under paragraph 1 [of Article 4] *shall include a statement of available evidence* with regard to the existence and nature of the subsidy in question. (emphasis added)

159.

this respect, it is available evidence of the character of the measure as a "subsidy" that must be indicated, and not merely evidence of the existence of the measure. We would have preferred that the Panel give less relaxed treatment to this important distinction.

162. Following the European Communities' request for consultations, the United States and the European Communities held three separate sets of consultations over a period of nearly five months.[167] It appears that, during this entire five-month period, the United States did not raise any objection to the content of the European Communities' request for consultations under Article 4.2 of the *SCM Agreement*. Once these proceedings reached the panel stage, the United States explained its view that nothing in either the DSU or the *SCM Agreement* "requires us to perfect the European Communities' pleadings for it".[168] The Panel, however, found that "the United States consciously chose not to seek clarification regarding the evidence in question at the point it received the request for consultations".[169]

163. Nor, it seems, did the United States object to the allegedly deficient request for consultations during those DSB meetings when the European Communities' request for establishment of a panel was on the agenda of the DSB and the Panel was established.[170] Indeed, the first occasion on which the United States objected to the request for consultations was in a request for preliminary findings, submitted to the Panel on 4December 1998, more than a year after the date of the request for consultations.[171]

164. The thrust of the United States' position is that the European Communities' request for consultations is defective to the point that it cannot form the basis for proceedings before a panel. However, despite the defects that it saw in the request for consultations, the United States allowed that request to be acted upon and to form the basis of three sets of consultations with the European Communities about the FSC measure during a period of five months.

165. As we have said, a year passed between submission of the request for consultations by the European Communities and the first mention of this objection by the United States – despite the fact that the United States had numerous opportunities during that time to raise its objection. It seems to us that, by engaging in consultations on three separate occasions, and not even raising its objections in

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[167]Consultations were held on 17 December 1997, 10 February 1998, and 3 April 1998 (Panel Report, para. 1.3).

[168]Panel Report, para. 7.10.

[169]*Ibid*.

[170]The first request for establishment of a panel was on the agenda of the DSB at the meeting held on 23 July 1998 (WT/DSB/M/47). The panel was established at the DSB meeting held on 22 September 1998 (WT/DSB/M/48).

[171]Panel Report, p. 5, footnote 19.

the two DSB meetings at which the request for establishment of a panel was on the agenda, the United States acted as if it had accepted the establishment of the Panel in this dispute, as well as the consultations preceding such establishment. In these circumstances, the United States cannot now, in our view, assert that the European Communities' claims under Article 3 of the *SCM Agreement* should have been dismissed and that the Panel's findings on these issues should be reversed. Accordingly, we decline the United States' appeal from the Panel's refusal to dismiss the European Communities' claim under Article 3 of the *SCM Agreement* due to the European Communities' alleged failure to comply with Article 4.2 of that Agreement. Thus, we do not find it necessary to rule on whether the European Communities' request for consultations includes a "statement of available evidence" that satisfies the requirements of Article 4.2 of the *SCM Agreement.*

166.

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> Even assuming that footnote 59 requires Members to attempt to resolve their differences through alternative tax fora, that footnote does not provide that the right to resort to WTO dispute settlement at any time is circumscribed by that alleged requirement.[173]

168. As a consequence, the Panel denied the United States' request to dismiss or defer the European Communities' claims regarding the FSC administrative pricing rules, pending consideration of these rules in an appropriate tax forum.[174]

169. The United States urges us to review the Panel's finding because "the Panel chose to rule on this issue"[175], and because the European Communities has "framed this dispute as one involving transfer pricing issues".[176]

administrative pricing rules, we consider that the issue of whether the European Communities should have first availed itself of the facilities of a forum other than the WTO is moot. For this reason, we believe that it is not necessary for us to rule on this part of the United States' appeal, and we reserve our opinion thereon.

IX. FSC Administrative Pricing Rules

172. Before the Panel, the European Communities submitted that the FSC administrative pricing rules, which may be used by an FSC to determine both its foreign trad th3nocT -0 theexempts part oe a)t c

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175. The European Communities makes a conditional appeal against this finding of the Panel. The conditions under which this appeal is made are, first, that we have reversed or modified some aspect of the Panel's findings or recommendations so that it would then be necessary for us "to complete the Panel's work" or, second, that we consider that the United States could implement the recommendations and rulings of the DSB in this case without removing the value-based condition found in Section 927(a)(1)(C) of the United States Internal Revenue Code.[184] As we have upheld all the Panel's findings under the *SCM Agreement*, we believe that the first condition on which the European Communities' appeal is predicated does not arise. As for the second condition, we do not consider that it is appropriate for us to speculate on the ways in which the United States might choose to implement the rulings and recommendations of the DSB.

176. For these reasons, we decline to rule on the European Communities' conditional appeal relating to Article 3.1(b) of the *SCM Agreement*.

XI. Findings and Conclusions

177. For the reasons set out in this Report, the Appellate Body:

(a)

(e) upholds the Panel's denial, in paragraph 7.11 of the Panel Report, of the United States' request to dismiss the European Communities' claims under Article 3 of the *SCM Agreement* on the ground that the European Communities failed to include in its request for consultations "a statement of available evidence regarding the existence and nature of the subsidy in question", as required by Article 4.2 of the *SCM Agreement*;

(f) declines to examine the Panel's denial, in paragraph 7.22 of the Panel Report, of the request by the United States that the Panel dismiss or defer the European Communities' claims regarding the FSC administrative pricing rules pending recourse by the European Communities to the facilities of an appropriate tax forum;

(g) declines to examine the Panel's finding, in paragraph 7.127 of the Panel Report, that it was neither necessary nor appropriate to make findings with respect to the European Communities' claims under Article 3.1(a) of the *SCM Agreement* relating to the FSC administrative pricing rules; and

(h) declines to examine the Panel's finding, in paragraph 7.132 of the Panel Report, that it was neither necessary nor appropriate to make findings with respect to the European Communities' claims under Article 3.1(b) of the *SCM Agreement.*

178. 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 Report, to be inconsistent with its obligations under Articles 3.1(a) and 3.2 of the *SCM Agreement* and under Articles 10.1 and 8 of the *Agreement on Agriculture*, into conformity with its obligations under those Agreements.

179. We wish to emphasize that our ruling is on the FSC measure only. As always, our responsibility under the DSU is to address the legal issues raised in an appeal in a dispute involving a particular measure. Consequently, this ruling is in no way a judgement on the consistency or the inconsistency with WTO obligations of any other tax measure applied by any Member. Also, this is not a ruling that a Member must choose one kind of tax system over another so as to be consistent with that Member's WTO obligations. In particular, this is not a ruling on the relative merits of
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180. By entering into the *WTO Agreement*, each Member of the WTO has imposed on itself an obligation to comply with *all* the terms of that Agreement. This is a ruling that the FSC measure does not comply with *all* those terms. The FSC measure creates a "subsidy" because it creates a "benefit" by means of a "financial contribution", in that government revenue is foregone that is "otherwise due". This "subsidy" is a "prohibited export subsidy" under the *SCM Agreement* because it is contingent upon export performance. It is also an export subsidy that is inconsistent with the *Agreement on Agriculture*. Therefore, the FSC measure is not consistent with the WTO obligations of the United States. Beyond this, we do not rule.

Signed in the original at Geneva this 10th day of February 2000 by:

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Julio Lacarte-Muró
Presiding Member

_____ _____

James Bacchus
Member

Florentino Feliciano
Member