*UNITED STATES – TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS": SECOND RECOURSE TO ARTICLE 21.5 OF THE DSU BY THE EUROPEAN COMMUNITIES*

**WT/DS108**

# ANSWERS OF THE UNITED STATES TO THE PANEL'S QUESTIONS TO THE PARTIES IN CONNECTION WITH THE SUBSTANTIVE MEETING

**July 11, 2005**

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**1. What is the current legal basis for the grandfathering of the original FSC scheme?**

1. Section 2 of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (the ETI Act) repealed the provisions of the U.S. Internal Revenue Code that provided the FSC tax exemption. Section 5 of the ETI Act provides that the changes made by the Act apply generally to transactions after September 30, 2000. Section 5(c) of the Act provides an exception to that general effective date, setting forth two transition rules for transactions involving a FSC. One transition rule provides that the repeal of the FSC tax exemption shall not apply to transactions of existing FSCs that occur before January 1, 2002. The second transition rule provides that the repeal of the FSC tax exemption shall not apply to transactions that occur after December 31, 2001, and that are pursuant to binding contracts satisfying certain conditions; *i.e.*, such contracts are "grandfathered." These FSC transition rules have not been modified by subsequent legislation, although the first transition rule does not apply to current transactions.

**In particular, is the FSC grandfathered exclusively through Section 5 of the ETI Act?**

2. Yes.

**2. How does the AJCA relate to the FSC scheme and its grandfathering? Does the AJCA address the continuation or repeal of the FSC grandfathering provisions explicitly or by implication?**

3. The American Jobs Creation Act (the AJCA) does not modify the FSC provisions repealed by the ETI Act or the transition rules for the FSC tax exemption contained in the ETI Act.

**Does the AJCA stipulate (whether explicitly or by implication) that it does *not* affect the grandfathering of FSC?**

4. Nothing in the legislative language modifies, implicitly or explicitly, the transition rules for the FSC tax exemption contained in the ETI Act.

**3. Section 101(a) of the AJCA states: "Section 114 is hereby repealed". Does Section 101 of the AJCA repeal the *entire* ETI Act?**

5. No. Section 101 repeals only the portions of the ETI Act that created the ETI tax exclusion. Section 101 does not modify the provisions in the ETI Act that repeal the FSC provisions.

**4. Does Section 101 of the AJCA (or any other provision of the AJCA) refer to section 5 of the ETI Act?**

6. No.

**If so, in what way?**

7. In light of the answer to the first part of Question 4, this question is not applicable.

**5. How does the US respond to the EC argument that since the US failed to take any action to repeal section 5 of the ETI Act, there is no relevant provision in the AJCA that the EC could have quoted in its Panel request in respect of this "failure"?**

8. Article 21.5 of the DSU applies, *inter alia*, to disagreements regarding the "existence" of measures taken to comply. Thus, Article 21.5 expressly contemplates a situation where there may be no measure that a complaining party can quote or to which it can cite. In addition, Article 21.5 also points to how one can satisfy the requirement of Article 6.2 of the DSU to "state the problem clearly." The complaining party merely has to explain that the necessary measure to comply does not exist. The EC failed to do so, and nothing in Article 21.5 excuses the EC's failure.

9. Moreover, the fact that there was no provision in the AJCA for the EC to cite to or quote is irrelevant for purposes of Article 6.2 of the DSU. Under Article 6.2, the EC had to "state the problem clearly". To the extent that the EC had a problem with the alleged failure to repeal section 5 of the ETI Act, it could have so stated in its panel request without reference to any provision in the AJCA. Instead, the EC panel request indicates that the subject of the dispute is limited to sections 101(d) and (f) of the AJCA, which have nothing to do with section 5 of the ETI Act or the FSC tax exemption.[1] The EC panel request does not even mention section 5 of the ETI Act.

10. Finally, it bears emphasis that, as recognized by prior panels, the terms of reference of an Article 21.5 panel are established by the request for establishment of the panel.[2] Because the EC panel request fails to mention an alleged failure to repeal section 5 of the ETI Act, the EC's claims regarding this alleged failure – expressed for the first time in the EC's first written submission – are not within the Panel's terms of reference.

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[1] *See Opening Statement of the United States of America at the Substantive Meeting of the Panel*, June 30, 2005, paras. 21-24 (hereinafter "U.S. Opening Statement").

[2] *See, e.g., Australia – Salmon (Article 21.5)*, para. 7.10, subpara. 7; *Australia – Leather (Article 21.5)*, para. 6.3 ("[A]s in the original dispute, the Panel's terms of reference are defined by the 'request for establishment' ... .").

**6. Are there any original FSC subsidies (other than the ETI provisions grandfathering original FSC subsidies) at issue?**

11. Based on the EC first written submission, the United States understands that the only FSC subsidies allegedly at issue are those provided pursuant to the grandfathering provision of section 5(c)(1)(B) of the ETI Act. Of course, as the United States has demonstrated, even these subsidies are not within the Panel's terms of reference, because the EC's panel request was limited to sections 101(d) and (f) of the AJCA and the transition provisions for the ETI Act tax exclusion.

**7. Is there any difference between the ETI and AJCA grandfathering arrangements (i.e. can the same taxpayer continue to benefit from both FSC and ETI benefits)?**

12. The ETI Act is clear that a taxpayer may not claim benefits on a transaction under both the ETI rules and the FSC rules.

**9. What are the specific "recommendations and rulings" at issue within the meaning of Article 21.5 of the *DSU* (i.e. from the original and/or first compliance proceedings)?**

13. The recommendations and rulings at issue within the meaning of Article 21.5 of the DSU are those that the Appellate Body made in the first Article 21.5 proceeding pertaining to the ETI Act, and that the DSB subsequently adopted. The EC's claims that the United States has failed to withdraw the ETI Act tax exclusion within the meaning of Article 4.7 of the SCM Agreement appear to relate to a recommendation that the first Article 21.5 panel did not make under Article 4.7 of the SCM Agreement. As discussed in response to question 24, it was proper for the panel not to make such a recommendation.

**10. The EC Panel request states, in part:**

**"In particular, the European Communities respectfully requests the Panel to find the following:**

> **that the United States has failed to withdraw its prohibited subsidies as required by Article 4.7 of the *SCM Agreement*, has failed to bring its scheme into conformity with its WTO obligations and has thus failed to implement the DSB's recommendations and rulings, as specified by the DSB on 20 March 2000 and on 29 January 2002, as required by Articles 19.1 and 21.1 of the *DSU*."**

**Do Parties consider that Articles 19.1 and 21.1 of the DSU give rise to independent and enforceable obligations? If so, what is their nature and extent?**

14. Neither provision gives rise to an obligation. Article 19.1 is not directed at Members, but instead is directed at panels and the Appellate Body. Article 21.1 is not directed at anyone in particular, but instead informs the remainder of Article 21 by articulating a goal of the dispute settlement system. As such, Article 21.1 is similar to Article III:1 of the GATT 1994, which the Appellate Body has found contains general principles that inform the specific obligations found in Article III.[3]

**11. How would a general obligation to bring a measure into conformity relate to the recommendation of the first 21.5 Appellate Body report: "...and 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*."**

15. At the outset, the United States notes that it is uncertain as to what the Panel means by its reference to "a general obligation to bring a measure into conformity". Article 21.5 provides a specific jurisdiction to panels with respect to the recommendations and rulings of the DSB. To the extent the "general obligation" referred to in the question is different from the DSB's recommendations and rulings, it would be different from the basis of a panel's review under Article 21.5. Nonetheless, for the reasons set forth in the U.S. Opening Statement, paras. 16-18, the Appellate Body's reference to Article 4.7 in the quoted passage pertained to section 5 of the ETI Act, and not to the ETI Act tax exclusion itself.

16. More generally, prior panels and the Appellate Body have recognized that the recommendation to "withdraw the subsidy" is different from the recommendation to "bring the measure into conformity". As discussed by one panel:

> "Withdraw the subsidy" is, as discussed above, different from "bring the measure into conformity", the recommendation required under Article 19.1 of the DSU. This conclusion is consistent with the observation of the Appellate Body in *Brazil – Aircraft*:
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> > Article 4.7 [of the SCM Agreement] contains several elements which are different from the provisions of Articles 19 and 21 of the DSU with respect to recommendations by a panel and implementation of rulings and recommendations of the DSB. For

[3] *Japan – Alcohol (AB)*, pages 17-18.

> example, Article 19 of the DSU requires a panel to recommend that the Member concerned bring its measure "into conformity" with the covered agreements. In contrast, Article 4.7 of the *SCM Agreement* requires a panel to recommend that the subsidizing Member *withdraw* the subsidy".[4]

17. In *EC – Sugar Subsidies*, the Appellate Body found that a panel engaged in false judicial economy when the panel made a recommendation under Article 19.1 of the DSU, but failed to make a recommendation under Article 4.7 of the DSU.[5] According to the Appellate Body, by declining to rule on claims concerning Article 3 of the SCM Agreement, the panel precluded a recommendation under Article 4.7 of the SCM Agreement. This, in turn, amounted to a failure on the part of the panel to discharge its obligation under Article 11 of the DSU to make "such other findings as will assist the DSB in making the recommendations or in giving the rulings provided for in the covered agreements." Implicit in the Appellate Body's reasoning, however, is the notion that the remedy under Article 19.1 and the remedy under Article 4.7 are different. If they were the same, then it is difficult to see how the panel could have been found to have engaged in "false" judicial economy.

**12. To date, the Panel discerns no US response to the EC's assertions regarding non-compliance with the DSB recommendations and rulings associated with the violations of the *Agreement on Agriculture* and the *GATT 1994*, and also involving Articles 19 and 21 of the *DSU*. Does the US contest that the WTO inconsistencies persist to the extent they are grandfathered?**

18. Yes. Articles 19.1 and 21.1 of the DSU, which are the provisions identified in the EC panel request, do not impose obligations. With respect to the *Agreement on Agriculture* and the GATT 1994, because no time period was ever established regarding implementation of the DSB's recommendations and rulings concerning these provisions, the United States was not precluded from adopting reasonable transition provisions to govern the phase-out of the ETI Act tax exclusion. *See* US First Submission, para. 19.

**13. The EC referred today to the following US statement to the DSB in November 2004:**

**"The representative of the United States, speaking under "Other Business", said that in connection with the dispute on: "United States – Tax Treatment for 'Foreign Sales Corporations'" (DS108), her delegation was pleased to inform the DSB that on 22 October 2004, President Bush had**

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[4] *Australia – Leather (Article 21.5)*, para. 6.42, *quoting from Brazil – Aircraft (AB)*, para. 191 (emphasis in original; footnote omitted).

[5] *EC – Sugar Subsidies (AB)*, para. 335.

**signed into law the American Jobs Creation Act of 2004 ("AJCA"). The AJCA had repealed the tax exclusion of the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000" ("ETI Act"). It had thereby withdrawn the subsidy found to exist and brought the measure in question into conformity with US WTO obligations."[1]**

[1] **WT/DSB/M/178, para. 38.**

**Does the United States view itself as being under a general obligation to bring its measures into conformity with its obligations under the covered agreements? If so, what would the legal relationship be between such a general obligation and Article 4.7 of the *SCM Agreement*?**

19. With respect to the first part of the question, the United States is not certain what the Panel means. If by "general obligation" the Panel is referring to the general provisions governing dispute settlement, then the United States notes that Article 19.1 of the DSU provides that, in the event of a finding of an inconsistency with a covered agreement, panels and the Appellate Body shall recommend that the Member concerned "bring the measure into conformity with that agreement."[6] This was the recommendation that the Appellate Body made in the first Article 21.5 proceeding with respect to the ETI Act tax exclusion.[7]

20. With respect to the relationship between this "general obligation" and Article 4.7 of the SCM Agreement, as discussed above in response to Question 11, the recommendation under Article 4.7 of the SCM Agreement to "withdraw the subsidy" is different from the recommendation under Article 19.1 of the DSU to "bring the measure into conformity". While it is possible that in a given case action to comply with one recommendation might comply with the other, the opposite is also true.

**14. How does the United States interpret the following recommendation in the first Article 21.5 Appellate Body report, referred to by the EC:**

**"The Appellate Body *recommends* that the DSB request the United States to <u>bring the ETI measure</u>, found in this Report, and in the Panel Report as modified by this Report, <u>to be inconsistent with its obligations under Article 3.1(a) of the *SCM Agreement*</u>, under Articles 3.3, 8 and 10.1 of the *Agreement on Agriculture,* and under Article III:4 of the GATT 1994, <u>into conformity with its obligations under those Agreements</u>, and that the DSB request the United States to implement fully the recommendations and**

[6] See also the U.S. answer to question 11 above.
[7] *US – FSC (Article 21.5) (AB)*, para. 257.

**rulings of the DSB in *US – FSC,* made pursuant to Article 4.7 of the *SCM Agreement*." (emphasis added)**

21. As previously explained by the United States,[8] when one reads the quoted paragraph – paragraph 257 – in conjunction with paragraph 256 of the Appellate Body report, it is clear that in the emphasized text the Appellate Body was referring to the ETI Act tax exclusion, as opposed to the transition provisions for the FSC tax exemption contained in section 5 of the ETI Act. In accordance with the recommendation set forth in the emphasized text, the AJCA repealed the ETI Act tax exclusion, subject to reasonable transition provisions as set forth in sections 101(d) and (f) of the AJCA.

**16. Is the AJCA "a measure taken to comply with the recommendations and rulings" within the meaning of Article 21.5 of the *DSU*? Why or why not?**

22. Yes. The AJCA repealed the ETI Act tax exclusion in compliance with the recommendations and rulings of the DSB.

**17. Is the ETI Act "a measure taken to comply with the recommendations and rulings" within the meaning of Article 21.5 of the *DSU*? Why or why not?**

23. Yes. The ETI Act repealed the FSC tax exemption in compliance with the recommendations and rulings of the DSB.

**19. At page 7 of its oral statement of today, the United States asserts: "Instead, the Appellate Body referenced the recommendations and rulings in US-FSC, which were made before the ETI Act tax exclusion even existed." How, if at all, is this temporal element relevant?**

24. The United States has explained that the Appellate Body's reference to the recommendations and rulings in *US – FSC* under Article 4.7 of the SCM Agreement related to its finding that section 5 of the ETI Act failed to fully withdraw the FSC subsidy.[9] The fact that the ETI Act did not exist at the time of those recommendations and rulings reinforces the point that the Appellate Body could not have been referring to the ETI Act tax exclusion.

[8] *See* U.S. Opening Statement, paras. 16-17.

[9] *First Written Submission of the United States of America*, June 2, 2005, para. 15 (hereinafter "U.S. First Submission"); U.S. Opening Statement, paras. 11-18.

**20. Is the EC complaining about the time the US has taken beyond the original implementation period? If so, what are the relevant WTO obligations?**

25. The United States will await the EC's explanation of what it is complaining about.

**21. In para. 3 of its oral statement of today, the United States expresses tantalization at the prospect "of the EC being required for the first time to demonstrate how these *de minimis* tax exemptions and exclusions have caused harm to EC trade interests." How are purported *de minimis* adverse effects relevant to required withdrawal of a prohibited subsidy?**

26. As explained at the meeting with the Panel, the United States is not arguing that there is a *de minimis* exception for prohibited subsidies under Article 3 of the SCM Agreement. The United States was merely expressing its view that this dispute, and its current prolongation, has never had anything to do with actual harm to EC trade interests.

**22. What kind of "findings" would be appropriate or inappropriate for an Article 21.5 *DSU* panel to make?**

27. It is difficult to answer this question in the abstract. Suffice it to say that the text of Article 21.5 suggests some of the parameters for an Article 21.5 panel. A panel can make findings as to whether or not measures taken to comply exist. If measures taken to comply exist, a panel also can make findings as to whether such measures are consistent with covered agreements. Of course, a panel established under Article 21.5 of the DSU is also limited to its terms of reference.[10]

**23. If an Article 21.5 *DSU* panel does not have the authority to alter previously adopted recommendations and rulings, what are the implications for this case of the purported lack (in the first Article 21.5 panel report) of any explicit recommendation under Article 4.7 of the *SCM Agreement*?**

28. The United States does not believe that there are any implications. Regardless of what the first Article 21.5 Panel did or did not do, the fact remains that the Appellate Body made certain specific recommendations and these specific recommendations (and not others) were adopted by the DSB.

[10] This Panel was established with standard terms of reference under DSU Articles 6.2 and 7.1; see *Constitution of the Panel: Note by the Secretariat*, WT/DS108/30, circulated 9 May 2005.

**24. Does an Article 21.5 *DSU* panel dealing with prohibited subsidies have the mandate and/or the obligation to make a recommendation under Article 4.7 of the *SCM Agreement*?**

29. An Article 21.5 panel has specific, limited jurisdiction as provided in Article 21.5 itself. That is, the panel is limited to the question of the existence or consistency with a covered agreement of measures taken to comply. An Article 21.5 panel thus does not have the mandate to make a recommendation under Article 4.7 of the SCM Agrement.

30. The United States notes an additional reason for this conclusion. Article 21.5 provides that any such dispute over the existence or consistency with a covered agreement of measures taken to comply is to "be decided through recourse to these dispute settlement procedures," which is a reference to the DSU. Article 4.7 of the SCM Agreement is not part of the DSU and so would not be available to an Article 21.5 panel.

**25. How does this relate to the issue of whether that panel has the mandate and/or the obligation to "specify in its recommendation the time period within which the measure must be withdrawn" under Article 4.7 of the *SCM Agreement*?**

31. Since an Article 21.5 panel does not have the mandate to make a recommendation of withdrawal under Article 4.7 of the SCM Agreement, then it would also not have the mandate to specify the time period for withdrawal.

**26. Does Article 4.7 of the *SCM Agreement* impose an independent obligation on the Member found to be granting or maintaining a prohibited subsidy or does it have independent effect in the absence of a panel recommendation thereunder?**

32. The United States is uncertain as to what the Panel means by "independent obligation." Nevertheless, like Article 19.1 of the DSU – discussed above in connection with Question 10 – Article 4.7 is addressed to panels, and does not impose an obligation on Members. Thus, the text of Article 4.7 indicates that the recommendation to withdraw a subsidy must be made by a panel.

**28. Do Parties take the view that the first Article 21.5 panel should have made an explicit recommendation containing the terms "withdraw the subsidy without delay" under Article 4.7 of the *SCM Agreement*? If so, what, in the US view would have been the appropriate recommendation?**

33. Insofar as the ETI Act tax exclusion is concerned, the EC did not request that the Article 21.5 Panel make any findings that the tax exclusion resulted in a failure to withdraw the subsidy within the meaning of Article 4.7 of the SCM Agreement. Moreover, even though the

EC had cited in the Article 21.5 proceeding to Article 4 of the SCM Agreement, the EC expressly requested that the Panel refrain from making any recommendations. Under these circumstances, the Panel cannot be faulted for not making an explicit recommendation under Article 4.7. And as noted above, an Article 21.5 panel is operating under specific, limited jurisdiction which does not include a recommendation under Article 4.7 of the SCM Agreement.

**29. What is your opinion of any implications for this Panel of the first Article 21.5 panel's view that the original recommendation "remains operative"?[3]**

[3] **"The Panel, noting that the United States did not respond to this EC comment and that practice in this area has not been entirely consistent in Article 21.5 *DSU* proceedings, is of the view that the original recommendation adopted by the DSB on 20 March 2000 remains operative. We have therefore deleted what was originally paragraph 9.3 of the interim report...." (footnote omitted)**

34. The United States does not believe that there are any implications. As discussed above, the relevant recommendations and rulings for purposes of this dispute are those that were made by the Appellate Body in the first Article 21.5 proceeding and that were adopted by the DSB.

35. On a related topic, this may be the appropriate point to note that the United States disagrees with the assertion made by the EC at the substantive meeting with the Panel to the effect that it somehow was incumbent upon the United States to object to the EC request that the first Article 21.5 Panel refrain from making any recommendations. The EC is responsible for its own actions in WTO disputes, and silence by the United States should not be construed as either agreement or disagreement with the wisdom of such actions.

**30. What are the parties' views on a situation where a panel does *not* find a violation of Article 3 of the *SCM Agreement*, and makes no recommendation under Article 4.7 of the *SCM Agreement*? To what extent would this limit the capacity of the Appellate Body to reach a different substantive conclusion from the panel?**

36. This questions seems to go to the ability of the Appellate Body to complete the analysis of a panel that it has reversed, and is difficult to address in the abstract. Suffice it to say that in *EC – Sugar Subsidies*, the Appellate Body concluded that it should not complete the panel's analysis with respect to Article 3 and Article 4.7.[11] However, the Appellate Body's conclusions were based on the facts of that particular case. In principle, given the right set of facts, the Appellate Body presumably could reverse a panel's findings under Article 3 and, if necessary, complete the panel's analysis under Article 3. However, Article 4.7 of the SCM Agreement

[11] *EC – Sugar Subsidies (AB)*, paras. 336-341.

specifically applies only to panels and not to the Appellate Body. The United States notes in this connection the various proposals in the DSU negotiations to add a remand procedure to the DSU.

**31. The third section of the EC Panel request, entitled "Request for establishment of a Panel", requests the Panel to find the following:**

**– "that the United States has failed to withdraw its prohibited subsidies as required by Article 4.7 of the *SCM Agreement*, has *failed to bring its scheme into conformity with its WTO obligations and has thus failed to implement the DSB's recommendations and rulings, as specified by the DSB on 20 March 2000 and on 29 January 2002*, as required by Articles 19.1 and 21.1 of the *DSU*." (emphasis added)**

**Does the text in italics encompass the grandfathering of the original FSC subsidies? Why or why not?**

37. The text in italics does not encompass the grandfathering of the original FSC subsidies provided for in section 5 of the ETI Act. As previously explained,[12] the subject of the dispute is set forth in the second section of the EC panel request, which refers to section 101(d) and (f) of the AJCA, but not the grandfathering of the FSC tax exemption. The italicized text does not describe the subject of the dispute, but instead simply sets forth the EC's claim that sections 101(d) and (f) – previously identified as the subject of the dispute – are inconsistent with the 2000 and 2002 DSB recommendations.

38. The United States emphasizes again that nowhere in the EC panel request is section 5 of the ETI Act mentioned.

**32. How does the US respond to the EC argument in paras. 25-26 of the EC rebuttal submission about the scope of section 2 of the EC Panel request? In particular, the EC submits that the following language in section 2 of its Panel request "covers both the contracts benefiting from the ETI scheme which are expressly "grandfathered" by the JOBS Act and the "older" contracts benefiting from the FSC scheme which were "grandfathered" by the ETI Act through section 5":**

**"the European Communities considers that Section 101 of the JOBS Act contains provisions which will allow US exporters to continue benefiting**

[12] U.S. First Submission, para. 20; U.S. Opening Statement, paras. 21-24.

**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."**

39. The quoted passage refers to provisions "contain[ed]" in section 101 of the AJCA. However, no provision in the AJCA allows U.S. exporters to continue benefiting from the FSC tax exemption. As discussed above in response to Question 2, any grandfathering with respect to the FSC tax exemption is provided for exclusively by section 5 of the ETI Act. Thus, under any fair reading, the quoted passage cannot constitute a reference to section 5 of the ETI Act or an alleged failure to withdraw FSC subsidies.

40. Moreover, in the paragraph immediately preceding the quoted paragraph, the EC specifically references section 101(d) and (f). Thus, the assertion that "Section 101 . . . contains provisions" is clearly a reference to section 101(d) and (f), which, as previously explained, related exclusively to the ETI Act tax exclusion.