BEFORE THE
WORLD TRADE ORGANIZATION
APPELLATE BODY

United States – Tax Treatment for "Foreign Sales Corporations": Second Recourse to Article 21.5 of the DSU by the European Communities

(AB-2005-9)

APPELLANT SUBMISSION OF THE UNITED STATES OF AMERICA

November 21, 2005

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SERVICE LIST

OTHER PARTY TO THE DISPUTE

H.E. Mr. Carlo Trojan, Permanent Delegation of the European Commission

THIRD PARTIES

H.E. Mr. Bruce Gosper, Permanent Mission of Australia
H.E. Mr. Clodoaldo Hugueney, Permanent Mission of Brazil
H.E. Mr. Sun Zhenyu, Permanent Mission of China

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Panel Report	Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations" – Second Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/RW2, circulated 30 September 2005
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I. Introduction and Executive Summary

1. The U.S. Congress understood that enacting the *American Jobs Creation Act of 2004* ("AJCA") would result in a mutually satisfactory resolution of the dispute that began over the Foreign Sales Corporation tax provisions of U.S. law. Regrettably, the EC has chosen to prolong the dispute. Speculation as to why the EC chose to prolong this dispute have appeared in the press, in particular speculation that the EC decided to break with the understanding that it had provided to Congress in order to exert leverage in the separate *Airbus* dispute, notwithstanding the strictures in Article 3.10 of the DSU. *See Lamy Links Airbus Case to EU Willingness to Accept FSC Repeal Bill*, INSIDE U.S. TRADE (Oct. 1, 2004), page 23.[1]

2. Be that as it may, the present proceeding concerns an appeal from the report of the Panel. The authority of a panel, including a panel established under Article 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* ("DSU"), is limited. A panel must deal with the measures and claims as they are presented to it, and subject to the terms of the covered agreements. It may not redefine those measures and claims in order to reach the outcome that the panel considers appropriate.

3. Unfortunately, the Panel here exceeded its authority. With respect to the tax exclusion for extraterritorial income ("ETI tax exclusion"), the Panel found that the transition provisions in the AJCA constituted a failure to implement a recommendation by the Dispute Settlement Body ("DSB") under Article 4.7 of the *Agreement on Subsidies and Countervailing Measures* ("SCM Agreement"). The Panel's finding was in error because there was no recommendation by the

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[1] *See also EU to Lift Sanctions on US but Warns on Boeing*, FINANCIAL TIMES (Oct. 26, 2004), page 12 (The EU request for WTO review "is primarily aimed at maintaining leverage against Boeing, which is backing Washington in a separate WTO complaint against European subsidies for Airbus ... .").

DSB under Article 4.7 with respect to the ETI tax exclusion. The Panel's conclusion that there was such a finding was based on a misinterpretation of Article 4.7, Article 21.5 of the DSU, and the prior history of this dispute, and reflected a basic misunderstanding of the operation of the WTO dispute settlement system.

4. With respect to the tax exemption for foreign sales corporations ("FSC"), the Panel incorrectly found that section 5(c) of the *FSC Repeal and Extraterritorial Income Exclusion Act of 2000* ("ETI Act") was within the Panel's terms of reference. This finding of the Panel was in error, because the panel request of the European Communities ("EC") did not include section 5(c). This error, in turn, resulted in the Panel erroneously making findings on a measure that was not within its terms of reference.

II. Background

5. Because the Panel's errors flow, in part, from its misinterpretation of the prior history of this dispute, it is necessary at the outset to describe that history. This dispute began with an EC challenge to the foreign sales corporation ("FSC") provisions of U.S. tax law. The original Panel found that the FSC tax exemption constituted an export subsidy prohibited by Articles 3.1(a) and 3.2 of the SCM Agreement.[2] Pursuant to Article 4.7 of the SCM Agreement, the original Panel recommended that the United States withdraw the FSC subsidy with effect from October 1,

[2] *US – FSC (Panel)*, para. 8.1(a). The original Panel also found the FSC provisions to be inconsistent with provisions of the *Agreement on Agriculture*.

2000.[3] The Appellate Body subsequently modified the original Panel's reasoning, but affirmed the original Panel's findings under the SCM Agreement.[4]

6. Subsequently, the United States enacted the ETI Act. The ETI Act repealed the FSC provisions, subject to a general transition provision and a grandfather provision for certain pre-existing binding contracts that allowed the FSC tax exemption to be claimed after November 1, 2000. These provisions are contained in section 5(c) of the ETI Act.[5] The ETI Act also created a new tax exclusion for extraterritorial income ("ETI tax exclusion").

7. Following the enactment of the ETI Act, the EC initiated a proceeding under Article 21.5 of the DSU in which it essentially complained of two things. First, with respect to the FSC tax exemption, the EC claimed that the transition and grandfather provisions contained in section 5(c) of the ETI Act resulted in a failure to withdraw the FSC tax exemption as required by the original Panel's recommendation pursuant to Article 4.7. Second, with respect to the ETI tax exclusion, the EC alleged that the tax exclusion constituted a subsidy in its own right that was prohibited by the SCM Agreement and that was inconsistent with other provisions of the WTO agreements. The EC did not, however, claim or argue that the ETI tax exclusion constituted a failure to withdraw within the meaning of Article 4.7.[6]

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[3] *US – FSC (Panel)*, para. 8.8. The DSB later modified the withdrawal deadline to November 1, 2000.

[4] *US – FSC (AB)*, para. 177(a).

[5] To be precise, the general transition provision was contained in section 5(c)(1)(A) of the ETI Act, and the grandfather provision was contained in section 5(c)(1)(B).

[6] This can be seen from the first written submission of the EC in the first Article 21.5 proceeding. In the "Legal Analysis" section of the EC submission, the only reference by the EC to an alleged failure to withdraw under Article 4.7 was made in connection with the transition and grandfather provisions of section 5 of the ETI Act. *US – FSC (Article 21.5) (Panel)*, Annex A-1, para. 241. Likewise, in the "Conclusion" section, wherein the EC laid out the specific

8. With respect to the transition and grandfather provisions in section 5(c) of the ETI Act relating to the FSC tax exemption, the Article 21.5 Panel found that these provisions resulted in a failure on the part of the United States to withdraw the FSC subsidies that were found in the original proceeding to be prohibited, and, thus, constituted a failure to implement the recommendations and rulings of the DSB pursuant to Article 4.7 of the SCM Agreement.[7] The Appellate Body affirmed this finding.[8] In the language of Article 21.5, the Article 21.5 Panel and the Appellate Body found that a measure taken to comply with the recommendations and rulings of the DSB did not exist.

9. With respect to the ETI tax exclusion, the Article 21.5 Panel found that the exclusion constituted an export subsidy inconsistent with Article 3.1(a) of the SCM Agreement.[9] The Appellate Body affirmed this finding.[10] In the language of Article 21.5, the Article 21.5 Panel and the Appellate Body found that a measure taken to comply – the ETI Act – was inconsistent with a covered agreement.

10. However, while the Article 21.5 Panel found that the ETI tax exclusion constituted a prohibited export subsidy, it did not make a recommendation pursuant to Article 4.7 with respect

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findings that it wanted the Article 21.5 Panel to make, the only finding sought by the EC with respect to Article 4.7 related to the transition and grandfather provisions of section 5 of the ETI Act. *US – FSC (Article 21.5) (Panel)*, Annex A-1, para. 259, sixth bullet.

[7] *US – FSC (Article 21.5) (Panel)*, paras. 8.170 and 9.1(e). The transition provision is not at issue in the present proceeding, as the EC acknowledges that the provision has expired. Panel Report, Annex A-1, para. 36. Thus, the Panel's findings regarding section 5 are limited to the grandfather provision. Panel Report, para. 7.61.

[8] *US – FSC (Article 21.5) (AB)*, para. 256(f). The Article 21.5 Panel also found, and the Appellate Body affirmed, inconsistences with Article III:4 of the *General Agreement on Tariffs and Trade 1994* ("GATT 1994") and provisions of the *Agreement on Agriculture*.

[9] *US – FSC (Article 21.5) (Panel)*, paras. 8.75 and 9.1(a).

[10] *US – FSC (Article 21.5) (AB)*, para. 256(b).

to the ETI tax exclusion. For its part, the Appellate Body recommended that the DSB request the United States to bring the ETI measure into conformity with its obligations under Article 3.1(a) of the SCM Agreement, as well as provisions of the *Agreement on Agriculture* and Article III:4 of the GATT 1994.[11] However, the Appellate Body did not make any recommendation pursuant to Article 4.7 of the SCM Agreement with respect to the ETI tax exclusion. To the extent that the Appellate Body made a recommendation referencing Article 4.7, it recommended "that the DSB request the United States to implement fully the recommendations and rulings of the DSB in *US – FSC*, made pursuant to Article 4.7 of the *SCM Agreement*."[12] By citing to the original proceeding regarding the FSC tax exemption, the Appellate Body clearly was referring to the recommendation that the FSC tax exemption – not the ETI tax exclusion – be withdrawn.

11. Thus, neither the Article 21.5 Panel report nor the Appellate Body report contained a recommendation pursuant to Article 4.7 regarding the ETI tax exclusion. Accordingly, when it adopted the reports, the DSB did not make a recommendation or request pursuant to Article 4.7 regarding the ETI tax exclusion.

12. On October 22, 2004, the AJCA was enacted, which repealed the ETI tax exclusion. During the development of the AJCA, U.S. officials consulted closely with officials of the EC at all levels. U.S. officials explained the types of transition rules that are standard in U.S. tax legislation, and emphasized that such rules were essential in order to obtain passage of the repeal of the ETI tax exclusion by the U.S. Congress.

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[11] *US – FSC (Article 21.5) (AB)*, para. 257.
[12] *US – FSC (Article 21.5) (AB)*, para. 257.

13. With respect to the general transition provision, the EC indicated that its primary concern was that the transition period not exceed two years. Although there were legislative proposals then pending for transition periods as long as five years, in section 101(d) of the AJCA Congress accommodated the EC's concerns by limiting the transition period to a two-year period. During this period, taxpayers are eligible to exclude an amount of income based on a portion of what they would have been able to claim had the ETI tax exclusion not been repealed.

14. With respect to the grandfathering of pre-existing contracts, the EC officials never indicated to U.S. officials that they had a problem with a grandfather provision *per se*. Therefore, in section 101(f) of the AJCA, Congress limited the grandfather provision to certain transactions that occur pursuant to a binding contract (1) between the taxpayer and an unrelated party (2) entered into before September 17, 2003, and (3) which has been binding on both parties at all times since that date. Congress chose September 17, 2003, because that was the date legislation to repeal the ETI Act was submitted in the U.S. Senate. Because legislation to repeal the ETI tax exclusion previously had been submitted in the U.S. House of Representatives, as of September 17, 2003, taxpayers were on notice that there was legislation in both houses of Congress to repeal the ETI tax exclusion and that, when entering into new contracts, they no longer could count on the continued existence of the ETI tax exclusion. Adoption of an earlier date also would have been inconsistent with common practice regarding tax legislation that effectuates major changes in tax law. In any event, the cut-off date of September 17, 2003, significantly limited the availability of the grandfather provision, because the AJCA was not enacted until October 22, 2004.

15. With respect to the FSC provisions, the AJCA does not modify the FSC provisions repealed by the ETI Act or the transition rules for the FSC tax exemption contained in section 5(c) of the ETI Act. Nothing in the legislative language of the AJCA modifies, explicitly or implicitly, the transition rules in section 5(c).[13]

16. Sections 101(d) and (f) did not contain any surprises for the EC. Each element of these provisions was contained in either the House or Senate versions of the legislation, and each element had been explained to EC officials prior to passage of the AJCA. In particular, by limiting the general transition period to two years, Congress accommodated what EC officials had indicated was their primary concern, and, as indicated above, based on the EC representations Congress understood that this would provide a mutually satisfactory resolution to the dispute.

III. The Panel Erred in Concluding that the United States Failed to Implement a DSB Recommendation and Ruling under Article 4.7 to Withdraw Prohibited Subsidies

17. The Panel concluded that by enacting section 101 of the AJCA, the United States failed to implement fully DSB recommendations and rulings to withdraw prohibited subsidies,[14] finding that the "operative DSB recommendations and rulings" were "under Article 4.7 of the SCM Agreement.[15] The Panel based this conclusion on two fundamental errors.

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[13] *See* Panel Report, para. 7.61; *see* also Answers *of the United States to the Panel's Questions to the Parties in Connection with the Substantive Meeting*, July 11, 2005, paras. 3-7.

[14] Panel Report, para. 8.1. Oddly, the Panel appears to have proceeded with its reasoning and conclusions with almost no citation to the particular claims, arguments or submissions of the EC.

[15] Panel Report, para. 7.64.

18. The first fundamental error concerned sections 101(d) and 101(f) of the AJCA and the ETI tax exclusion, and consisted of the Panel's erroneous conclusion that there was a DSB recommendation under Article 4.7 of the SCM Agreement to withdraw the ETI tax exclusion. This fundamental error flowed from a series of separate, but interrelated, legal errors committed by the Panel. First, the Panel misinterpreted Article 4.7 of the SCM Agreement, essentially confusing the obligation on panels under that provision concerning the recommendation they are to make with obligations on Members provided in the covered agreements. Second, instead of applying the text of Article 21.5 of the DSU as written, the Panel improperly applied a standard of "fixing the problem." Third, in large part as a result of the first two errors, the Panel incorrectly concluded that the reports of the Article 21.5 Panel and the Appellate Body in the first Article 21.5 proceeding contained findings that the ETI tax exclusion was inconsistent with an obligation under Article 4.7 of the SCM Agreement to withdraw prohibited subsidies. Fourth, the Panel erred in finding that Article 4.7 of the SCM Agreement is part of the DSU. Fifth, the Panel justified its flawed interpretations of Article 4.7 and Article 21.5 on the erroneous conclusion that those interpretations were necessary in order to avoid undermining the WTO dispute settlement system.

19. The Panel's second fundamental error concerned the grandfather provision in section 5(c) of the ETI Act for the FSC tax exemption. Although there was a DSB recommendation under Article 4.7 to withdraw the measures providing for the FSC tax exemption, the Panel's terms of reference did not include as a measure section 5(c). Thus, in finding that section 5(c) constituted a failure to implement a DSB recommendation and ruling under Article 4.7 of the SCM

Agreement to withdraw the FSC measures,[16] the Panel exceeded its terms of reference and acted inconsistently with Articles 6.2 and 21.5 of the DSU.

A. The Panel Improperly Equated the Recommendation Called for in Article 4.7 with an Obligation on Members under the Covered Agreements

20. As noted above, the recommendation of the original Panel under Article 4.7 of the SCM Agreement pertained to the FSC tax exemption, and the only reference to Article 4.7 by the Appellate Body in the first Article 21.5 proceeding also pertained to the FSC tax exemption. There was no recommendation under Article 4.7 with respect to the ETI Act. Thus, in order to find in favor of the EC's claim that the AJCA's transition and grandfather provisions for the ETI tax exclusion constituted a breach of Article 4.7 of the SCM Agreement, the Panel had to create an obligation to withdraw the ETI tax exclusion within the meaning of Article 4.7.

21. The Panel did so by essentially transforming a DSB recommendation and ruling under Article 4.7 to withdraw the measures giving rise to the FSC tax exemption into a general obligation to withdraw prohibited subsidies. According to the Panel:

> A "measure taken to comply" should be *fully consistent* with a Member's WTO obligations. In terms of prohibited subsidy disputes, this requires the withdrawal of the prohibited subsidy. A Member's obligation to withdraw a prohibited subsidy is a constant. It remains until *full* implementation of DSB recommendations and rulings is achieved.[17]

According to the Panel, it is the withdrawal recommendation made in the original panel proceeding that becomes the "operative" recommendation in respect of all future measures taken

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[16] *See* Panel Report, paras. 7.61, 7.64.
[17] Panel Report, para. 7.31 (italics in original).

to comply.[18] Indeed, the Panel goes so far as to assert that there is a "continuing obligation" under Article 4.7 to withdraw "prohibited subsidies".[19]

22. Of course, this is not what Article 4.7 says. Instead, Article 4.7 provides as follows:

> If the measure in question is found to be a prohibited subsidy, the panel shall recommend that the subsidizing Member withdraw the subsidy without delay. In this regard, the panel shall specify in its recommendation the time period within which the measure must be withdrawn.

23. There are several aspects of Article 4.7 worth noting. First, Article 4.7, like its generic counterpart in the DSU – Article 19.1 – is directed to panels and not to Members. Thus, any obligations imposed by Article 4.7 are imposed on panels.

24. Second, in directing panels to recommend the withdrawal of the subsidy, Article 4.7 does not refer to any subsidy, but instead refers expressly to "the measure in question . . . found to be a prohibited subsidy". In the second sentence of Article 4.7, which deals with the time period for withdrawal of the measure, the reference to "measure" is clearly a reference to the "measure in question" as identified in the first sentence. In other words, the "measure" that is subject to the Article 4.7 withdrawal recommendation is the measure considered by the original panel, and not any future measure taken to comply that might be found to constitute a prohibited subsidy.[20] In the context of this dispute, "the measure in question" that had to be withdrawn was the FSC tax exemption.

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[18] Panel Report, paras. 7.36, 7.39.

[19] Panel Report, para. 7.56; *see also* Panel Report, para. 7.58.

[20] *Canada – Aircraft (Article 21.5) (AB)*, para. 33 ("Pursuant to [Article 4.7], the recommendations and rulings of the DSB in the original proceedings required Canada to 'withdraw' the measure 'found to be a prohibited export subsidy'.").

25. Thus, in finding that the adopted recommendation of the original panel under Article 4.7 applies to measures other than the FSC tax exemption, the Panel committed legal error by ignoring the plain text of Article 4.7. A conclusion to the contrary would run afoul of the prescription in both Article 3.2 and Article 19.2 of the DSU to the effect that recommendations of the DSB, panels and the Appellate Body cannot add to or diminish the rights and obligations provided in the covered agreements.

B. The Panel Mischaracterized the Task of an Article 21.5 Panel as One of Determining Whether a Member Has "Fixed the Problem"

26. A second error committed by the Panel was its mischaracterization of the task of a panel under Article 21.5 of the DSU. According to the Panel, that task is one of determining whether a Member has "fixed the problem".

27. Article 21.5 provides, in pertinent part, as follows: "Where there is a disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings such dispute shall be decided through recourse to these dispute settlement procedures ... ." Thus, an Article 21.5 panel can face two different tasks: (1) to determine whether measures to comply exist; and (2) if such measures do exist, whether they are consistent with covered agreements. Which of these tasks is before a particular panel, and the scope of a particular task, is determined in reference to the panel's terms of reference and the particular claims advanced by the parties to the proceeding.

28. The Panel, however, departed from the text and concluded that the task of a panel under Article 21.5 is "to decide a disagreement as to whether a Member has implemented DSB

recommendations and rulings and 'fixed the problem'."[21] How the Panel reached such a conclusion is unclear. Earlier in the report, the Panel announced that DSB recommendations and rulings adopted in an original panel proceeding "remain operative through compliance panel proceedings under Article 21.5 of the *DSU* until the 'problem' is entirely 'fixed', in terms of *full* withdrawal of the prohibited subsidy."[22] Later, the Panel asserted that the findings of the Article 21.5 Panel and the Appellate Body in the first Article 21.5 proceeding "confirmed that the United States had not 'fixed the problem' of WTO-inconsistency identified in the original proceedings by withdrawing fully the prohibited subsidy."[23]

29. The Panel's mischaracterization of the task of a panel under Article 21.5 is not merely a harmless exercise in literary license. By characterizing a panel's task as ensuring that a "problem" is "fixed", the Panel appears to have conferred on itself the authority to ignore the precise text of Article 4.7 of the SCM Agreement and Article 21.5, its terms of reference and the particular claims advanced by the complaining party and instead to define for itself the "problem". To reiterate, Article 4.7 requires a panel to recommend withdrawal of the measure "found to be a prohibited subsidy" – here, the FSC tax exemption. Article 4.7 does not go further and direct a panel to recommend that a Member refrain from enacting any new provisions that may provide a prohibited subsidy.[24] With respect to an Article 21.5 panel, its task, in this

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[21] Panel Report, para. 7.54.
[22] Panel Report, para. 7.36 (italics in original).
[23] Panel Report, para. 7.49.
[24] Of course, Members have an obligation under Article 3.2 of the SCM Agreement not to grant or maintain prohibited subsidies, but that is a different matter from the question of what a panel's task is.

context, is to determine whether the measure "found to be a prohibited subsidy" – here, the FSC tax exemption – has been withdrawn.[25]

30. However, according to the Panel, the "problem" addressed by the original Panel was not the FSC tax exemption, but rather "prohibited subsidies". From there, it was a short step for the Panel to conclude that the recommendation of withdrawal under Article 4.7 embraced not only the FSC tax exemption – the measure "found to be a prohibited subsidy" – but any future measures found to be prohibited subsidies.

31. However, by redefining the "measure" for purposes of the Panel's Article 4.7 recommendation as "prohibited subsidies,"[26] the Panel effectively and impermissibly blurs the distinction between the original measure and the measure taken to comply. As observed by the Appellate Body in the context of Article 21.5:

> In principle, a measure which has been "taken to comply with the recommendations and rulings" of the DSB will *not* be the same measure as the measure which was the subject of the original dispute, so that, in principle, there would be two separate and distinct measures: the original measure which *gave rise* to the recommendations and rulings of the DSB, and the "measures taken to comply" which are – or should be – adopted to *implement* those recommendations and rulings.[27]

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[25] Of course, an Article 21.5 panel may also have the task of determining whether measures taken to comply are consistent with covered agreements, including the SCM Agreement.

[26] The United States notes that the Panel's use of the term "prohibited subsidies" lacks precision since that term is simply a legal label assigned to a measure based on an application of the facts and the law.

[27] *Canada – Aircraft (Article 21.5) (AB)*, para. 36 (italics in original; footnote omitted).

C. The Panel Misinterpreted the Findings and Recommendations of the Article 21.5 Panel and the Appellate Body in the First Article 21.5 Proceeding

32. In an effort to bolster its assertion that the 2000 DSB recommendation under Article 4.7 in the original proceeding was not limited to the FSC provisions, the Panel asserted that the Article 21.5 Panel and the Appellate Body previously had found that the 2000 DSB recommendation applied to the ETI tax exclusion. In so doing, the Panel misinterpreted the findings and recommendations of the Article 21.5 Panel and the Appellate Body in the first Article 21.5 proceeding.

33. With respect to the Article 21.5 Panel, the Panel stated that it "expressly indicated the view that the original Article 4.7 recommendation 'remain[ed] operative'."[28] However, the Article 21.5 Panel's statement that the original Article 4.7 recommendation "remained operative" was made in response to a comment by the EC on the interim report in which the EC asserted that the Panel should not make new recommendations.[29] The only findings made by the Article 21.5 Panel concerning Article 4.7 of the SCM Agreement pertained exclusively to the FSC tax exemption and section 5 of the ETI Act. In the section of its report entitled "Transitional Issues", the Article 21.5 Panel found that the United States had not "*fully* withdrawn the FSC subsidies . . . and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 of the *SCM Agreement*."[30] This finding was repeated in paragraph 9.1(e) of the Article 21.5 Panel Report.[31] This was the *only* finding by the

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[28] Panel Report, para. 7.56.
[29] *US – FSC (Article 21.5) (Panel)*, para. 7.5.
[30] *US – FSC (Article 21.5) (Panel)*, paras 8.170 (emphasis added).
[31] *US – FSC (Article 21.5) (Panel)*, para. 9.1(e).

Article 21.5 Panel under Article 4.7. The Article 21.5 Panel did not find that any other portion of the ETI Act constituted a failure to withdraw the FSC subsidies within the meaning of Article 4.7.[32]

34. Moreover, the issue is not whether the 2000 DSB recommendation under Article 4.7 is "operative." Instead, the question is "operative with respect to what?" The United States does not dispute that the 2000 DSB recommendation under Article 4.7 is operative with respect to the FSC provisions – the measures that were "found to be a prohibited subsidy." However, the United States does dispute that the 2000 DSB recommendation is "operative" with respect to the ETI tax exclusion, a tax exclusion provided by legislation that did not even exist at the time of the 2000 DSB recommendation.

35. Turning to the report of the Appellate Body in the first Article 21.5 proceeding, the Panel describes the Appellate Body's recommendation as follows:

> For its part, the Appellate Body recommended "that the DSB request the United States to implement fully the recommendations and rulings of the DSB in *US – FSC*, made pursuant to Article 4.7 of the *SCM Agreement*." Furthermore, the Appellate Body recommended that the United States bring the ETI measure into conformity with its obligations under the relevant covered agreements, *including the SCM Agreement*. These adopted recommendations and rulings recognize the continuing non-withdrawal of the prohibited subsidies and the continuing obligation on the United States to withdraw them fully pursuant to Article 4.7 of the *SCM Agreement* and to bring itself into conformity with the relevant covered agreements, including the *SCM Agreement*.[33]

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[32] The fact that the findings of the Article 21.5 Panel under Article 4.7 were limited to the transition and grandfather provisions concerning the FSC tax exemption is not surprising. As noted above, in the first Article 21.5 proceeding, the only finding sought by the EC with respect to Article 4.7 related to the transition provisions for the FSC tax exemption contained in section 5 of the ETI Act.

[33] Panel Report, para. 7.56 (footnotes omitted; italics in original).

The Panel thus concludes that the Appellate Body found that the enactment of the ETI tax exclusion constituted a failure to implement the DSB recommendation under Article 4.7.

36. The problem with the Panel's conclusion is that it is inconsistent with what the Appellate Body found and recommended. Recall that the Appellate Body upheld, rather than modified, the findings of the Article 21.5 Panel under Article 4.7. In paragraph 256(f) of its report, the Appellate Body stated that it

> upholds the Panel's finding, in paragraphs 8.170 and 9.1(e) of the Panel Report, that the United States has not *fully* withdrawn the subsidies . . . and that the United States has, therefore, failed *fully* to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 of the *SCM Agreement* ... .[34]

As noted above, paragraphs 8.170 and 9.1(e) of the Article 21.5 Panel Report pertained to section 5 of the ETI Act and the transition and grandfather provisions for the FSC tax exemption, not the ETI tax exclusion.

37. In paragraph 257 of the Appellate Body report, the Appellate Body drew upon the language in paragraph 256 to recommend "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*."[35] Contrary to the Panel's conclusion, this recommendation had nothing to do with the ETI Act tax exclusion. Instead, the Appellate Body referenced the recommendations and rulings in *US – FSC*, which were made before the ETI Act tax exclusion even existed.

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[34] *US – FSC (Article 21.5) (AB)*, para. 256(f) (emphasis added).
[35] *US – FSC (Article 21.5) (AB)*, para. 257 (emphasis added).

38. In summary, the original Article 21.5 process resulted in two different sets of findings and recommendations.[36] One set pertained to section 5 of the ETI Act and the transition provisions for the FSC tax exemption. The other set pertained to the ETI tax exclusion. With respect to the ETI tax exclusion, while there were findings of inconsistency with provisions of several covered agreements, there was no finding or recommendation concerning Article 4.7. Thus, the Panel is simply incorrect when it concludes that the Appellate Body made a finding that the enactment of the ETI tax exclusion resulted in non-compliance with the DSB's recommendation under Article 4.7 to withdraw the FSC provisions.

D. The Panel's Interpretations of Article 4.7 of the SCM Agreement and Article 21.5 of the DSU Are Not Necessary to Avoid Undermining the WTO Dispute Settlement System

39. In order to justify its erroneous interpretations of Article 4.7 of the SCM Agreement and Article 21.5 of the DSU, the Panel suggested that if an original recommendation under Article 4.7 did not apply to new subsidies, this "might lead to a potentially never-ending cycle, whereby a

[36] In this regard, it is the view of the United States that Article 21.5 does not provide a mandate to make recommendations under Article 4.7 of the SCM Agreement. However, upon further reflection, the issues raised are of such a systemic nature that it would be better if they were not pursued in this appeal, given that, as discussed, there was no Article 4.7 recommendation after the original proceeding so that the situation does not actually present itself. Similarly, the Panel's reasoning in paragraphs 7.43 and 7.44 (See for example, the statements: "This necessarily implies that the textual reference in Article 21.5 of the DSU to have "recourse to these dispute settlement procedures" cannot include the requirement to, once again, formulate additional recommendations under Article 19 of the DSU (and/or Article 4.7 of the SCM Agreement)." and "If an Article 21.5 panel made a new recommendation under Article 19 which, upon adoption by the DSB, required an additional time period for implementation, this would give an additional period of time for the Member concerned to bring itself into conformity with the covered agreements.") raise a number of broad systemic issues. Those findings also would appear to have implications for the Appellate Body's recommendation in the first Article 21.5 proceeding, but that issue is not presented in this appeal.

Member continues to adopt non-compliant measures in order to win more time to comply with adopted DSB recommendations and rulings."[37] The Panel asserted that contrary interpretations "would entirely undermine the effective operation of the WTO dispute settlement system."[38]

40. The Panel erroneously believed that only an Article 4.7 recommendation could require an obligation on a Member to withdraw a measure found to be a prohibited subsidy. To the contrary, when as a result of an Article 21.5 proceeding the DSB rules that a measure taken to comply is inconsistent with a covered agreement, the Member maintaining that measure must withdraw it or otherwise bring it into conformity with the relevant covered agreement. Nothing in the DSU or any other covered agreement suggests otherwise.

41. In the context of this dispute, the first Article 21.5 proceeding resulted in adopted findings that the ETI tax exclusion was inconsistent with Article 3.1(a) of the SCM Agreement, Articles 3.3, 8 and 10.1 of the Agreement on Agriculture, and Article III:4 of the GATT 1994.[39] The United States does not contest that it was under an obligation to remedy these inconsistencies with its WTO Agreement obligations. However, the United States does disagree, for the reasons set forth above, that this obligation flowed from Article 4.7 of the SCM Agreement or the recommendation made thereunder.

42. The flaw in the Panel's reasoning is highlighted if one alters the sequence of events. Suppose that the findings of an original panel do not include findings of a prohibited subsidy, but instead include findings of inconsistency under some other provision of the SCM Agreement or

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[37] Panel Report, para. 7.46.
[38] Panel Report, para. 7.46.
[39] *US – FSC (Article 21.5) (AB)*, para. 257.

another covered agreement. The Member in question takes a measure to comply, but this new measure is found in an Article 21.5 proceeding to provide a prohibited subsidy. Neither the panel nor the Appellate Body makes a recommendation under Article 4.7 because a panel established under Article 21.5 of the DSU may not make such a recommendation.[40]

43. The Panel appears to suggest that in this scenario, the subsidizing Member would be under no obligation to do anything with respect to the measure found to be a prohibited subsidy because there would not be any recommendation under Article 4.7. However, such a conclusion would be incorrect. Notwithstanding the absence of a recommendation under Article 4.7, the subsidizing Member could not maintain that measure consistently with its WTO Agreement commitments and would instead have an obligation to render the prohibited subsidy WTO-consistent either by withdrawing the measure in question altogether or by modifying it so as to render it WTO-consistent.

E. The Panel's Findings Regarding the FSC Tax Exemption Were Inconsistent with Articles 6.2 and 21.5 of the DSU

44. In addition to its findings regarding the ETI tax exclusion, the Panel found that through the continued operation of section 5(c)(1) of the ETI Act the grandfathering of the FSC tax exemption with respect to certain transactions remained, and that nothing in the AJCA modified the grandfather provision.[41] The Panel then proceeded to find that this continued maintenance of

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[40] The United States would note that this is more than a purely hypothetical situation. This possibility already presented itself in the *Canada Dairy* dispute, where the Article 21.5 panel could have easily found that the replacement subsidies were prohibited export subsidies within the meaning of Article 3 of the SCM Agreement, even though as a result of the exercise of judicial economy there was no Article 4.7 recommendation in the original proceeding.

[41] Panel Report, para. 7.61.

the FSC tax exemption resulted in a failure on the part of the United States "to implement fully the operative DSB recommendations and rulings to withdraw the prohibited subsidies and to bring its measures into conformity with its obligations under the relevant covered agreements."[42]

45. It is fundamental that a panel, including a panel established under Article 21.5 of the DSU, may make findings only with respect to measures within its terms of reference. As demonstrated below, the Panel's terms of reference did not include section 5(c)(1) of the ETI Act or any continued use of the FSC tax exemption. Therefore, the Panel's findings regarding section 5(c)(1) and the grandfathering of the FSC tax exemption were inconsistent with Articles 6.2 and 21.5 of the DSU.

IV. The Panel Erred in Finding that Section 5(c) of the ETI Act Was Within Its Terms of Reference

46. The Panel erred in finding section 5(c) of the ETI Act to be within its terms of reference.[43] Section 5(c) was not within the Panel's terms of reference because it was not included in the EC panel request. The only provisions identified as objectionable by the EC in its panel request were sections 101(d) and (f) of the AJCA, which are the transition provisions for the ETI tax exclusion and which do not concern the FSC tax exemption. The EC panel request does not mention section 5(c) at all, let alone a failure to withdraw section 5(c).

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[42] Panel Report, para. 7.65.

[43] As previously noted, the transition provision of section 5(c) has expired and is not at issue in this dispute. Only the grandfather provision is at issue.

47. More specifically, Section 2 of the EC panel request states as follows:

> **2. THE SUBJECT OF THE DISPUTE**
>
> Section 101 of the JOBS Act purports to repeal the ETI Act (Section 101 (a)). However, at the same time, it effectively maintains part of the ETI Act tax exemptions for a transitional period up to the end of 2006 (Section 101 (d)). Furthermore, the repeal of the ETI Act does not apply to certain contracts, without any time limits (Section 101(f)).
>
> In the light of the above, the European Communities considers that Section 101 of the JOBS Act contains provisions which will allow US exporters to continue benefiting from the tax exemptions already found to be WTO incompatible (a) in the years 2005 and 2006 with respect to all transactions, and (b) for an indefinite period with respect to certain contracts. Thus, the United States has failed to implement the DSB's recommendations and rulings by failing to withdraw without delay schemes found to be prohibited subsidies under the *SCM Agreement* and to bring its legislation into conformity with its obligations under the *SCM Agreement*, the Agreement on Agriculture and the GATT 1994.[44]

48. Section 2 clearly identifies as the subject of the dispute sections 101(d) and (f) of the AJCA, referring to them as "provisions which will allow US exporters to continue benefitting from the tax exemptions ... ." However, the only tax benefit conferred by these provisions is in the form of limited continued use of the ETI tax exclusion. Therefore, the only fair reading of the EC panel request is that it was limited to the transition and grandfather provisions in the AJCA concerning the ETI tax exclusion, and not the provisions of section 5 of the ETI Act concerning the FSC tax exemption.

49. Notwithstanding the plain text of Section 2 of the EC panel request, the Panel found that the EC's panel request included section 5 of the ETI Act. The Panel's reasons for this finding do not withstand scrutiny.

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[44] WT/DS108/29, page 2.

50. First, the Panel asserted that Section 2 of the EC panel request presented section 101 of the AJCA as the subject of the dispute.[45] According to the Panel, because section 101 does not repeal section 5 of the ETI Act, section 5 is within the Panel's terms of reference. However, the EC panel request does not define as the subject of the dispute what is *not* contained in section 101. Instead, it complains about what section 101 *contains*; *i.e.*, that it "*contains* provisions which will allow US exporters to continue benefitting ... ." (Emphasis added).

51. Second, the Panel refers to the fact that elsewhere in the EC panel request there are references to the ETI Act in its entirety, as well as to the prior panel and Appellate Body reports adopted in this dispute.[46] However, the fact that the EC panel request describes the prior history of the dispute is neither surprising nor particularly informative as to the scope of the matter before the Panel.

52. Third, the Panel cited the fact that the EC panel request referred to a failure to withdraw prohibited subsidies and a failure to implement DSB recommendations and rulings from the original and first Article 21.5 proceedings.[47] However, these facts also are not particularly informative. Given that this dispute has involved two different measures found to be prohibited subsidies – the FSC tax exemption and the ETI tax exclusion – the mere reference to a failure to withdraw prohibited subsidies does not indicate whether the alleged failure pertains to the FSC tax exemption, the ETI tax exclusion, or both. Likewise, given the EC's claim that the ETI tax exclusion is subject to the Article 4.7 recommendation made by the original Panel, the reference

[45] Panel Report, para. 7.80.
[46] Panel Report, para. 7.82.
[47] Panel Report, para. 7.82.

to both the original and first Article 21.5 proceedings does not shed light on the scope of the second Article 21.5 proceeding.

53. Fourth, the Panel states that Article 6.2 of the DSU does not require identification of specific aspects of a specific measure, and does not prescribe the manner or method for identifying a specific measure at issue.[48] However, assuming for purposes of argument that the Panel's statement is correct, this does not mean that when a panel request expressly identifies the "subject of the dispute" and then defines the subject of the dispute by referring to the provisions *contained* in a law, a panel is free to ignore the matter or method actually used to identify the measures at issue.

54. In short, while the Panel paid lip service to the requirement that a panel request be read as a whole, in reality, it did not do so.[49] Reading a panel request as a whole does not mean automatically giving equal weight to every word or every section of the request. As is true for any exercise in interpretation, certain words or certain sections of a document may be more probative than others with respect to a particular issue. In this case, the section of the EC panel request entitled "THE SUBJECT OF THE DISPUTE" was, as the title suggests, more probative than other sections as to the measures covered by the panel request. This is particularly true since the main purpose of the panel request is to give notice to the other party and to other Members as

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[48] Panel Report, para. 7.82.

[49] The Panel states that the United States argued that the Panel should have looked exclusively at section 2 of the EC panel request. Panel Report, note 90. This statement is in error, as the United States clearly argued that the Panel should consider the request as a whole. *Comments of the United States on the EC's Answers to the Panel's Questions to the Parties in Connection with the Substantive Meeting*, July 15, 2005, para. 22. However, the U.S. position was and is that in reading the request as a whole, section 2 must be given considerable weight.

to the "matter" that is the subject of the dispute. Members and the other party are not properly given notice if the requesting party is free to specify that one set of measures is the "subject of the dispute" while bringing in a whole separate set of measures by inference from a passing reference in a background section of the request. Indeed, under the Panel's approach, the reference in the background section to "the ETI Act" means that the ETI Act in its entirety was within the Panel's terms of reference, including provisions that had never been the subject of dispute and that had nothing to do with a claim of prohibited subsidies.

55. In addition, reading a panel request as a whole does not mean ignoring relevant aspects of the request. To reiterate, section 2 of the EC panel request complained about provisions *contained* in section 101 of the AJCA, not provisions that were *not* contained in section 101, a fact that the Panel ignores. Moreover, nowhere in the EC panel request is section 5 of the ETI Act even mentioned, a fact that the Panel also ignores.

56. Finally, the Panel justified the inclusion of section 5(c) on the grounds that, in its view, the United States was not prejudiced by a lack of clarity in the EC panel request.[50] However, where, as here, a matter is not within a Panel's terms of reference because a claim, a measure or both are not included in the panel request, there is no need for a responding Member to show prejudice. For example, in *US – OCTG from Mexico*, the panel found that a particular claim by Mexico was not within its terms of reference, even though the United States had not made any preliminary objection to that effect. According to the panel, "we consider this issue to be 'a defect that, by its very nature, deprives a panel of its authority to deal with and dispose of a matter, and that,

[50] Panel Report, paras. 7.83-7.86.

accordingly, ... [it is] one which a panel must examine even if both parties to the dispute remain silent thereon."[51] Thus, without considering whether or not the United States had been prejudiced, the panel declared that it would make no findings with respect to the claim in question.

57. In summary, under Article 7.1 of the DSU, the Panel's terms of reference were defined by the EC's panel request under Article 6.2 of the DSU. Any fair reading of the EC panel request as a whole leads to the conclusion that the EC panel request did not include section 5 of the ETI Act and the grandfather provision for the FSC tax exemption. Therefore, the Panel's conclusion to the contrary is inconsistent with Articles 6.2 and 7.1 of the DSU.[52]

V. Conclusion

58. For the foregoing reasons, the United States respectfully requests that the Appellate Body find that the findings and conclusions of the Panel listed in the U.S. Notice of Appeal and further discussed herein are in error, and that the Appellate Body reverse those findings.

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[51] *US – OCTG from Mexico (Panel)*, para. 7.20 (brackets and ellipses in original).

[52] Indeed, the Panel's interpretative stretch to bring section 5(c) within its terms of reference is particularly puzzling given the Panel's recognition that the EC "'is not seeking repetition of' the findings, recommendations and rulings 'already made in previous Reports and by the DSB in this dispute'." Panel Report, para. 3.2. The first Article 21.5 proceeding resulted in recommendations and rulings regarding section 5(c) to which this Panel's findings add nothing.