TABLE OF CONTENTS

I. INTRODUCTION AND OVERVIEW 1

II. FACTUAL BACKGROUND 8
- A. National Tax Systems Vary in Their Approaches to Foreign-Source Income and Double Taxation 8
  - 1. Differing Approaches to Taxing Foreign-Source Income 9
  - 2. Methods of Avoiding Double Taxation 10
  - 3. The U.S. Tax System 14
    - a. The Definition of "Gross Income" Is the Starting Point for Demarcating the Jurisdictional Limits of U.S. Taxation of Income 14
    - b. U.S. Treatment of Foreign Versus Domestic Income 16
  - 4. European Tax Systems 17
- B. The GATT's Treatment of Tax Exemptions for Foreign-Source Income 19
  - 1. The DISC 19
  - 2. GATT Article XVI:4 and the Illustrative List of Export Subsidies 20
  - 3. The *Tax Legislation* Panel Found That the Basic Features of a Territorial Tax System Inherently Subsidize Exports 23
  - 4. Footnote 2 of the Illustrative List of the 1979 Subsidies Code 24
  - 5. The 1981 Understanding Overturned the Legal Findings of the *Tax Legislation Panel*, But Not the Panel's Factual Findings 26
- C. The FSC 29
- D. The ETI Act 32
  - 1. Objectives of the Act and Its Effect on the U.S. Tax System 32
    - a. Compliance with the Panel and Appellate Body Reports 32
    - b. A New U.S. Approach to Taxation of Foreign Income 33
    - c. A Measure to Avoid Double Taxation 34
  - 2. Excluded Extraterritorial Income 34
    - a. The Foreign Nature of Excluded Extraterritorial Income 35
    - b. Calculating the Exclusion 37
  - 3. Evenhanded Treatment of Taxpayers 38
  - 4. The Act's Effective Date and Transition Rules 39
- E. How the ETI Act Differs from the FSC Provisions 40
  - 1. The FSC Was a Relatively Narrow Exception 40
  - 2. The Act Makes a Fundamental Shift in U.S. Tax Treatment of Extraterritorial Income 42
  - 3. Unlike the FSC, the Act Does Not Require Exportation 42
- F. Comparison of the ETI Act and European Territorial Systems 43

III. ISSUES RAISED IN THIS PROCEEDING 46

IV. LEGAL ARGUMENT 47

A. The Panel Erred in Finding that the ETI Act Confers a Subsidy 47
1. The Legal Standard Under Article 1.1(a)(1)(ii) 47
2. The Panel Misapplied the Appellate Body's Comparison Test 48
a. The Panel Misconstrued the Concept of "Gross Income" 49
b. The Panel Cannot Save Its Analysis By Creating a "Specific Versus General" Exclusion Distinction 51
c. The Panel's "Overall Rationale and Coherence" Corollary Also Does Not Save Its Analysis 52
d. The Panel's New Corollaries to the Appellate Body's Standard Will Lead to "Perilous Systemic Implications" 54
e. The Panel's New Corollaries Would Render European Territorial Tax Exemptions Subsidies 56
3. The Panel Failed to Apply the "But For" Test 58
4. The Panel Erroneously Found That Extraterritorial Income Would Otherwise Be Subject to Tax as Gross Income 59
B. The Panel Erred in Finding That the ETI Act's Exclusion Is Contingent Upon Export Performance Under Article 3.1(a) of the SCM Agreement 60
1. The Meaning of Article 3.1(a) 61
2. The Panel Expanded the Scope of Article 3.1(a) Beyond Its Terms 63
a. The Availability of a Subsidy to Purely Domestic Transactions Is Irrelevant Under Article 3.1(a) 63
b. Article 3.1(a) Does Not Prohibit Subsidies That Benefit Exporters If Conferred Through Export-Neutral Principles 66
i. It Is Immaterial Under Article 3.1(a) That Subsidy Beneficiaries Can Choose to Export 66
ii. Exportation Is "One of Several Other Conditions" Only Where It Is a Mandatory Condition 69
iii. An Expansion of Beneficiaries Can Cure an Export-Contingent Subsidy 70
3. The Panel Misconstrued the ETI Act By Considering Its Exclusion Only as It Relates to U.S.-Produced Goods 73
C. The Panel Erred in Finding that the ETI Act Is Not a Measure to Avoid Double Taxation Under the Fifth Sentence of Footnote 59 78
1. The ETI Act Is a Measure to Avoid Double Taxation Under Footnote 59 80
a. Measures Deemed Not to Be Export Subsidies in Annex I Are Not Prohibited by the SCM Agreement 80
b. Paragraph (e) Governs Export-Specific Income Tax Measures . . 81
c. Footnote 59 Qualifies Paragraph (e) 82
d. The Meaning of the Fifth Sentence of Footnote 59 83
e. Measures to Avoid Double Taxation Under Footnote 59 85
f. The ETI Act Was Designed to Avoid Double Taxation 87
g. The Act's Exclusion Is Akin to Territorial Exemptions Under EC Member State Tax Systems 89
2. The Panel Erroneously Imposed on the United States the Burden of

Proving that the ETI Act Is a Measure to Avoid Double Taxation Under Footnote 59 90
3. The Panel's Four New Principles and New Standard of Review Cannot Be Derived from the Ordinary Meaning of the Fifth Sentence of Footnote 59 94
a. Contrary to the Panel's Assertion, a Measure to Avoid Double Taxation Need Not Apply to All Doubly Taxed Income 94
b. Contrary to the Panel's Assertion, a Measure to Avoid Double Taxation Need Not Apply With Strict Precision 96
c. Contrary to the Panel's Assertion, a Measure to Avoid Double Taxation Need Not Have a "Permanent Establishment" Requirement 99
d. Contrary to the Panel's Assertion, It Is Irrelevant that WTO Members Have Tax Treaties 101
e. Footnote 59 Does Not Entail a "Reasonable Legislator" Standard 103
4. The Appellate Body Should Provide Clear Guidance 106
D. Should the Appellate Body Reverse the Panel and Find that the ETI Act Is a Measure to Avoid Double Taxation Within the Meaning of the Fifth Sentence of Footnote 59, It Should Complete the Panel's Analysis and Find that the ETI Act Is Not a Prohibited Subsidy by Virtue of Footnote 5 of the SCM Agreement 108
E. The Panel Erred in Finding that the ETI Act Is Inconsistent with U.S. Obligations under Articles 8 and 10.1 of the Agreement on Agriculture 110
F. The Panel Erred in Finding That the ETI Act is Inconsistent With Article III:4 of GATT 1994 111
1. The Measure at Issue 111
2. The Meaning of Article III:4 112
3. The Panel Improperly Found That the 50 Percent Rule "Affects" the Use of Imported Products in the United States 113
a. The Panel Failed to Demonstrate a Necessary Relationship Between the 50 Percent Rule and the Use of Imported Products in the United States 113
b. Unlike Earlier Cases Involving Measures That Dealt With Discriminatory Treatment Accorded to Imports, the ETI Act's 50 Percent Rule Is a Measure of General Application That Is Not Directed Against Imports 114
c. The Panel Improperly Held That "Less Favorable" Treatment of Imports Necessarily Exists Even When a Requirement Can Be Satisfied by Other Means 115
4. The Panel Erred in Finding that the 50 Percent Rule Accorded Treatment "Less Favorable" to Imported Products Than to Like Products of United States Origin 116
a. The Panel Failed to Follow the Methodology Set Forth by the Appellate Body in *Korea Beef* 116
b. The Panel's Findings Are Not Supported by Article III:4 118

G. The Panel Erred in Finding That the ETI Act's Transition Rules Are Inconsistent with the Full Withdrawal of the FSC Subsidies 119

V. CONCLUSION 120

I. INTRODUCTION AND OVERVIEW

1. The United States has appealed the report of the Panel in this dispute[1] to the Appellate Body because the Panel erred in its findings and analysis. In condemning the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 ("the ETI Act" or "the Act") as no better than its predecessor, the Panel made findings that are over broad, devoid of standards on central issues, contrary to established WTO principles, and inconsistent with the direction and the details of the original findings made by the Panel and the Appellate Body in this dispute.

2. As a broader matter, the Panel's findings and analysis have far-reaching institutional implications. The Panel's central findings, if correct, lead inescapably to the conclusion that WTO subsidy rules, as applied to taxes, are not neutral with respect to tax regimes. Instead, as construed by the Panel, the subsidy rules either deem most tax regimes as conferring prohibited subsidies, or, alternatively, they discriminate against Members with worldwide tax systems by requiring them either to go without the export incentives that are inherent in territorial tax systems or to face WTO consequences for seeking to achieve tax parity. Neither result was intended by the drafters of the WTO Agreement, and the United States believes that neither result is mandated by WTO rules, properly interpreted. It is essential to the present and future operation of the WTO as a constructive force for world trade that the Appellate Body face the startling implications of the Panel's analysis and reverse the Panel's findings.

3. **The Panel's Specific Findings.** The ETI Panel Report is analytically flawed and, if not corrected, would expand the meaning of provisions of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement"), and improperly alter the rights and obligations of

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[1] *United States - Tax Treatment for "Foreign Sales Corporations" - Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/RW, Report of the Panel circulated 20 August 2001 ("ETI Panel Report").

WTO Members. As discussed in detail in Section V below, the failings of the Panel report are several:

- The Panel has applied the concept of "revenue foregone" so that *any* deviation from a baseline taxing concept like "gross income" is a "subsidy" under Article 1 of the SCM Agreement. In reaching this result, the Panel devised two new standards that depart from the standard previously articulated by the Appellate Body; namely, finding subsidies wherever tax exclusions are "specific" rather than general or wherever they lack – in the view of the Panel – an "overall rationale and coherence."

- The Panel has given an extraordinarily expansive reach to the term "export subsidy" based on two new doctrines devised by the Panel: (1) a new reverse national treatment requirement under which domestic sales must be treated the same as export sales for tax purposes; and (2) a new test under which a tax exclusion becomes a prohibited export subsidy if some subset of users realizes a benefit by exporting.

- Finally, the Panel extrapolated from the fifth sentence of footnote 59 to the SCM Agreement four new principles regarding the way countries can institute measures to avoid double taxation, as well as a new and unique standard of review. None of these principles can be found in the text of the fifth sentence or the SCM Agreement. To make matters worse, the Panel has said that none of its newly articulated principles is dispositive. Instead, the standard applied by the Panel leaves Members with no guidance as to the boundaries of the fifth sentence of footnote 59.

4. In a stark reversal from the original *FSC* report, which was highly textual and which relied on a literal application of treaty terms, the ETI Panel Report rests on grounds that find no support in the text of the covered agreements, that provide no meaningful guidance for WTO Members, and that scrupulously avoid dealing with the sweeping implications they carry.

5. **The Broader Implications of the Panel's Findings.** The Panel's analysis necessarily carries with it one of two broad implications, neither of which would be consistent with the intention of the drafters of the WTO provisions the Panel applied.

6. One apparent implication of the ETI Panel Report is that European tax systems that incorporate territorial principles would also be inconsistent with the broad findings articulated by the Panel. This was the result reached in 1976 in the *Tax Legislation Cases* that found both the U.S. DISC provisions and the territorial limits of several European tax systems to be subsidies. This result caused an impasse in the GATT that was broken only by a 1981 GATT Council Understanding that resolved the issue. That resolution held until the EC challenged the FSC provisions some 16 years later.

7. This concern that arguments being made by the EC would apply with equal force to benefits inherent in most European tax systems was raised in arguments the United States made before the Panel, both in the prior proceeding regarding the FSC and in the instant proceeding involving the ETI Act. With respect to numerous EC arguments, the United States pointed out that if the FSC or the ETI Act were deemed WTO-inconsistent, then corresponding tax benefits conferred by territorial limitations in European systems must be as well. In the Article 21.5 panel hearing, the Panel finally engaged on this issue, and repeatedly questioned EC representatives regarding whether the arguments they were advancing against the United States would not apply with equal force to European tax systems.

8. In its report, however, the Panel completely avoided this issue of symmetry or tax equity, devoting only one sentence in a footnote to a summary of the U.S. assertion and the EC reply. The Panel's silence leaves unresolved questions that are critically important to understanding the meaning of the WTO rules and to determining what would be a WTO-consistent response.

9. The alternative implication of the Panel report – that a worldwide tax system cannot adopt measures to emulate the tax benefits that territorial systems inherently confer on exports – would mean that the WTO subsidy rules, as construed by the Panel, do indeed incorporate a bias favoring one type of tax system over another. Both the EC's submissions and the Panel itself disavow that this is the necessary implication of the Panel's findings. This is belied, however, by the comments of several European officials whose response to this concern is simply that the United States is not required to have the tax system that it has. If the United States were to adopt a European-style tax system, the comments go, then there would be no issue. Putting aside the question of whether European-style systems actually are protected under the Panel's analysis, this response confirms that the Panel's findings do necessarily suggest that the WTO rules carry a bias in favor of some tax systems over others.

10. The obvious problem with this "just-do-it-our-way" solution is that it contradicts the unambiguous statement by the Appellate Body in its prior report in this dispute that WTO obligations do not "compel Members to choose a particular kind of tax system." As the Appellate Body emphasized, so long as Members respect their WTO obligations, each "Member, in principle, has the sovereign authority to tax any particular categories of revenue it wishes" and "*not* to tax any particular categories of revenues." For the reasons discussed below, however, the ETI Panel Report effectively would foreclose the sovereign right of the United States to adopt a tax system that starts with a worldwide principle but excludes categories of income similar to those not taxed by territorial systems.

11. The discrepancy between the prior statements of the Appellate Body and the Panel's legal analysis becomes even more obvious when one takes into account the economic realities of different tax systems in the real world. No developed country has a purely territorial or purely worldwide tax system. Instead, all systems tax some, but not all, categories of "offshore income." It obviously is possible to reach approximately the same point by starting with territorial limits and reaching out to tax certain categories of offshore income or, alternatively, by starting with a worldwide tax rule and excluding certain categories of offshore income. If one approach is acceptable and the other unacceptable under WTO rules, then WTO rules will have elevated form over substance and reached a result that cannot command broad acceptance among WTO Members.

12. **The Burden on the Appellate Body.** The Appellate Body bears a substantial burden in this case. The Appellate Body must, of course, interpret and apply the rules that the Members negotiated and adopted. The Appellate Body is not free to effectively amend provisions of the SCM Agreement, even if those provisions prove to be flawed or unavoidably inconsistent with basic GATT and WTO principles of reciprocity and non-discrimination.

13. The Appellate Body does, however, have the latitude and the obligation to deal with specific legal errors and to interpret provisions of the SCM Agreement and other WTO agreements in a manner that is faithful to the fundamental GATT principle of non-discrimination and is consistent with the intention of the drafters of those provisions. As argued below, the United States believes that the rules of the SCM Agreement, if read in accordance with the correct method of interpretation under public international law, do not mandate a result that

discriminates among different types of tax systems and that is at odds with the object and purpose of the drafters of the WTO Agreement.

14. If, however, the Appellate Body were to conclude that existing WTO rules permit the export incentives inherent in territorial tax systems but disallow corresponding incentives when adopted in a worldwide tax system, the United States believes that it would be incumbent upon the Appellate Body to address this fact and the implications that would go with it. If the rules are inconsistent with the principle of non-discrimination or with the drafters' intention that trade rules should be neutral as to the choice of a tax system, it is appropriate for the Appellate Body to say so. If the rules foreclose any adjustment to a worldwide tax system that would replicate incentives inherent in territorial tax systems, it is important that the Appellate Body acknowledge that.

15. A failure by the Appellate Body to address the underlying issue of tax symmetry – the issue that has fueled this dispute for 30 years – would render a fiction the supposed freedom proclaimed by the Appellate Body of each Member "to choose a particular type of tax system." If the WTO rules are biased against one type of tax system, then the choice is not free. However, if this is, indeed, the situation, then it is better to have the Appellate Body say so clearly than to leave the outcome in doubt.

16. **False Issues.** The United States also wishes to state expressly what, in its view, some of the issues or dynamics of this case are *not.* Although the ETI Act is obviously at issue in this case, it is not the details of the ETI Act that are at the root of this protracted conflict. The central issue, which is presented by the ETI Act in much the same way that it was presented by the FSC

and the DISC, is how can a worldwide tax system incorporate benefits comparable to those found in territorial tax systems without offending WTO rules, which are intended to be neutral with respect to a Member's choice of tax systems. The intricacies of the 50 percent rule regarding certain foreign value or the ETI Act's transition rules, while important, are distinctly secondary to the central issues that relate directly to equity between different tax systems.

17. In addition, this is not a case in which the United States implicitly takes the view that simply because the Panel's report was adverse to the United States, the rules or the system under which it is generated must be flawed. The United States does not insist that it should prevail in every case or that when it does not, there must be some systemic flaw responsible for the outcome. The record of the United States to the contrary is quite clear. Not only does the United States have a strong record of accepting adverse WTO findings but, in this case, the United States also made an extraordinary effort in the midst of a Presidential election to make fundamental changes to its tax laws that were designed to bring U.S. law into compliance with WTO rules.

18. Rather, the conundrum of this case is more complex. It is that if the dispute settlement process produces a final result in this dispute that enshrines a fundamental inequity, the resolution of this conflict will not have been advanced. Instead, the outcome likely will be a proliferation of disputes, as one Member challenges the tax system of another Member through either WTO dispute settlement or domestic countervailing duty proceedings. Therefore, the underlying issue of tax equity must be addressed and resolved.

19. The United States believes that it is incumbent on the Appellate Body to provide meaningful guidance on the central issues in this case. Whether the next step in this controversy is a re-examination of the SCM Agreement provisions under which this dispute is being adjudicated, challenges to the corresponding benefits provided by territorial tax systems, further changes to U.S. law, or simply a contest over what, if any, trade effects these widely dispersed tax benefits have, it is essential that the Appellate Body provide the parties with principled guidance.

II. FACTUAL BACKGROUND

20. This appeal is the latest round in a dispute that has divided Europe and the United States for nearly thirty years. It concerns fundamental differences over the way countries structure their tax systems and the manner in which they tax – or refrain from taxing – income earned outside their borders. It also demonstrates some of the challenges faced by the multilateral trading system in dealing with the intersection of trade rules and the taxation of international income. This section explains the origins of the dispute, its treatment under the GATT system, how it led to enactment of the ETI Act, and how the ETI Act replicates aspects of European and other tax systems common around the world.

A. National Tax Systems Vary in Their Approaches to Foreign-Source Income and Double Taxation

21. The taxation systems of the nations of the world are diverse. The U.S. tax system is different from the tax regimes of EC member States. The tax regimes of EC member States differ markedly among themselves, and the tax regimes of other WTO Members also are unique.

However, despite the differences among the world's numerous and varied methods of taxation, certain common characteristics exist.

1. Differing Approaches to Taxing Foreign-Source Income

22. With regard to taxation of income, there are two generally recognized bases for imposition of a tax: jurisdiction over a party earning income (the country of residence of the taxpayer), and jurisdiction over the activity or transaction that produces the income (the country of source of the income).[2] Under the residence principle, a country generally taxes the income of persons subject to its jurisdiction irrespective of where those persons earn income. This is sometimes referred to as a worldwide system of taxation. Under the source principle, a country taxes income earned within its borders. This is known as a territorial system of taxation. Most countries employ a mix of both principles.[3]

23. Because WTO Members and other countries apply different tax regimes, and rely on the foregoing principles in their own different ways, the potential for double taxation can arise when two sovereigns claim the right to tax the same income of the same taxpayer. This can occur whenever a transaction involves two countries, because one country's source-based tax on income earned within its borders may overlap with another country's residence-based tax on the same income earned by one of its residents.

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[2] *United States - Tax Treatment for "Foreign Sales Corporations"* ("*FSC (Panel)*"), WT/DS108/R, Report of the Panel, as modified by the Appellate Body, adopted 20 March 2000, para. 4.312, note 146, *citing to* Edward H. Gardner, *Taxes on Capital Income: A Survey*, in George Kopits, ed., *Tax Harmonization in the European Community: Policy Issues and Analysis*, IMF Occasional Paper No. 94 (Washington, D.C. 1992), page 52.

[3] *Id.*; *see also* EC Second Written Submission to the *FSC* Panel, Annex EC-2 (hereinafter "Annex EC-2"), para. 4 (Exhibit US-5).

24. The potential for this overlap is significant with regard to exports, because exports, by their very nature, involve cross-border sales, a foreign source of payment, and at least some economic activities in two or more countries. To the extent that exporters engage in economic activities outside their country of residence – *e.g.*, through negotiation, marketing, sales, or distribution activities – they may be subject under the source principle to taxation on income attributable to such foreign activities by the countries in which those activities occur. At the same time, that same export-related income may be subject to taxation by the exporter's home country under the residence principle.[4]

2. Methods of Avoiding Double Taxation

25. If not remedied, the problem of double taxation can have significant negative consequences for cross-border trade flows.[5] Consequently, two fundamental approaches have developed for the avoidance or mitigation of double taxation of income earned in one country by the resident of another country: the exemption method and the credit method. These two approaches are employed by a country either unilaterally in its domestic laws or bilaterally in its income tax treaties with other countries, especially its major trading partners.[6]

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[4] As the EC itself has pointed out, double taxation also can occur where two or more countries assert taxing jurisdiction on the basis of source (or residence), due to the use of different criteria for defining the scope of their respective jurisdictions. Annex EC-2, note 3.

[5] As the EC told the *FSC* panel, "The necessity for relief is clear on grounds of equity and economic policy." Annex EC-2, para. 5.

[6] As the EC has stated, "Tax treaties prevent double taxation by allocating the right to tax various categories of income between the two countries concerned." Annex EC-2, para. 8.

26. In the context of bilateral agreements, the exemption and credit methods are reflected in and explained by the OECD and UN Model Tax Conventions,[7] which have been used in some form by almost all WTO Members as bases for bilateral tax agreements.[8] The Commentary to the *OECD Model Tax Convention* explains that both the exemption method and the credit

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[7] *Model Tax Convention on Income and Capital* (OECD 1997) ("*OECD Model Tax Convention*") (Exhibit US-7); *United Nations Model Double Taxation Convention Between Developed and Developing Countries*, Pub. No. ST/ESA/102 (1980).

[8] For example, the *OECD Model Convention* provides in pertinent part as follows:

METHODS FOR ELIMINATION OF DOUBLE TAXATION
Article 23A
EXEMPTION METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

* * * * *

Article 23B
CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:
   a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;
   b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

   Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

method serve to avoid double taxation.[9] The Commentary further acknowledges that countries are free to adopt one or both methods, and that the means by which they are implemented vary from country to country.[10]

27. Under the exemption method, a country avoids double taxation by not taxing income earned by taxpayers outside the country's territorial borders. Where corporate income is at issue, exemption may be applied without regard to whether the income in question is earned directly by a domestic corporation or by a foreign subsidiary or a foreign branch of a domestic corporation. In the case of a foreign subsidiary, this is accomplished in two steps: (1) by exempting the income earned by that subsidiary, and (2) by exempting whatever portion of that income is returned to the shareholder (the domestic parent company) as a dividend. The exemption method thus avoids double taxation on an *ex ante* basis; *i.e.*, the exemption is provided whether or not the taxpayer has actually been required to pay a tax to another country on that income. And, as the EC has acknowledged, "To the extent that foreign taxes are lower than domestic taxes, resident taxpayers with exempt foreign-source income are treated more favourably than other residents."[11]

28. The exemption method is a primary feature of the territorial system of income taxation. Because income earned outside such a country's borders is exempt from taxation in that country,

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[9] *OECD Model Tax Convention*, page C(23)-3 (Exhibit US-7) ("Articles 23A and 23B apply to the situation in which a resident of State R [residence] derives income from, or owns capital in, the other Contracting State S [source] . . . and that such income or capital, in accordance with the Convention, may be taxed in such other State S.").

[10] *Id.*, page C(23)-14 ("In view of the wide variety of fiscal policies and techniques in the different States regarding the determination of tax, especially deductions, allowances and similar benefits, it is preferable not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique.").

[11] Annex EC-2, para. 6.

that income cannot be subject to double taxation. In other words, if Country A taxes income purely on a territorial basis, it will not tax any income earned in Country B, and thus income earned in Country B by residents of Country A will not be subject to double taxation.[12] In the context of corporate taxation, however, a large number of countries, including many EC member States, tax income on a worldwide basis subject to a limited or partial exemption.[13]

29. Under the credit method, a country taxes the worldwide income of its residents, but allows a credit against domestic income tax for certain taxes paid by the taxpayer to a foreign country on the foreign-source portion of its income. The credit approach generally avoids double taxation on an *ex post* basis, meaning that the extent of relief provided by the country of residence is determined only after a taxpayer pays taxes in a foreign country. It is the foreign taxes actually paid that, subject to certain limitations and conditions, provide the baseline for determining the relief provided by the country of residence. Under the credit method, it is the higher of the source country tax rate and the residence country tax rate that prevails.

30. Although the credit method is used principally by countries that apply the worldwide system of income taxation, in some cases a combination of the exemption and credit methods is used, with different methods applying to different types or categories of income.

[12] As the EC has observed, "Countries that apply a territorial system, of course, do not need special provisions for the avoidance of double taxation, since in the exercise of their residence jurisdiction, they do not tax foreign source income." Annex EC-2, para. 5.

[13] *See, e.g.,* Annex EC-2, paras. 6, 7 and 10.

3. The U.S. Tax System

a. The Definition of "Gross Income" Is the Starting Point for Demarcating the Jurisdictional Limits of U.S. Taxation of Income

31. The United States Internal Revenue Code ("IRC" or "the Code") taxes a wide range of income, but its reach is not unlimited. The scope of the IRC with respect to income taxes is largely defined by Subtitle A, Chapter 1, Subchapter B, which runs from sections 61 through 291 of the Code. Few, if any, of the specific provisions of Subchapter B operate in isolation from its other provisions. Indeed, in many respects, they can be fully or properly understood only in context with the rest of the subchapter and, in some cases, with provisions outside the subchapter.

32. The starting point for demarcating the jurisdictional bounds of U.S. taxation in relation to income taxes is the first section of Part I of the subchapter – IRC Section 61 – which provides in relevant part that "gross income means all income from whatever source derived".[14] Section 61 goes on to list 15 examples of income that are deemed to be "gross income". These include compensation for services, interest, royalties, rents, dividends, and pensions. The types of income that Section 61 encompasses are further set out in Part II of Subchapter B, which consists of IRC Sections 71 through 90. These sections detail to what extent items such as alimony and separate maintenance payments, annuities, proceeds of endowment and life insurance contracts, and prizes and awards are "gross income" within the meaning of Section 61. Some of these

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[14] Exhibit US-4.

provisions are relatively short and straightforward,[15] but most are complex and contain exceptions and conditions.[16] Almost all are highly specific, addressing particular types of income that require detailed discussion.

33. Section 61 makes clear, however, that "gross income" is not unlimited. It states that "gross income" is income "from whatever source derived" "except as otherwise provided in this subtitle". Subtitle A addresses "Items Specifically Excluded from Gross Income" in Part III of Subchapter B of Chapter 1. Part III is comprised of IRC Sections 101 through 139 and deals with such issues as death payments, gifts and inheritances, compensation for injuries or sickness, amounts received under accident and health plans, contributions by employer to accident and health plans, and other items. The exclusion for extraterritorial income created by the ETI Act is found in Section 114 within Part III. Like the inclusions identified in Part II, some of the exclusions are relatively simple and straightforward,[17] but most are complex and involve conditions and exceptions.[18]

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[15] *See, e.g.,* IRC § 88 (Certain Amounts with Respect to Nuclear Decommissioning Costs). In this regard, the EC invited the Panel to consult provisions of the IRC other than those expressly cited by the EC by referring the Panel to the Internet website <www.fourmilab.ch/ustax/www/contents.htlm>. *Answers of the European Communities to the Questions of the Panel*, ETI Panel Report, Annex F-2, para. 115, note 49. A comparable website maintained by the U.S. Government Printing Office is <www.access.gpo.gov/uscode/uscmain.html>.

[16] *See, e.g.*, IRC § 72 (Annuities; Certain Proceeds of Endowment and Life Insurance Contracts).

[17] *See, e.g.,* IRC § 115 (Income of States, Municipalities, etc.).

[18] *See, e.g.,* IRC § 105 (Amounts Received under Accident and Health Plans).

b. U.S. Treatment of Foreign Versus Domestic Income

34. Prior to the adoption of the FSC provisions and then the ETI Act, the U.S. tax system was generally described as operating on a worldwide basis, but this was true only in part. The United States asserts the right to tax all income earned by U.S. citizens and residents (including U.S. corporations), as well as income earned by nonresidents within U.S. borders. Because the United States defines the residence of corporations for tax purposes on the basis of place of incorporation, a U.S. corporation is defined as one that is organized under the laws of one of the 50 States within the United States or the District of Columbia.[19] Absent the FSC or the ETI Act, the U.S. tax system would treat income earned by U.S. corporations outside the United States as taxable, even if that income had no relationship to any transaction or economic activities occurring inside the United States.

35. However, the United States generally does not tax income that is earned outside the United States by foreign corporations and non-resident aliens. Foreign corporations are defined as all corporations that are not organized in one of the 50 states or the District of Columbia.[20] Income of a foreign corporation that is "engaged in a trade or business within the United States" is taxed by the United States to the extent that the income is "effectively connected" to a U.S. trade or business.[21] In addition, passive, investment-type income earned within the United States by a non-resident alien individual or a foreign corporation also is taxable.[22]

[19] *FSC (Panel)*, para. 4.164, *citing to* IRC § 7701(a)(4).
[20] *FSC (Panel)*, para. 4.315, *citing to* IRC §§ 7701(a)(4) and (9).
[21] *See FSC (AB)*, discussing IRC § 882(a).
[22] IRC §§ 871(a) and 881.

36. In some contexts, the United States relies on tax credits to avoid double taxation. The United States also maintains 56 bilateral income tax treaties with a minority of its trading partners. These tax treaties often alter the application of tax provisions regarding foreign-related transactions, and they are usually intended to have two effects. The first is to substantially lower or eliminate the withholding tax of the source country on investment-type income. The second is to provide additional forms of double taxation relief beyond that provided by otherwise applicable domestic laws. In this regard, U.S. bilateral tax treaties act in parallel with the foreign tax credit provisions (and, as explained below, the ETI Act). These treaties may result in double taxation relief beyond that afforded by U.S. domestic law. They also provide comparable supplemental relief to whatever double taxation avoidance mechanism the particular treaty partner makes available.[23]

4. European Tax Systems

37. Many European countries impose income taxes on a territorial basis, at least in part. To the extent that income is taxed on a territorial basis, the home country generally does not tax income from activity conducted outside its territory, whether such activity is conducted by a domestic corporation with a foreign branch or by a foreign subsidiary. Such a tax exemption for income from offshore activity includes income derived from the sale of goods exported from the

[23] One way they do this is by offering what is generally a higher and more clearly defined threshold of business activities in the host country that will cause income earned from such activities by residents of the other country to be taxed in the host country. In other words, bilateral tax treaties may provide that the reach of the tax systems of the two countries involved will be pulled back and made applicable only under more limited circumstances.

home country. This exemption is provided regardless whether any foreign tax is imposed on such income.

38. EC member States tend to apply the territorial principle most purely in the context of income earned by individuals. They tend to apply a mix of worldwide and territorial principles in the case of corporate income. According to the EC, "[w]ith the exception of France, the EC Member States tax their resident companies on their worldwide income and, as a principle, the domestic source income of foreign companies."[24] However, the EC has further explained that some member States provide at least a partial exemption for foreign-source income earned by resident companies.[25]

39. In addition, companies resident in EC member States receive an exemption, generally of 100 percent, for dividends received from foreign subsidiaries in which they own as little as a 5 percent holding.[26] This "participation exemption," which is equivalent to a "dividends-received deduction" under U.S. tax law, is an application of the territorial principle to dividends earned outside the borders of the parent company's country of residence. "[T]he rationale of the exemption of foreign dividend income is to avoid economic double taxation",[27] as the EC has

[24] Annex EC-2, para. 10.

[25] Annex EC-2, para. 6.

[26] Even the highest level of minimum shareholding required by an EC member State for enjoying this exemption is only 25 percent. Moreover, only Belgium and Italy exempt less than 100 percent of foreign dividends received, and Belgium's exemption rate is 95 percent. Annex EC-2, para. 18. Finally, under EC Directive 90/435/EEC, EC member States are required to adopt some form of double taxation relief for cross-border dividend flows from controlled subsidiaries within Europe. Annex EC-2, para. 13.

[27] Annex EC-2, para. 20.

explained, "in cases where the parent-subsidiary relation constitutes a concentrated economic (and thereby often operational) unit."[28]

B. The GATT's Treatment of Tax Exemptions for Foreign-Source Income

40. The differences between the tax systems of the United States and certain European countries resulted in one of the most protracted disputes the GATT faced. To resolve this dispute, the GATT established principles that influenced the drafting of the SCM Agreement and that are relevant here. To understand those principles, it is necessary to review the history from which they evolved.

1. The DISC

41. The origins of the present dispute date from the early 1970s, when the United States first attempted to replicate the territorial aspects of European tax systems within the context of its worldwide system of taxation. In 1971, the United States enacted the Domestic International Sales Corporations (DISC) tax provisions, which allowed exporters to establish domestic subsidiaries that would receive a limited version of the tax deferral normally available only to foreign entities.

42. In February 1972, the EC requested GATT dispute settlement consultations regarding the DISC, alleging that the DISC constituted an export subsidy under Article XVI:4 of GATT 1947. The United States then requested similar consultations with France, Belgium, and the Netherlands, contending that if the DISC were an export subsidy, then the tax exemptions provided by these countries for foreign-source income also were export subsidies. The United

[28] *Id.*, para. 25.

States and the EC requested the establishment of panels concerning their respective claims, and four panels, each with the same membership, were established. These disputes became known, and have been referred to in this dispute, as the *Tax Legislation Cases*.

2. GATT Article XVI:4 and the Illustrative List of Export Subsidies

43. The key provision in the *Tax Legislation Cases* was Article XVI:4 of GATT 1947, which contained the original ban against export subsidies. Article XVI as initially crafted did not address export subsidies. The contracting parties found Article XVI lacking in a number of important respects, and subsequently decided to renegotiate and amend the provision. In particular, the current part B, which addresses export subsidies, was added in 1955 and generally came into effect for those parties accepting its obligations in 1957.[29] The revised Article XVI contained a new paragraph 4, which provides that "contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product ... ."

44. Article XVI:4 does not specify a date on which its prohibition was to become operative, providing only that "as from 1 January 1958 or the earliest practicable date thereafter," contracting parties were to cease granting export subsidies on non-agricultural products. Article XVI:4 also does not define what an export subsidy is. To rectify these issues, at least in

[29] BISD 3S/222, 224-227 (1955); *Protocol Amending the Preamble and Parts II and III of the GATT, 1955* (Agreement No. 33 in App. C), GATT Doc. L/717 (1957).

part, on 19 November 1960 a number of GATT contracting parties agreed to a declaration giving effect to Article XVI:4 for the first time.[30]

45. Accompanying that declaration was a report of a working party that, as part of its proceedings, examined a proposal by the Government of France that would become the first Illustrative List of Export Subsidies.[31] The working party's report explained that "governments prepared to accept the declaration contained in Annex A agreed that, for the purpose of that declaration, these practices generally are to be considered subsidies in the sense of Article XVI:4 ... ."[32] Included in France's proposal was a practice in paragraph (c) that was the precursor to paragraph (e) in Annex I of the SCM Agreement (to be discussed in detail below). Paragraph (c) in the 1960 list stated that "[t]he remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises" should be considered to be an export subsidy.[33]

46. All of the parties to the *Tax Legislation Cases* – France, Belgium, the Netherlands, and the United States – agreed to the declaration.[34] Each of the three European governments at the time had territorial tax systems or systems that contained features of a territorial system. Each system considered part of the sales income from export transactions to be foreign and thus exempt from taxation.

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[30] L/1381, BISD 9S/32 (19 November 1960).
[31] BISD 9S/185.
[32] *Id.*, at 187.
[33] *Id.*, at 186.
[34] *Analytical Index: Guide to GATT Law and Practice*, 6th ed. (1994), page 433.

47. These European governments argued in the *Tax Legislation Cases* that Article XVI:4 and paragraph (c) of the Illustrative List did not apply to their territorial exemptions because these exemptions were common practices found around the world, they covered exports only as part of a broader group, and they served to avoid double taxation of foreign income.[35] They pointed out that it was inconceivable that they would have supported adoption of a provision in the Illustrative List that would render impermissible a central aspect of their own systems of taxation. Indeed, it would have been particularly ridiculous for France to have made a proposal that would ban a practice that was central to its own system of taxation.

48. That France surely did not intend to do so is conclusively demonstrated not only by the fact that France had instituted its territorial tax system in the early 1900's,[36] but also by the fact that each of the European defendants in the *Tax Legislation Cases* argued that it was simply impossible to believe that GATT Article XVI:4 had meant to impose requirements that would have revolutionized world tax practice.[37] In fact, the 1960 Illustrative List proposed by France was a *verbatim* copy of a list attached to the ban on export subsidies adopted by the Organization for European Economic Cooperation (OEEC), which went into effect in 1959 and 1960.[38] In

[35] *See, e.g.*, BISD 23S/127, paras. 18-19.
[36] BISD 23S/114, para. 20.
[37] BISD 23S/114, para. 20 (France); BISD 23S/127, para. 21 (Belgium); BISD 23S/137, para. 21 (Netherlands).
[38] The French proposal identifies the text of the proposed illustrative list as having been taken from the annex to OEEC Document C(59)202. GATT Doc. L/1260 (1 August 1960), page 2.

proposing the Illustrative List, France merely sought to ensure that GATT obligations on export subsidies would be the same as OEEC obligations.[39]

3. The *Tax Legislation* Panel Found That the Basic Features of a Territorial Tax System Inherently Subsidize Exports

49. The panel issued its reports in the four cases on November 2, 1976,[40] finding that the DISC and the European tax systems had the characteristics of an export subsidy and thus were impermissible under the GATT. With respect to the DISC, the panel concluded that "the DISC legislation in some cases had effects which were not in accordance with the United States obligations under Article XVI:4 [of GATT]."[41] The panel also found that "deferral did not attract the interest component of the tax normally levied for late or deferred payment and therefore . . . to this extent, the DISC legislation constituted a partial exemption which was covered by . . . the illustrative list."[42]

50. With respect to the European practices, the panel found that basic features of a territorial tax system inherently subsidize exports. The panel found that the "application of the territoriality principle," in the case of Belgium and France, and the "application of the world-wide principle by the Netherlands, in conjunction with the qualified exemption in respect of foreign income"

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[39] GATT Doc. SR.17/3 (4 November 1960).

[40] *Tax Legislation - United States Tax Legislation (DISC)*, L/4422, BISD 23S/98, Report of the Panel adopted 7-8 December 1981; *Tax Legislation - Income Tax Practice Maintained By France*, L/4423, BISD 23S/114, Report of the Panel adopted 7-8 December 1981; *Tax Legislation - Income Tax Practice Maintained By Belgium*, L/4424, BISD 23S/127, Report of the Panel adopted 7-8 December 1981; *Tax Legislation - Income Tax Practice Maintained By The Netherlands*, L/4425, BISD 23S/137, Report of the Panel adopted 7-8 December 1981.

[41] BISD 23S/98, para. 74.

[42] *Id.*, at para. 71 (referring to the 1960 illustrative list).

allowed "part of the export activities belonging to an economic process originating in the country, to be outside the scope of [the applicable country's] taxes. In this way [the country] has foregone revenue from this source and created a possibility of pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries".[43]

51. The panel's rulings against the European tax practices were based on the following three propositions: (1) that income generated by economic processes of a foreign branch or subsidiary may properly be viewed as "originating in" the country in which the parent company engages in export activities; (2) that foregoing tax revenue on income attributable to these foreign economic processes creates the possibility of a pecuniary benefit to exports from low tax rates in the foreign country in which those processes occur; and (3) that a subsidy on exports arises where export sales are subjected to lower taxes than comparable domestic sales. With respect to the argument raised by the European countries that the exemption method was a widely accepted method of avoiding double taxation, the panel found that this did not excuse the preferential tax treatment of export sales as compared to domestic sales.[44]

4. Footnote 2 of the Illustrative List of the 1979 Subsidies Code

52. The parties to the *Tax Legislation Cases* blocked adoption of the panel reports for nearly five years. During that time, negotiations regarding the meaning and application of GATT Article XVI were undertaken. In 1979, a number of GATT contracting parties, including the

[43] BISD 23S/114, para. 47; BISD 23S/127, para. 34; and BISD 23S/137, para. 34.
[44] *See, e.g.*, BISD 23S/137, para. 35.

countries involved in the *Tax Legislation Cases*, entered into the Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade, otherwise known as the Subsidies Code.[45]

53. The Subsidies Code contained revised rules concerning export subsidies, including a new Illustrative List of Export Subsidies. Footnote 2 of that Illustrative List addressed key elements of the *Tax Legislation* panel reports. Footnote 2 provided as follows:

> The signatories recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The signatories further recognize that nothing in this text prejudges the disposition by the CONTRACTING PARTIES of the specific issues raised in GATT document L/4422 [the DISC panel report].
>
> The signatories reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any signatory may draw the attention of another signatory to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the signatories shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of signatories under the General Agreement, including the right of consultation created in the preceding sentence.
>
> Paragraph (e) is not intended to limit a signatory from taking measures to avoid the double taxation of foreign source income earned by its enterprises or the enterprises of another signatory.

54. Footnote 2 adopted part of the *Tax Legislation* panel's reasoning, but rejected part of it as well. The footnote incorporated the panel's analysis with respect to the issues of deferral and

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[45] Belgium, France, and the Netherlands were not signatories to the Subsidies Code, but were subject to it by virtue of the EC's signature.

arm's length pricing, but departed from the panel's rationale with respect to double taxation. Footnote 2 expressly provided that countries may take steps to avoid the double taxation of income. The European countries had argued for that position in the *Tax Legislation Cases*, but the panel had rejected it, finding that exempting foreign-source income earned in export-related transactions subsidizes exports by treating such income more favorably than income earned in comparable domestic transactions.[46]

55. Thus, while the fate of the panel decisions concerning GATT Article XVI:4 remained uncertain, the parties to those cases largely resolved their differences with respect to the key principles that would guide future measures and disputes. It would take another two years before the parties agreed that these newly established principles should be applied retroactively to the *Tax Legislation Cases* and form the basis upon which those cases would ultimately be resolved.

5. The 1981 Understanding Overturned the Legal Findings of the *Tax Legislation Panel*, But Not the Panel's Factual Findings

56. Until 1981, France, Belgium, and the Netherlands continued to refuse to accept the panel's findings against them, claiming that the GATT rules never had been intended to prohibit particular tax systems or to require the taxation of foreign-source income.[47] For its part, the

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[46] In a revealing switch of positions, the EC has abandoned the position it took in the *Tax Legislation Cases*, and, as discussed below, argues in this dispute that the exemption method of double taxation avoidance results in an export subsidy because exports sales are treated differently than domestic sales for tax purposes.

[47] These three countries stated their positions in the following memoranda: C/97/Rev. 1 (21 March 1977) and C/97/Add. 1 (21 July 1977) (France); C/98 (15 March 1977) and C/98/Add. 1 (21 November 1977) (Belgium); and C/99 (15 March 1977) (Netherlands).

United States refused to accept the DISC finding unless the GATT also adopted the panel findings on the European tax practices.

57. The parties finally agreed to the adoption of all four reports subject to an understanding that effectively revised the reports by incorporating into them the principles of footnote 2 of the Subsidies Code Illustrative List. This was achieved by means of a GATT Council action which adopted the reports subject to an "understanding":

> The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.[48]

58. Following adoption of the reports, the Chairman of the Council made a statement in which he noted that the Council's adoption of the panel reports and the Understanding did "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.*"[49] The Chairman further noted that, as the *Tax Legislation Cases* arose under GATT Article XVI,[50] the adoption of the panel reports – as opposed to the adoption of the Understanding – did not affect

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[48] *Tax Legislation*, BISD 28S/114 (December 7-8, 1981). The United States agreed to adoption of the DISC report without conceding that the DISC violated the GATT.

[49] *Id*. (Emphasis added).

[50] In fact, the cases were decided before the conclusion of the Tokyo Round negotiations.

the rights and obligations of signatories to the Subsidies Code.[51] Likewise, the Chairman clarified that neither the adoption of the panel reports nor the adoption of the Understanding as an interpretation of GATT Article XVI:4 modified that provision or affected the rights of contracting parties under it.[52]

59. Drawing on the key elements of footnote 2, the Council set forth the following basic principles to guide interpretation of GATT Article XVI:

- foreign economic processes need not be taxed by the exporting country;
- more specifically, foreign economic processes in export-related transactions need not be taxed by the exporting country;
- the failure to tax any such process does not constitute an export subsidy;
- foreign economic processes are not considered export activities for purposes of Article XVI;
- measures can be adopted to avoid double taxation of foreign income; and
- arm's-length pricing should be observed in export-related transactions involving related parties.

60. In this way, the 1981 Understanding reached by the GATT Council effectively overruled the panel's *legal* findings with respect to the territorial exemptions provided by France, Belgium, and the Netherlands. This new legal standard permitted France, Belgium, and the Netherlands to retain their exemption-oriented tax systems, notwithstanding the fact that those systems tax export-related transactions more favorably than comparable domestic transactions. However, the 1981 Understanding did not alter the panel's *factual* findings that the use of the exemption method by these three countries resulted in exports being taxed more favorably than comparable domestic transactions.

[51] BISD 28S/114.
[52] *Id.*

C. The FSC

61. The initial view of the United States was that the 1981 Understanding validated the DISC. However, other GATT contracting parties disagreed, and in an effort finally to resolve the dispute that had raged for a decade, in October 1982, the United States committed to the GATT Council that it would propose legislation that would address concerns of other GATT contracting parties.

62. In 1984, the United States enacted the Deficit Reduction Act of 1984, Title VIII of which replaced the DISC provisions with the FSC provisions. The FSC provisions were intended to provide a limited territorial-type system of taxation for U.S. exports that complied with GATT subsidy rules, in particular those laid out in footnote 2 and the 1981 Understanding. The accompanying legislative materials to the enactment of the FSC stated this intention explicitly

> Under GATT rules, a country need not tax income from economic processes occurring outside its territory. Accordingly, Congress believed that certain income attributable to economic activities occurring outside the United States should be exempt from U.S. tax in order to afford U.S. exporters treatment comparable to what exporters customarily obtain under territorial systems of taxation.[53]

Thus, in designing the FSC, Congress sought to devise a GATT-consistent method by which it could provide a partial exemption from taxation of foreign-source income earned in export-related transactions.

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[53] *FSC (Panel)*, para. 4.333, *quoting* from Staff Comm. On Taxation, 98th Cong., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (1985), at 1042. The FSC was designed to cure the alleged defects in the DISC by instituting an entirely different system – using a foreign, rather than a domestic company – that would be compatible with all applicable GATT standards.

63. The FSC provisions provided that a portion of the export income of an eligible foreign sales corporation or FSC was exempt from Federal income tax only if the economic processes which give rise to the income took place outside the United States.[54] A FSC had to have a foreign presence, it had to have economic substance, and activities that related to its export income had to be performed by the FSC outside the U.S. customs territory.[55] Furthermore, the income of the FSC had to be determined according to transfer prices specified in the statute.[56] This treatment was intended to be similar to the exemption of income attributable to a foreign branch or foreign subsidiary of a French, Belgian, or Dutch corporation under a territorial-type system.[57]

64. FSC also allowed a domestic corporation a 100-percent dividends-received deduction for dividends distributed from the FSC out of earnings attributable to certain foreign trade income.[58] Thus, shareholders of a FSC were eligible for a 100 percent dividends-received deduction from distributions made out of the earnings and profits attributable to the qualifying income of a FSC. This treatment corresponded to the "participation exemption" typically provided by territorial-type tax systems, such as those of France, Belgium, and the Netherlands.

65. The FSC differed from the DISC in fundamental respects that were intended to conform to the principles articulated in the 1981 Understanding. Unlike a DISC, which was a U.S. corporation, a FSC had to be incorporated outside the U.S. customs territory in a jurisdiction that

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[54] *FSC (Panel)*, para. 2.2.
[55] *Id.*, paras. 2.2, 2.8.
[56] *Id.*, para. 2.5.
[57] *Id.*, para. 4.336.
[58] *Id.*, para. 2.3.

meets U.S. requirements for exchange of information on tax matters.[59] Unlike a DISC, which was not a taxable entity, a FSC filed a separate tax return and paid taxes, including estimated taxes, on a substantial portion of its income.[60] In further contrast to a DISC, a FSC had to have a foreign office and maintain a set of permanent books of account at that office, thereby rendering the FSC equivalent to a foreign branch office or a permanent establishment.[61] Moreover, a FSC was required to be legally and financially responsible for certain crucial economic processes occurring outside the United States.[62] Only if a FSC met these requirements would the FSC provisions exempt from taxation income attributable to those foreign economic processes.[63]

66. More than fifteen years after the enactment of the FSC provisions, however, the United States learned that the rules to which the FSC provisions were designed to comply were no longer the governing rules. More specifically, the Appellate Body affirmed a panel finding that (1) the FSC tax exemption constituted a subsidy under the SCM Agreement because the exemption was provided by means of three express exceptions from otherwise applicable tax provisions; and (2) this subsidy was export-specific because the FSC tax exemption was available only with respect to income earned from exports.[64]

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[59] *Id.*, para. 4.338.
[60] *Id.*
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *FSC (AB)*.

D. The ETI Act

67. Following the adoption of the *FSC* Panel and Appellate Body reports, the United States enacted the ETI Act. The Act was drafted to achieve two primary objectives. First, to comply with the DSB's recommendations, section 2 of the Act repealed the FSC provisions.[65] Second, section 3 of the Act established a new regime for the treatment of extraterritorial income intended to conform to the new standards articulated by the Panel and the Appellate Body.[66] Under the new regime, extraterritorial income is generally excluded from gross income for U.S. tax purposes, and, as explained below, is thereby placed outside the taxing jurisdiction of the United States. As such, the ETI Act was designed in important part to serve as a method of avoiding double taxation.

1. Objectives of the Act and Its Effect on the U.S. Tax System

68. The main underlying rationales for the ETI Act are explained below.[67]

a. Compliance with the Panel and Appellate Body Reports

69. The legislative history makes clear that one of the objectives of the Act was to comply with the findings contained in the *FSC* Panel and Appellate Body reports.[68] The Act

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[65] The Act § 2 (Exhibit US-1). The FSC provisions formerly were contained in IRC §§ 921-927.

[66] The Act § 3 (Exhibit US-1).

[67] Reports of the relevant committees of the U.S. Congress form essential parts of the legislative history of the Act and explain the underlying intent of Congress. The relevant reports are S. Rep. No. 106-416 (2000) ("*Senate Report*") (Exhibit US-2); and H.R. Rep. No. 106-845 (2000) ("*House Report*") (Exhibit US-3).

[68] *Senate Report*, page 5; *House Report*, page 3.

accomplishes this objective in two ways. First, the Act repeals the FSC provisions with effect from October 1, 2000. From that date, no corporation may elect to be treated as a FSC.[69]

70. Second, the Act remedies the main defect in the FSC found by both the Panel and the Appellate Body – namely, that the FSC tax exemption was an exception to otherwise applicable tax rules that applied only to exports. Rather than providing unique or special treatment for export-related income, the Act treats all foreign sales and all taxpayers alike. Under the Act, as under many EC and other tax systems, income that is outside U.S. taxing jurisdiction is in no way limited to income earned through exporting. Thus, taxpayers receive the same U.S. tax treatment with respect to income derived from foreign transactions regardless whether exports are involved. Moreover, the Act's exclusion of income applies without regard to whether the income is earned by a U.S. or foreign individual, a U.S. or foreign corporation, or a partnership or other pass-through entity.

b. A New U.S. Approach to Taxation of Foreign Income

71. In addition to implementing the DSB's recommendations, the Act also was intended to rationalize the treatment of foreign income under the U.S. system of taxation.[70] By excluding extraterritorial income from the definition of "gross income", the Act fundamentally changes the way the United States taxes foreign income.[71] As the legislative history of the Act makes clear,

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[69] The Act § 5(b)(1).

[70] Wholly apart from the *FSC* dispute, the United States Senate had begun a process of reviewing the international provisions of the IRC with hearings early in 1999. Among the issues identified was the need to re-examine the U.S. tax treatment of foreign income. *Senate Report*, page 5; *see also House Report*, page 18.

[71] *Senate Report*, page 17.

the definition of "gross income," as modified by the Act, defines the outer limits of U.S. tax jurisdiction.[72] The Act creates a new general rule under which excluded extraterritorial income earned by U.S. taxpayers is outside U.S. taxing jurisdiction. In recognition of this, the legislative history states that the territorial limitations created by the Act "parallel the exclusions under most territorial tax systems, particularly those employed by European Union member states."[73]

c. A Measure to Avoid Double Taxation

72. Finally, the Act provides a method for avoiding double taxation.[74] The legislative history makes clear that Congress intended that the Act's exclusion serve as a means of avoiding double taxation of excluded income.[75] Because the exclusion avoids double taxation, the Act disallows foreign tax credits and deductions that otherwise might be allocable to excluded extraterritorial income.[76] By excluding certain foreign income, the Act adopts an internationally-accepted method for avoiding double taxation, a method employed by a number of EC member States and other countries.

2. Excluded Extraterritorial Income

73. Under section 114(a) of the IRC, as added by the Act, extraterritorial income is excluded from "gross income." Thus, extraterritorial income is placed outside the limits of U.S. taxing jurisdiction.

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[72] *Id.*, page 16.
[73] *Id.*, page 5.
[74] *Id.*, pages 2, 6.
[75] *House Report*, page 18 ("the extraterritorial income excluded by this legislation from the scope of U.S. income taxation is parallel to the foreign-source income excluded from tax under most territorial tax systems"); *see also Senate Report*, page 5.
[76] The Act § 3, amending IRC § 114(c)-(d).

74. The Act provides a detailed definition of the term "extraterritorial income." The definition is contained primarily in new sections 114, 941, 942, and 943 of the IRC. These sections are included in Exhibit US-1 and are summarized here.

75. There are three main aspects to the definition of extraterritorial income. Extraterritorial income generally is defined as (1) qualifying foreign trade income (2) attributable to foreign trading gross receipts (3) with respect to which the taxpayer has performed certain foreign economic processes.[77] This definition contains both a qualitative and a quantitative component. The qualitative component relates to the type of transactions subject to an exclusion, while the quantitative component relates to the amount of the exclusion. Each of these components is described below.

a. The Foreign Nature of Excluded Extraterritorial Income

76. The first and perhaps most basic element of extraterritorial income is that it arises from extraterritorial transactions – *i.e.*, foreign sales, leases and rentals. The Act provides that extraterritorial income must derive from one of the following five categories of foreign transactions:

(1) the sale of qualifying property for its use or disposition outside the United States,
(2) the lease of qualifying property for use by the lessee outside the United States,
(3) the provision of services related and subsidiary to the first two categories,
(4) the provision of managerial services performed for unrelated persons in connection with the first three categories, and
(5) the provision of engineering or architectural services for projects located outside the United States.[78]

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[77] The Act § 3, amending IRC §§ 114(b)- (e) and 942(b)(1).

[78] The Act § 3, amending IRC § 941(a)(1). To be precise, under section 114(e),

(continued...)

The Act makes the extraterritorial nature of excluded income clear by providing that the goods sold or leased are ultimately not to be used, and services not to be performed, in the United States, and also may not be for the use of the United States itself or any instrumentality thereof.[79]

77. In addition, the Act requires that the gross receipts from which excluded extraterritorial income arises must have a nexus with activity occurring in a foreign jurisdiction. Excluded extraterritorial income can be derived only from transactions with respect to which the taxpayer (or a related person) engages in solicitation, negotiation, or contracting activities in a foreign jurisdiction, and incurs a certain threshold amount of costs associated with economic activities in a foreign jurisdiction.[80] These foreign economic activities (or "processes") may consist of one or more of the following five categories:

(1) advertising and sales promotion,
(2) processing of customer orders and arranging for delivery,
(3) transportation outside the United States in connection with delivery to the customer,
(4) billing activities, and
(5) the assumption of credit risk.[81]

The threshold amount of costs that must be associated with economic activities in a foreign jurisdiction is 50 percent of the aggregate total costs incurred in all five categories or 85 percent

[78] (...continued)
extraterritorial income is defined as gross income attributable to "foreign trading gross receipts." The term "foreign trading gross receipts", in turn, is defined by section 942(a) as gross receipts derived from one of the five categories of foreign transactions listed here.

[79] The Act § 3, amending IRC § 942(a)(2).

[80] The Act § 3, amending IRC §§ 942(b)(1), 942(b)(2)(A).

[81] The Act § 3, amending IRC § 942(b)(3).

of the total costs incurred in any two of the five categories.[82] These foreign economic processes must be performed, and the threshold requirements met, with respect to every foreign transaction giving rise to excluded extraterritorial income.

78. The Act also provides that no more than 50 percent of the fair market value of any goods involved may be attributable to articles produced outside the United States and direct labor costs incurred outside the United States.[83] Goods can meet this requirement even if 100 percent of the fair market value of their inputs is foreign.

b. Calculating the Exclusion

79. The Act provides a partial exclusion for extraterritorial income. The Act states that "qualifying foreign trade income" is the amount of income from covered transactions, which, if excluded, would reduce the taxpayer's taxable income by the greatest of: 15 percent of foreign trade income, 1.2 percent of total gross receipts, or 30 percent of foreign sale and leasing income.[84] Different methods are needed because different taxpayers use different business models, and the use of only one method could lead to disparate results among businesses engaged in similar foreign business activities. Taxpayers are therefore allowed to choose the method for quantifying excluded income that is most appropriate to their business circumstances.[85]

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[82] The Act § 3, amending IRC § 942(b)(2)(A)(ii) and (B).

[83] The Act § 3, amending IRC § 943(a)(1)(C).

[84] The Act § 3, amending IRC § 941(a)(1).

[85] The Act § 3, amending IRC § 941(a)(2). Of the three calculations used to determine "qualifying foreign trade income", one is a percentage of overall "foreign trade income", one is a percentage of total receipts, and the third – involving "foreign sale and leasing income" – is a percentage of a subset of "foreign trade income". In other words, "foreign sale and leasing income" is a type of foreign trade income. "Foreign sale and leasing income" is "foreign trade (continued...)

3. Evenhanded Treatment of Taxpayers

80. The Act applies equally to individuals, partnerships, and corporations that earn excluded extraterritorial income. The Act applies to all taxpayers that are subject to U.S. taxation, regardless whether they are located in the United States or abroad.[86] As explained by the legislative history,

> the bill requires that property manufactured outside of the United States be manufactured by (1) a domestic corporation, (2) an individual who is a citizen or resident of the United States, (3) a foreign corporation that elects to be subject to U.S. taxation in the same manner as a U.S. corporation, or (4) a partnership or other pass-through entity all of the partners or owners of which are described in (1), (2), or (3) above.[87]

81. This requirement is intended to equalize treatment of U.S. taxpayers operating abroad in branch form with the treatment of U.S. taxpayers operating abroad in corporate subsidiary form.[88] To reinforce this evenhanded treatment, the Act provides that property may be the subject of a qualifying transaction even if it is produced outside of the United States.[89]

82. In addition, the Act permits a foreign corporation to elect to be treated as a domestic corporation to ensure that property produced outside the United States need not be produced by a

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[85] (...continued)
income" that is attributable to the lease of certain types of property, or that is directly tied to the performance of the prescribed foreign economic processes described above. The Act § 3, amending IRC § 941(c).

[86] The Act § 3, amending IRC § 942(a)(2).

[87] *Senate Report*, page 10.

[88] *Id.*

[89] The Act § 3, amending IRC § 943(a)(1)(A).

U.S. corporation.[90] This election is similar to other elections given to taxpayers that would not otherwise be subject to U.S. tax jurisdiction.[91]

4. The Act's Effective Date and Transition Rules

83. The Act is effective for transactions after September 30, 2000.[92] In particular, no FSCs may be created after September 30, 2000.[93] A foreign corporation created after September 30, 2000, will be treated under general rules applicable to all foreign corporations. None of the rules under the former FSC provisions, including the special "dividends-received deduction", will be available to such a corporation or its U.S. parent. In addition, subject to reasonable and customary transition rules, described below, the FSC provisions cease to have any application with respect to post-effective date transactions.

84. Transition relief is common under U.S. tax law in order to avoid undue hardship or confusion with respect to pre-existing business arrangements entered into under pre-existing law. Section 5(c) of the Act provides that the Act's amendments do not apply to a transaction in the ordinary course of a trade or business of a FSC already in existence as of September 30, 2000,

[90] The Act § 3, amending IRC § 943(e)(1).

[91] For example, a foreign corporation may elect to be treated as a U.S. corporation under IRC § 953(d) (relating to foreign insurance companies), IRC § 897(i) (relating to foreign corporations with U.S. real property interests), and IRC § 1504 (relating to foreign corporations formed solely for foreign law purposes). *See* Exhibit US-4.

[92] The Act § 5(a).

[93] The Act § 5(b)(1).

which occurs: (1) before January 1, 2002,[94] or (2) after December 31, 2001, pursuant to certain binding contracts made before September 30, 2000.[95]

85. At any time during the transition period, a taxpayer may elect to apply the Act to a transaction that would otherwise be eligible for transition relief.[96] Such an election would be effective for the taxable year for which it was made and for all subsequent taxable years.[97] Under no circumstances is a taxpayer permitted to apply the FSC provisions and the Act to the same transaction or transactions.[98] The Act automatically applies (without any election or other notification) to transactions not covered by the transition rules.[99]

E. How the ETI Act Differs from the FSC Provisions

86. The EC has attempted to portray the Act as "essentially the same subsidy" as the FSC.[100] This is erroneous, for it ignores the fundamental ways in which the Act differs from the FSC.

1. The FSC Was a Relatively Narrow Exception

87. Prior to adoption of the Act, the U.S. tax system operated principally on a worldwide basis. The United States asserted the right to tax all income earned by U.S. citizens and residents (including U.S. corporations). The United States also subjected to tax income earned by nonresidents conducting activity within U.S. borders.

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[94] The Act § 5(c)(1)(A).
[95] The Act § 5(c)(1)(B)(i)-(ii).
[96] The Act § 5(c)(2).
[97] *Id.*
[98] *Senate Report*, page 21.
[99] The Act § 5(a).
[100] *See, e.g.*, *First EC 21.5 Submission*, ETI Panel Report, Annex A-1, para. 121.

88. Subject to certain anti-deferral rules, the United States generally taxed the U.S. shareholders of foreign corporations at the time income was distributed to the U.S. shareholder. Notwithstanding this general rule, the United States has adopted a series of "anti-deferral" regimes that, in general, respond to specific concerns about potential tax avoidance by U.S. corporations through foreign affiliates. One of these regimes is found in subpart F of the IRC. Subpart F limits the availability of deferral for certain types of income earned by certain controlled foreign subsidiaries of U.S. companies.[101] Pursuant to subpart F, a U.S. shareholder that controls a foreign corporation must pay U.S. tax on certain types of income earned by the foreign corporation at the time the income is earned by such foreign corporation, and without regard to whether the income is distributed to the shareholder.

89. As the Panel and Appellate Body found in *FSC*, the FSC operated as an exception to these general rules of U.S. corporate taxation, subjecting the income of a foreign corporation directly to U.S. taxation. It provided a dividends-received deduction for income repatriated by a foreign subsidiary to a domestic parent. It created an exception to subpart F for income of a controlled foreign corporation that otherwise might have been deemed to be immediately taxable to the foreign corporation's parent. And, of course, the FSC applied only to income from "export property"; *i.e.*, property manufactured in the United States and sold abroad.

[101] IRC § 951 (US-4).

2. The Act Makes a Fundamental Shift in U.S. Tax Treatment of Extraterritorial Income

90. The Act modified the general rule of U.S. taxation by amending the definition of "gross income", the term which, under U.S. tax law, defines the boundaries of U.S. taxing jurisdiction. In contrast to the former U.S. worldwide approach, the Act excludes income earned in qualifying foreign transactions from the definition of gross income and, thus, modifies the extent to which the United States seeks to tax such income.

91. This new general rule applies to a substantially broader category of income than that which was exempted from tax under the FSC provisions. It applies to foreign transaction income irrespective of whether the goods in question were produced in the United States. It requires no related foreign company to be involved in the transactions in question, and it is applicable to a broader group of taxpayers, including foreign corporations.

92. Thus, unlike the FSC, the Act's exclusion of income from U.S. taxation is automatic. It does not result from the creation of an exception to U.S. general rules for taxing foreign corporations, an exception to the subpart F rules, or an exception to the rules governing the dividends received deduction. Instead, the Act's exclusion is part of the U.S. general rules of taxation.

3. Unlike the FSC, the Act Does Not Require Exportation

93. Not only is the Act broader than the FSC in terms of the rules it establishes for the U.S. tax system and with respect to the taxpayers that may use it, it also is broader with respect to the transactions it covers. Unlike the FSC, the Act is not limited to ''export property". Instead, the Act applies to income involving property produced within or without the United States. Indeed,

unlike the FSC, excluded income under the Act can arise from transactions involving property that is manufactured and sold outside the United States, and all of the value of which is comprised of 100 percent foreign content. As in the case of European territorial tax regimes, exporters are eligible for the exclusion, but the Act nowhere requires a taxpayer to export in order to earn excluded extraterritorial income.

F. Comparison of the ETI Act and European Territorial Systems

94. The U.S. Congress recognized that by excluding extraterritorial income from gross income, the Act "parallels the foreign-source income excluded under most territorial tax systems, particularly those employed by European Union member states."[102] As noted above, many European countries impose income taxes on a territorial basis, at least in part. Subject to numerous exceptions, European governments applying a territorial approach do not tax income earned outside their borders. European territorial exemptions extend not only to income earned by resident corporations and offshore branches, but also to income earned by foreign subsidiaries and dividends paid to domestic parents by foreign subsidiaries.

95. European tax exemptions for offshore income apply to three types of transactions: imports, wholly foreign transactions, and exports. In most cases, European countries do not require the foreign tax rate to be equal to or greater than the home country rate and, in some instances, no minimum foreign rate is required at all. Thus, European companies with overseas operations in low tax jurisdictions can receive a tax benefit from a territorial exemption. Insofar as the sale of goods is concerned, European manufacturers operating in these types of tax regimes

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[102] *Senate Report*, page 5.

may obtain the benefits of a territorial exemption only by exporting. Indeed, this was the very point made by the panel in the *Tax Legislation Cases*.

96. As indicated above, no EC member State now provides a blanket exemption for foreign-source income. In fact, as the EC explained to the Panel in the initial proceeding, EC member States providing an exemption for foreign-source income do so only partially, and most generally treat foreign-source income as an exception to the general rule that the worldwide income of a domestic corporation is subject to taxation in its country of residence.[103] Thus, just as the Act has introduced an element of territoriality into the U.S. system of taxation, European systems themselves are based upon a mix of worldwide and territorial principles.

97. This confluence of worldwide and territorial approaches is perhaps most striking in the Dutch tax system. As the Appellate Body may recall from the initial *FSC* proceeding, as a general matter, Dutch resident companies are liable for corporate income tax on a worldwide basis. The income of foreign branches of Dutch resident companies, however, is generally not taxed. Even in the absence of a treaty, income earned by a foreign branch of a Dutch company that is subject to *any* income tax in a foreign country is also exempt from Dutch tax.[104]

98. In addition, the income of a foreign subsidiary of a Dutch company is not subject to Dutch income tax, even in the case of income from export activities, so long as the subsidiary does not have substantial activities in the Netherlands. Moreover, any Dutch shareholder that

[103] Annex EC-2, para. 2.
[104] *FSC (Panel)*, para. 4.809.

owns five percent or more of a foreign corporation may generally exempt from tax 100 percent of the dividends paid by the foreign corporation to that shareholder.

99. As with a foreign branch, income from a foreign subsidiary will qualify for the exemption so long as the subsidiary is subject to *any* national-level income tax in its country of residence. Thus, a subsidiary that is resident in a low-tax jurisdiction such as the Netherlands Antilles is generally exempt from Dutch tax on income earned outside the Netherlands. Moreover, a Dutch parent corporation will, subject to certain requirements, receive a 100 percent participation exemption (dividends-received deduction) on dividends from that subsidiary, even though the income may be subject to tax in the Netherlands Antilles at a very low rate of tax (two or three percent).

100. To appreciate how the Dutch system operates, assume that a Dutch manufacturing company and its Netherlands Antilles sales subsidiary engage in an export transaction in which the subsidiary acts on the parent company's behalf to sell items exported from the Netherlands, and the companies together earn a total of $100,000.[105] Further assume that each company earns the equivalent of $50,000 under arm's-length transfer pricing principles. The Netherlands Antilles subsidiary's income from the transaction – that is, $50,000 – would be fully exempt from taxation by the Netherlands and, at a 3 percent rate, would owe tax of only $1,500 to the Netherlands Antilles.

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[105] For a more detailed discussion of this example, see *FSC (Panel)*, paras. 4.809 and 4.1042.

101. Due to the 100 percent participation exemption, the Dutch parent corporation would not pay taxes upon the repatriation of the exempt income earned by the foreign subsidiary. On the other hand, the Dutch parent company would be liable for taxes in the Netherlands, at a rate of 35 percent, on the income it earned from the transaction; *i.e.,* the other $50,000. The taxes on this income would amount to $17,500. The overall taxes on the total export income of $100,000 would be $19,000 – or an effective tax rate of 19 percent – resulting in a tax savings of $16,000 ($35,000-$19,000) as compared to the tax that would have been incurred if the same transaction had involved a domestic sale.

III. ISSUES RAISED IN THIS PROCEEDING

102. The following issues are raised in this proceeding for resolution by the Appellate Body:

a. Whether the Panel erred in finding that the exclusion of extraterritorial income from U.S. taxation confers a subsidy within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.

b. Whether the Panel erred in finding that the exclusion of extraterritorial income from U.S. taxation is contingent upon export performance within the meaning of Article 3.1(a) of the SCM Agreement.

c. Whether the Panel erred in finding that the exclusion of extraterritorial income from U.S. taxation does not constitute a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59 of the SCM Agreement.

d. Assuming that the Panel did err in its findings regarding the fifth sentence of footnote 59, whether a measure to avoid double taxation within the meaning of the fifth sentence cannot be regarded as a prohibited subsidy by virtue of footnote 5 to the SCM Agreement.

e. Whether the Panel erred in finding that the Act's exclusion of extraterritorial income from U.S. taxation is inconsistent with U.S. obligations under the Agreement on Agriculture.

f. Whether the Panel erred in finding that the Act's 50 percent rule regarding certain foreign value provides less favorable treatment to imported goods in comparison to the treatment afforded to like domestic goods in violation of Article III:4 of GATT 1994.

g. Whether the Panel erred in finding that the ETI Act's transition rules are inconsistent with the DSB's recommendation regarding withdrawal of the FSC subsidy.

IV. LEGAL ARGUMENT

A. The Panel Erred in Finding that the ETI Act Confers a Subsidy

103. The Panel erred in several respects in finding that the ETI Act confers a subsidy. As we describe below, the Panel failed to apply the applicable legal standards correctly and overlooked essential provisions of the U.S. tax code. For these reasons, the Appellate Body should reverse the Panel's finding.

1. The Legal Standard Under Article 1.1(a)(1)(ii)

104. Article 1 of the SCM Agreement provides that "a subsidy shall be deemed to exist if . . . there is a financial contribution by a government . . . and a benefit is thereby conferred." Article 1 provides a number of definitions for the term "financial contribution." The definition most relevant to tax matters is Article 1.1(a)(1)(ii). That provision states that a "financial contribution" exists where "government revenue that is otherwise due is foregone or not collected."

105. In considering whether a government has foregone revenue that is otherwise due, it may be appropriate to examine whether revenue would be collected "but for" the contested measure. This "but for" standard appears to apply most comfortably where a WTO Member creates a narrow tax-reducing exception to a general and broader tax-raising rule. The Panel found the

FSC tax provisions to be a subsidy on the ground that they represented just such a "but for" exception,"[106] and the Appellate Body sustained the use of the "but for" test in that instance.[107]

106. However, the Appellate Body explained that there may be instances where a "but for" analysis is not appropriate. The Appellate Body indicated that the subsidy definition requires a basic comparison between the tax revenue effects of the challenged measure, on the one hand, and the tax treatment in "some other situation" on the other.[108] The Appellate Body clarified that such a comparison involves weighing the challenged measure against a "normative benchmark" or "prevailing domestic standard" found in the tax laws of the Member involved.[109] The notion underlying this "comparison" test appears to be that, while a country is free to tax or not to tax any category of income it chooses, deviations from or exceptions to a category of income it otherwise has elected to tax can be said to involve the foregoing of revenue that is "otherwise due."[110]

2. The Panel Misapplied the Appellate Body's Comparison Test

107. The Panel misapplied the Appellate Body's comparison test, stretching it beyond what the Appellate Body intended. Essentially, the Panel determined that, under the Appellate Body's test, it is appropriate to examine whether any provision of a tax system might subject income to tax when the contested measure would not. According to the Panel, this is proper even if the non-contested measure is taken out of context or is defined in part by the contested measure. If

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[106] *FSC (Panel)*, para. 7.45.
[107] *FSC (AB)*, para. 91.
[108] *Id.*, para. 90.
[109] *Id.*
[110] *Id.*

accepted, the Panel's gloss on the Appellate Body's test would allow future panels, in effect, to reconstruct parts of national tax codes in order to make comparisons that could not be made under national law. Indeed, the Panel's reasoning means that any time a Member taxes a category of income only in part, that Member confers a subsidy under Article 1.1(a)(1)(ii).

a. The Panel Misconstrued the Concept of "Gross Income"

108. A linchpin of the Panel's conclusion that the ETI Act confers a subsidy is its finding that the U.S. normative benchmark in this dispute is IRC Section 61 and that any narrowing of, or exception to, that provision is a subsidy. The Panel said that "it is clear to us that there is a 'prevailing' domestic standard and that the measure at issue functions, indeed, as an effective departure from it."[111] The Panel further said that "it is clear to us that where income does not qualify for the [ETI] 'exclusion' from 'gross income' . . ., it is not shielded from taxation."[112]

109. This reasoning oversimplifies the IRC and misconstrues the relationship between its parts. Section 61 cannot be read in isolation. It is inextricably linked to other IRC sections that define "gross income." Under U.S. law, "gross income" is defined not in Section 61 alone, but in Parts I - III of Chapter 1B, Subtitle A of the IRC. This of course includes Section 61, but also sections 71 through 90 (which set forth rules with respect to items specifically included in gross income), and sections 101 through 139 (which set forth rules with respect to items specifically excluded from gross income). There also are other provisions in the IRC that are part of the determination of gross income, such as IRC sections 871 and 882. To suggest, as the Panel does,

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[111] ETI Panel Report, para. 8.25.
[112] *Id.*

that any of the "gross income" exclusions can be read separate and apart from Section 61 is to ignore the text of Section 61 and the overall structure of the IRC. Section 61 states that "gross income" means "all income from whatever source derived," but it expressly qualifies this sweeping statement with the inclusion of the clear language "[e]xcept as otherwise provided in this subtitle."

110. Ironically, at one place in its report, the Panel did acknowledge that other IRC sections are integral to the full definition of gross income. As support for its conclusion that income defined as extraterritorial income would be taxed absent the Act, the Panel referred to sections 881 and 882 of the IRC, which make taxable certain passive income of foreign corporations, and which limit the gross income of foreign corporations to income that is effectively connected with a U.S. trade or business.[113] These provisions apply the reach of the U.S. taxing jurisdiction only to certain types of income earned by foreign corporations.[114] While the Panel cited the limitation contained in section 882 on the definition of gross income in the case of foreign corporations, it refused to consider the fact that the ETI Act's exclusion for extraterritorial income (Section 114) as a limitation on that term for both domestic and foreign corporations.

111. Exclusions from "gross income" like that for extraterritorial income cannot be separated from Section 61 and used for comparison against Section 61 as the Panel suggests. If the Panel's

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[113] *Id.*

[114] IRC § 11(d). Similarly, IRC sections 871 and 877 define the U.S. taxing jurisdiction over foreign individuals. IRC § 2(d).

reasoning is not reversed, then all WTO Members that rely on a concept like "gross income" likely will be quite surprised to learn that their similar exclusions also would be subsidies.[115]

b. The Panel Cannot Save Its Analysis By Creating a "Specific Versus General" Exclusion Distinction

112. Perhaps recognizing that it went too far in suggesting that all exclusions from "gross income" are subsidies, the Panel attempted to qualify its analysis by distinguishing between broad and specific exclusions. The Panel suggested that a broad exclusion might form part of a "prevailing domestic standard" but a narrow one could not. The Panel characterized extraterritorial income as "one of several, specific exclusions from the section 61 definition of 'gross income'"[116] and from that concluded that the ETI Act was an exception to the "prevailing standard," not a part of it. According to the Panel, had the category of extraterritorial income been broader, neater, or cleaner, it might not have been a subsidy.

113. The Panel acknowledged the Appellate Body's statement that a WTO Member has the sovereign authority "not to tax any particular categories of revenues,"[117] but it went on to create a corollary not found in the SCM Agreement or prior panel or Appellate Body reports. The Panel held that a Member may exclude a category of income only if it excludes "all of the income" in that category. The Panel said:

> Even assuming that income attributable to "foreign transactions" might be a "category" of income that might be excluded in a WTO-consistent manner (an issue we need not and do not decide here), the United States is not in fact excluding – or giving up an entitlement to raise revenue that it could "otherwise"

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[115] See discussion in subsections (d) and (e) below.
[116] ETI Panel Report, para. 8.24.
[117] *FSC (AB)*, para. 90.

> have raised with respect to – all of the income attributable to "foreign transactions", but rather only a portion of certain income defined by highly selective qualitative conditions and quantitative requirements and attributable only to certain *qualifying* "foreign" transactions ... .[118]

114. The Panel cites to no authority for drawing this distinction. Whether an excluded category of income is broad or narrow, simple or complex, or qualified or unqualified does not necessarily determine whether it results in the foregoing of revenue that is otherwise due. Indeed, a simple tax deduction could certainly involve the foregoing of revenue that is otherwise due, and a complex, fundamental definition of taxing jurisdiction might not.

115. The Panel appears to be incorporating the Article 2 concept of "specificity" into the definition of "subsidy" under Article 1. The Panel seems to be saying that because narrow or highly conditioned measures tend to more readily be perceived as actionable subsidies, it can borrow the concept of specificity in defining parts of Article 1. The problem with this theory is that Article 2 applies only *after* a subsidy has been identified under Article 1. Article 2.1 makes this plain by providing that its definitions serve to determine whether "a subsidy, *as defined in paragraph 1 of Article 1*, is specific." (Emphasis added). To hold that Article 1 can be applied based on the specificity of a measure at issue would be to interchange Articles 1 and 2.

c. The Panel's "Overall Rationale and Coherence" Corollary Also Does Not Save Its Analysis

116. The Panel creates another bold, new corollary to the Appellate Body's standard in attempting to explain why it considers the extraterritorial income to not be the type of category of

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[118] ETI Panel Report, para. 8.40.

income a government can exclude without conferring a subsidy. The Panel posits that the ETI Act's exclusion does not derive from "some kind of overall rationale and coherence."[119]

117. The Panel cites to no part of the SCM Agreement or any prior panel or Appellate Body reports to support its "overall rationale and coherence" corollary. The Panel does not even try to explain why the presence or absence of a "rationale" matters in terms of whether a measure foregoes revenue "otherwise due" or not. After all, the Appellate Body said that a Member is free "*not* to tax any particular categories of revenues."[120] It did not say a country had to have an "overall rationale" for its choice not to tax or for the categories of revenues it creates.

118. To buttress its position, the Panel stated that the ETI Act might have had a suitable "rationale" if it "represent[ed] a coherent approach to corporate earnings derived from offshore activities only," instead of applying to transactions involving goods used outside the United States.[121] The United States, however, never maintained that the Act was designed to exclude all income derived from offshore activities. Rather, the U.S. Congress explained that the exclusion was aimed at foreign trade income, derived from "foreign sales."[122] The Panel does not explain, as it should have, why it considers a tax exclusion for income from foreign activities to have more of a "rationale" than one for income from foreign transactions.

119. Remarkably, the Panel expressly refrained from ruling upon whether income attributable to foreign transactions constitutes a "category" of income that might be excluded in a WTO-

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[119] *Id.*, para. 8.27.
[120] *FSC (AB)*, para. 90.
[121] ETI Panel Report, para. 8.28.
[122] *House Report*, page 17; *Senate Report*, page 5.

consistent manner, saying this is "an issue which we need not and do not decide here."[123] Extraterritorial income, as defined by the Act, is derived from a broad array of foreign transactions involving goods produced either within or outside the United States and used outside the United States. Whether or not foreign-transaction income is a category of income that may be excluded without conferring subsidies is a fundamental issue that the Panel should not have ignored.

d. The Panel's New Corollaries to the Appellate Body's Standard Will Lead to "Perilous Systemic Implications"

120. A grave problem attendant to the two corollaries to the Appellate Body's standard that the Panel appears to have created out of whole cloth is how they are to be implemented. By what criteria are WTO Members to know if their tax exclusions are sufficiently broad or lacking in conditions? At what point does an exclusion become too narrow or too conditioned? And, what gives an exclusion an "overall rationale and coherence"?

121. The Panel's reasoning fails to take into account the reality that most tax systems – like that of the United States – are quite complex and contain few simple, unqualified and unconditioned measures. If a taxing jurisdiction-reducing measure is safe from being deemed a subsidy only if it is unqualified, unconditioned, or simple, then a great many exclusions from tax around the world have just become subsidies. And if the Panel is going to hold countries to a standard of having an unassailable "rationale" for each taxing jurisdiction-reducing measure, then few measures will pass muster.

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[123] *Id.*, para. 8.40.

122. The Panel, to the contrary, claimed that if it were to have held that the ETI Act is not a subsidy, such an outcome would have had "perilous systemic implications."[124] The Panel said that if the United States could exclude from "gross income" any category of income it wished, then it could exclude all income generated from export activities and escape the reach of the SCM Agreement.[125] This concern, however, runs counter both to the Appellate Body's statement that WTO Members are free not to tax any category of income they choose and to the Panel's own "specific versus general" corollary. Such an exclusion would seem to involve a relatively simple, broad, and unqualified category – the very type of category the Panel said could be excluded from "gross income." While the United States is not aware of any country that has chosen to exclude from tax all export income, the text of Article 1:1(a)(1)(ii) indicates that such a practice would be a subsidy only if it can be shown that tax on such income is "otherwise due" in some other situation under the domestic laws of the country in question.

123. The Panel's displeasure with what it deems to be "the highly formulaic approach"[126] of the United States does not justify the Panel departing from the text of the SCM Agreement. The Panel is not free to contort the text in order to condemn laws it does not like.

124. Contrary to the Panel's approach, what the United States did in fashioning the Act was to be attentive to the words of Article 1.1(a)(1)(ii) and the words of the *FSC* Panel and the Appellate Body, as the United States' WTO obligations require. Ironically, the Panel's approach in this proceeding was not textual, but rather was based on standards that are nowhere reflected

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[124] *Id.*, para. 8.39.
[125] *Id.*
[126] *Id.*, para. 8.38.

in the text or the negotiating history of the SCM Agreement. When one applies both the actual terms of the Agreement and the standards articulated by the *FSC* Panel and the Appellate Body, it becomes clear that the Act's exclusion of extraterritorial income is not a "subsidy" within the meaning of Article 1 of the SCM Agreement.

e. The Panel's New Corollaries Would Render European Territorial Tax Exemptions Subsidies

125. The Panel's new corollaries, if allowed to stand, would mean that most of the tax systems in Europe also are subsidy schemes. European tax systems exclude from taxation a wide variety of categories of foreign-source or extraterritorial income, but not in any uniform manner. Indeed, most European countries have detailed rules that allow certain income, either earned abroad or associated with foreign transactions, to escape domestic tax or to be taxed to a lesser extent. Like the Act, these systems reflect particular judgments as to the size and extent of the categories that are not subject to domestic tax. The specific character of the resulting exclusions from taxation varies from country to country. To give just a few brief examples:

- In *Belgium*, resident companies are subject to Belgian corporate income taxes on profits from their activities, wherever conducted, unless specifically excluded by domestic law or as a result of a tax treaty. One such exclusion is that 75 percent of foreign branch income generated in a country with which Belgium has not concluded an income tax treaty is exempt from Belgian tax. Another category of income that is excluded from taxation is foreign-source dividend income. Ninety-five percent of dividend income from a foreign subsidiary to a shareholder owning at least 5 percent of the shares of the subsidiary (or holding an interest in the subsidiary with an acquisition value of at least BFr 50 million) is not taxed; the remaining five percent is taxed.

- In *France*, foreign income attributable to operations conducted abroad – either by a company directly or though a branch – is exempt from tax. Ninety-five percent of dividend income received from a foreign company by a shareholder owning at least 10 percent of the shares of the company (or holding an interest in the foreign

company of at least FF 150 million) is exempt from French tax. However, this qualified exemption is further limited. A French corporate taxpayer is required to include in its taxable income its *pro rata* share of the income of a foreign company in which it has a direct or indirect interest of at least 10 percent or at least FF 150 million, if the foreign company is subject to a "privileged tax regime." A foreign tax regime is considered "privileged" if the foreign tax rate is two-thirds or less than the tax rate that would have been payable in France on the same income. This privileged tax regime rule does not apply if the foreign company at issue has an effective commercial or industrial activity predominantly performed in the local market. The privileged tax regime rule also may not apply under certain tax holidays or if a tax treaty provides for different tax treatment.

- In *Germany*, companies are subject to German corporate tax on their income regardless of its source if they have their statutory seat of business or effective place of management in Germany. However, Germany excludes from income amounts received from foreign branches and from foreign subsidiaries of corporate shareholders in about 70 treaty countries. The precise treatment of foreign-source income differs depending upon the country in which the foreign branch or subsidiary is located because the specific requirements for receiving the benefit vary from treaty to treaty.

- In *Italy*, resident companies are subject to corporate income tax on all sources of income. However, 95 percent of dividend income from a foreign company is exempt from Italian tax, as long as (1) the company paying dividends is resident in a country included in a "parent-subsidiary directive list" (currently EC countries) and (2) the Italian parent company has held more than 25 percent of the subsidiary's capital for over one year. This exemption applies only if the foreign company is located in a country that does not have a privileged tax system.

126. These are but a few examples of how tax systems around the world refrain from taxing categories of foreign income. The tax exclusions resulting under these systems are neither uniform, predictable by logic alone, or unqualified. They certainly do not forego taxation of all income from foreign activities, as the Panel seems to demand. Treating the Act's exclusion as a subsidy would require that parallel measures adopted by many, if not most, WTO Members also be treated as subsidies.

3. The Panel Failed to Apply the "But For" Test

127. As explained above, the Appellate Body found that an appropriate test for determining whether a government has foregone revenue that is "otherwise due" is to consider whether tax revenue would be collected in the absence of the contested measure (*i.e.*, the "but for" test). Notwithstanding the prior findings of the Panel and the Appellate Body with regard to the FSC provisions, the Panel did not apply the "but for" test in its examination of the ETI Act.

128. If the Panel had applied the "but for" test as it did with respect to the FSC, the Panel would have found that the ETI Act does not confer subsidies, because it does not involve the foregoing of revenue that is "otherwise due." Under a "but for" analysis, it is clear that the Act's exclusion of extraterritorial income is not a narrow tax-reducing exception to a general tax-raising rule. Instead, the limitation that the ETI Act places on the U.S. taxing authority was intended to be, and is a part of, the general rule of taxation itself. The ETI Act thus does not provide an exception against a broader definition of "gross income" that would otherwise apply; it is part of the definition of gross income.

129. Indeed, the very structure of the ETI Act indicates that the Act does not create the type of situation covered by the Panel's "but for" test. Under the Act, new section 114(a) of the IRC provides that "gross income" does not include extraterritorial income. This provision establishes a general rule of U.S. taxation that extraterritorial income is not subject to U.S. taxation. However, new section 114(b) creates an exception to section 114(a) to the effect that non-qualifying foreign trade income is taxable. Thus, the exception found in section 114(b) *raises* revenue. "But for" section 114(b), all extraterritorial income would be excluded from "gross

income" under section 114(a), and the exclusion of section 114(a) would be broader. As noted above, because section 114(a) is an integral part of the definition of "gross income," it forms part of the U.S. "normative benchmark" relevant to this case.

4. The Panel Erroneously Found That Extraterritorial Income Would Otherwise Be Subject to Tax as Gross Income

130. The Panel found that, in the absence of the ETI Act, extraterritorial income would be "gross income" and thus would be taxed.[127] In doing so, the Panel again failed to take into consideration important aspects of the IRC.

131. The Panel had no basis for assuming what the definition of "gross income" would be in the United States in the absence of the ETI Act. That would be a decision that is left to the United States. Furthermore, the Panel was inaccurate when it assumed that all "gross income" would in fact be taxed. The mere fact that income is "gross income" does not mean that it would in fact be taxed. "Gross income" is the starting point for the definition of taxable income. It is but the first step in determining whether income is actually taxed.

132. There are a numerous reasons why items of extraterritorial income would not in fact be taxed even if, in the absence of the ETI Act, those items were regarded as "gross income" under the IRC. In particular, the Act does not allow for deferral, deductions, or foreign tax credits in relation to excluded income. If the ETI Act were not in place, taxpayers would be expected to frame their activities to obtain the advantages of such tax-reducing mechanisms.

[127] ETI Panel Report, para. 8.25.

133. For example, U.S. companies that otherwise would earn extraterritorial income could structure their foreign operations through a jurisdiction that provides an exclusion for income from foreign sales similar to the exclusion currently provided by the Act (as by establishing the operation in a country that has adopted a territorial tax system). Income that otherwise would have been excluded income under the Act thus would not be subject to U.S. tax even in the absence of the Act. It therefore cannot be said that the United States has foregone any revenue in this situation.

134. Absent a factual basis for finding that the Act will, in fact, result in the United States foregoing tax revenue, it was error for the Panel to find that the ETI Act confers a subsidy.

B. The Panel Erred in Finding That the ETI Act's Exclusion Is Contingent Upon Export Performance Under Article 3.1(a) of the SCM Agreement

135. The Appellate Body need turn to Article 3.1(a) of the SCM Agreement only if it sustains the Panel's finding that the ETI Act confers a subsidy within the meaning of Article 1. If the ETI Act does not confer a subsidy, then it cannot be prohibited by Article 3.1(a).[128] Even if the Appellate Body should affirm the Panel's findings under Article 1, however, the ETI Act does not constitute a prohibited subsidy because the exclusion of income under the Act is not contingent upon export performance. As explained below, the Panel's finding that the Act's exclusion is a prohibited subsidy rests upon an incorrect legal interpretation of Article 3.1(a), as

[128] This is because Article 3.1(a) applies only where an Article 1 subsidy exists. Article 3.1(a) states in pertinent part that "the following subsidies, *within the meaning of Article 1*, shall be prohibited ... ." (emphasis added).

well as a fundamental misunderstanding of the ETI Act itself. For these reasons, the Appellate Body should reverse the Panel's findings under Article 3.1(a).

1. The Meaning of Article 3.1(a)

136. Article 3.1(a) provides in relevant part that "subsidies contingent in law or in fact, whether solely or as one of several other conditions, upon export performance" are prohibited. According to the Appellate Body, the "key word" in Article 3.1(a) is "contingent."[129] The Appellate Body has explained that the term "contingent" has an ordinary meaning of "conditional" or "dependent for its existence on something else."[130] Thus, for an export subsidy to exist within the meaning of Article 3.1(a), there must be a requirement that recipients export in order to receive the subsidy. Or, in the words of the Appellate Body, "the subsidy is available only upon fulfillment of the condition of export performance."[131]

137. It is not enough for a subsidy to be granted upon the mere expectation that the subsidy will lead to new or additional exports; the grant of the subsidy in and of itself must be conditioned on export performance. As the Appellate Body has said,

> It does not suffice to demonstrate solely that a government granting a subsidy *anticipated* that exports would result. The prohibition in Article 3.1(a) applies to subsidies that are *contingent* upon export performance ... . A subsidy may well be granted in the knowledge, or with the anticipation, that exports will result.

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[129] *Canada – Measures Affecting the Export of Civilian Aircraft* ("*Canada Aircraft (AB)*"), WT/DS70/AB/R, Report of the Appellate Body adopted 20 August 1999, para. 167.

[130] *Id.*

[131] *Canada – Certain Measures Affecting the Automotive Industry* ("*Canada Autos (AB)*"), WT/DS139/AB/R, WT/DS142/AB/R, Report of the Appellate Body adopted 19 June 2000, para. 100.

> Yet, that alone is not sufficient, because that alone is not proof that the granting of the subsidy is *tied to* the anticipation of exportation.[132]

138. Article 3.1(a) encompasses both *de jure* and *de facto* export subsidies. The Appellate Body has made clear that the meaning of Article 3.1(a) does not change in *de jure* as opposed to *de facto* cases.[133] What does change is the means by which a violation of Article 3.1(a) is demonstrated. The Appellate Body has explained that a *de jure* export contingency must be "demonstrated on the basis of the words of the relevant legislation" or "derived by necessary implication from the words actually used in the measure."[134] By contrast, a *de facto* claim "must be *inferred* from the total configuration of facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case."[135]

139. In the instant dispute, the EC's Article 3.1(a) claim is an exclusively *de jure* one.[136] The Panel had no basis to make a *de jure* finding that the Act's exclusion of extraterritorial income is export-contingent, however, for neither the text of the Act nor any necessary implication from that text supports such a finding. By going past the actual text of the Act to an analysis of its supposed operation, the Panel improperly converted its *de jure* inquiry into a *de facto* challenge to the Act. No claim other than a *de jure* claim is presented in this case, however, and no record has been assembled that could possibly support any *de facto* claim. Thus, whether characterized as *de jure* or *de facto*, the Panel's finding of export contingency is improper.

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[132] *Canada Aircraft (AB)*, paras. 171-172 (emphasis in original).
[133] *Id.,* para. 167.
[134] *Canada Autos (AB)*, para. 100.
[135] *Canada Aircraft (AB)*, para. 167 (emphasis in original).
[136] ETI Panel Report, para. 8.54.

2. The Panel Expanded the Scope of Article 3.1(a) Beyond Its Terms

140. The Panel erred in its Article 3.1(a) analysis in two key respects. First, it found that a measure constitutes an export subsidy under Article 3.1(a) whenever the measure treats domestic sales less favorably than foreign sales. Second, the Panel found that Article 3.1(a) prohibits any subsidy which, even though generally available under an export-neutral principle, is available to some subset of producers or goods only through exportation. These findings are not consistent with the text of Article 3.1(a) or relevant Appellate Body jurisprudence.

a. The Availability of a Subsidy to Purely Domestic Transactions Is Irrelevant Under Article 3.1(a)

141. One of the principal reasons the Panel gave for finding that the ETI Act runs afoul of Article 3.1(a) is that, while exports are a subset of the pool of possible foreign transactions giving rise to a tax exclusion, domestic sales are not included in the pool.[137] According to the Panel, the ETI Act's exclusion is export-contingent simply because it is not available to "goods produced within the United States sold for use within the United States"[138] – or, in other words, purely domestic transactions. The Panel stated that export contingency exists as long as there is differentiation between the treatment of domestic-produced goods sold domestically and those sold for export.[139] The Panel said that this is the "defining contrast."[140]

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[137] This, of course, is true of *any* system of taxation incorporating territorial principles, and is also true of most (if not all) worldwide systems of taxation that are constructed in an effort to avoid double taxation.

[138] ETI Panel Report, paras. 7.15, 8.60.

[139] *Id.*, para. 8.67.

[140] *Id.*

142. In doing so, the Panel has created an extraordinary and novel doctrine under Article 3.1(a) – a reverse national treatment requirement – under which domestic sales must be afforded no less favorable treatment than exports or other foreign sales. Such a requirement is plainly not present in the text of Article 3.1(a), which does not look to whether subsidies are or are not made available to domestic goods, sales, or income. Instead, Article 3.1(a) prohibits only those subsidies that are "contingent" on "export performance." The Appellate Body has used various phrases to explain this contingency, such as "conditioned on", "dependent for its existence on", and "tied to".[141] All of these terms suggests an examination of whether there is a requirement of, or linkage to, exportation as a prerequisite for receiving a government benefit. Whether domestic goods, sales, or income are treated equally or identically is simply not germane under Article 3.1(a).

143. The Panel's finding broadens the language of Article 3.1(a) significantly beyond the meaning intended by its drafters. If the drafters of the WTO Agreement had wished to imbue Article 3.1(a) with the Panel's proposed construction, they certainly knew how to do so. For example, the text of GATT Article III:4 states that "products . . . imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin ... ." Similarly, GATS Article XVII specifies that "each Member shall accord to services and service suppliers of any other Member . . . treatment no less favourable than that which it accords to its own like services and service suppliers".

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[141] *See, e.g.*, *Canada Aircraft (AB)*, paras. 166 and 171.

144. The Appellate Body has ascribed a different and far broader application for these national treatment provisions than it has ascribed for the export-contingency requirement in Article 3.1(a). For example, in *EC Bananas,* the Appellate Body said:

> The 'no less favourable treatment obligation' in Article III:4 has been consistently interpreted as a requirement to ensure effective equality of opportunities between imported products and domestic products. In this respect, it has been held that, since a fundamental objective of Article III is the protection of expectations on the competitive relationship between imported and domestic products, a measure can be found to be inconsistent with Article III:4 because of its potential discriminatory impact on imported products."[142]

The determination whether a subsidy is contingent on export performance thus is not simply equivalent to the goal of ensuring equal competitive opportunities – and equal expectation of such opportunities – between foreign and domestic products.

145. The Panel's expansive interpretation of Article 3.1(a), if upheld, would have dramatic and unintended consequences for tax systems throughout the world. Most countries tax income derived from foreign sources and activities differently than income derived from domestic sources and activities. This is clearly the case with respect to the tax systems of many EC member States, which provide a partial exemption for export-related income but provide no exemption for income derived from comparable domestic sales. The only way a domestic producer can benefit from a territorial exemption is by exporting; selling domestically will not qualify. By hinging its analysis of Article 3.1(a) on whether domestic sales income is taxed

[142] *European Communities - Regime for the Importation, Sale and Distribution of Bananas* ("*EC Bananas*"), WT/DS27/AB/R, Report of the Appellate Body adopted 25 September 1997, para. 216.

equivalently to foreign transaction income, the Panel has cast doubt on a wide array of common practices well beyond the measure involved in the present dispute.

b. Article 3.1(a) Does Not Prohibit Subsidies That Benefit Exporters If Conferred Through Export-Neutral Principles

146. Even though the exclusion of extraterritorial income under the ETI Act is plainly based upon export-neutral criteria – because exportation is not a condition of obtaining the tax exclusion – the Panel found that the exclusion should be regarded as export-contingent because *some* taxpayers benefit under the Act by exporting. The Panel in effect has said that a measure is in violation of Article 3.1(a) if exportation is *one* way of obtaining a governmental benefit. However, this new interpretation of Article 3.1(a) is at odds with its text and with prior Appellate Body reports.

i. It Is Immaterial Under Article 3.1(a) That Subsidy Beneficiaries Can Choose to Export

147. There is no disagreement that U.S. exporters – as well as foreign producers and sellers – are among the pool of potential taxpayers that may earn excluded income under the Act. However, this is no different from a wide array of subsidies that are available on an export-neutral basis. A simple production or sales subsidy – making a benefit available based on the achievement of established production or sales targets – may allow private parties to satisfy the requisite conditions through exporting. Indeed, some beneficiaries may be able to reach the necessary production or sales thresholds *only* by exporting. Nonetheless, absent unique factual

circumstances,[143] it is difficult to imagine labeling such subsidies as export subsidies. And, because this case involves only a *de jure* and not a *de facto* challenge to the ETI Act, any inquiry into whether such a unique set of facts could exist here is precluded by the narrow scope of this proceeding.

148. The Act's exclusion is based on a facially neutral principle – a tax exclusion for foreign-transaction income. That neutral principle can, but does not necessarily, encompass income derived from export transactions. The Act makes plain that goods that may be the subject of qualifying transactions can be manufactured, produced, grown, or extracted *within or outside* the United States.[144] That a private party might choose to export and thereby benefit from the exclusion does not mean that the exclusion is conditioned or dependent on exporting.

149. A broad range of taxpayers may earn extraterritorial income, including U.S. and foreign corporations, as well as individuals. Moreover, U.S. corporations may earn extraterritorial income through either domestic or offshore manufacturing operations. A U.S. multinational manufacturer can produce qualifying merchandise in foreign plants, and U.S. companies selling products abroad can source their goods through suppliers located outside the United States. Similarly, U.S.-based producers may choose to manufacture abroad or may choose to outsource production to a foreign manufacturer.

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[143] *See, e.g., Australia - Subsidies Provided to Producers and Exporters of Automotive Leather*, WT/DS126/R, Report of the Panel adopted 16 June 1999, para. 9.67, in which a panel found that Australia's grant of a production subsidy was a *de facto* export subsidy because the production thresholds were set so high that the beneficiary had to produce more leather for automobiles than could be absorbed by the Australian market.

[144] The Act § 3, amending IRC § 943(a)(1)(A).

150. The fact that Article 3.1(a) does not extend to subsidies conferred through export-neutral principles is confirmed by footnote 4 of the SCM Agreement. That footnote states: "The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of [Article 3.1(a)]." The fact that exporters are capable of earning excluded income under the Act is not sufficient to establish that the exclusion is *tied to* or *contingent upon* exportation.[145]

151. The Appellate Body has made clear that even where exporters have been targeted for receipt of subsidies, this does not alone make a subsidy export-contingent. In the *Canada Aircraft 21.5* case, the Appellate Body considered evidence that subsidies were specifically targeted to the aircraft industry because of its export orientation. The Appellate Body stated that Canada's "targeting factors may very well be relevant to an inquiry under Article 3.1(a) of the SCM Agreement, but they do not necessarily provide conclusive evidence that the granting of a subsidy is 'contingent,' 'conditional,' or 'dependent' upon export performance. In these proceedings, we do not see the two 'targeting' factors, by themselves, as adequate proof of prohibited export contingency."[146] The further factual inquiry required under the *Canada Aircraft 21.5* case would be improper in the present *de jure* proceeding. Even if it were proper,

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[145] *Canada Autos (AB)*, para. 172. In the Article 21.5 proceeding in *Canada Aircraft*, the Appellate Body said that a subsidy granted to enterprises that export does not "compel the conclusion that there is a relationship of conditionality or dependence such that the granting of a subsidy is 'tied to' export performance." *Canada – Measures Affecting the Export of Civilian Aircraft - Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/AB/RW, Report of the Appellate Body adopted 4 August 2000, para. 48.

[146] Ca*nada - Measures Affecting the Export of Civilian Aircraft - Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/AB/RW, Report of the Appellate Body adopted 4 August 2000, para. 49.

the Panel made no factual findings (and there are no uncontested facts in the record) relating to such an inquiry.

ii. Exportation Is "One of Several Other Conditions" Only Where It Is a Mandatory Condition

152. The Panel further misread Article 3.1(a) by failing to take note of a significant part of its text. Article 3.1(a) prohibits "subsidies contingent in law or in fact, *whether solely or as one of several other conditions*, upon export performance" (emphasis added). This language serves to underscore the notion that exportation must be a necessary condition for obtaining a benefit, not merely a choice that is left for private parties to make. Despite the fact that the parties briefed this issue extensively, the Panel did not address it in its report.[147]

153. Both sides agreed that a key word in the phrase "one of several other conditions" as it relates to this dispute is "other." The EC incorrectly suggested that the meaning of "other" is "alternative."[148] The EC suggested that providing private parties with a choice to export in order to secure a benefit implicates Article 3.1(a). But, as the United States pointed out, the ordinary meaning of the word "other" is "one – of two" or "[t]hat [which] follows the first, second; further, additional".[149] In this light, the term "other" is synonymous with *additional.*

154. Given the ordinary meaning of the term "other," the phrase "one of several other conditions" indicates that export performance may be an *additional* condition to others that apply, but export performance remains a condition that must be satisfied. The phrase "several

[147] ETI Panel Report, para. 8.22, note 152.
[148] *First EC 21.5 Submission*, ETI Panel Report, Annex A-1, para. 128.
[149] *First U.S. 21.5 Submission*, ETI Panel Report, Annex A-2, para. 134, *quoting from The New Shorter Oxford English Dictionary* (1993).

other conditions" thus means a series of conditions precedent – all of which must be satisfied for something to occur. Therefore, in the context of Article 3.1(a), only where a government provides a subsidy contingent on the fulfillment of a series of conditions, one of which is export performance, is such a subsidy "contingent, . . . as one of several other conditions, upon export performance."

iii. An Expansion of Beneficiaries Can Cure an Export-Contingent Subsidy

155. In fashioning its no-export-subset doctrine, the Panel went so far as to say that a subsidy remains export-contingent without regard to whether exports are a large or small part of the transactions covered by the measure in question. The Panel made this point in rejecting the U.S. argument that export contingency can be cured by expanding the universe of those eligible for a subsidy.[150] The Panel thus found that a former export-specific measure – the FSC – cannot be cured by broadening its scope of application to include non-export transactions. The Panel's finding overlooks the fact that the FSC and the ETI Act are different measures that need to be analyzed separately. More importantly, the Panel's finding on this point is at odds with the SCM Agreement and, if allowed to stand, would have a significant impact on both tax measures and subsidy programs throughout the world.

156. **The Panel's Finding Would Cast Doubt on Broad-Based, Export-Neutral Subsidies.** The Panel reduced the ETI Act to two broad, oversimplified categories: U.S.-made goods that must be exported and foreign-made goods that need not be exported. The Panel said that "the

[150] ETI Panel Report, para. 8.65.

fact that the Act also involves subsidies with respect to goods produced outside the United States . . . does not, in our view, vitiate the export-contingency of the Act."[151] The Panel went on to say that no matter how far the United States might try to expand the ETI Act, it could never remedy the fact that some beneficiaries that export may earn excluded income.[152]

157. The Panel's reasoning ignores the basic operation of any broad-based subsidy. As noted above, production or sales subsidies are export-neutral, but exporting may be one way for parties to secure the benefits at issue. For some parties, exporting may be the only way they could obtain the benefits.

158. Take, for example, a subsidy program that offers a direct government grant for any domestic manufacturer that sells 10,000 bicycles within or without the country. Relying on the Panel's analysis, this simple sales subsidy would be an export subsidy because there are only two ways a domestic bicycle manufacturer could meet the requirements: 1) to sell bicycles domestically, or 2) to export them. As a practical matter, given the fact that there is not infinite demand for bicycles domestically, some manufacturers will reach the 10,000 bicycles target only by exporting.

159. The Panel tries to blunt this concern by creating the "reverse national treatment" test discussed above. The Panel in effect is saying that the bicycle subsidy example would not be an export subsidy because domestic sales are treated equally with export sales. But, what the Panel does not, and cannot, explain is why it is permissible to create a subsidy for domestic sales and

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[151] ETI Panel Report, para. 8.64.
[152] *Id.*

export sales collectively, on the one hand, but it is impermissible to create one for export sales and wholly foreign sales collectively on the other. The text of Article 3.1(a) does not make such a distinction, and no rationale supplied by the Panel adequately supports it.

160. **The Breadth of an Export-Neutral Subsidy Is Relevant.** The Panel ignored the fact that expansion of the categories of persons eligible for a subsidy is the best way to cure a specific subsidy, of which export subsidies are one form. This fact is reflected in the text and structure of the SCM Agreement. According to SCM Article 1.2, Part II of the Agreement – which includes Article 3 – is relevant only where a "subsidy is specific in accordance with the provisions of Article 2." In turn, Article 2 sets out standards for determining whether a subsidy is "specific." Article 2.3 provides that subsidies contingent on export performance "shall be deemed to be specific."

161. Accordingly, an obvious and simple way to remedy a specific subsidy – such as an export subsidy – should therefore be to make the subsidy non-specific by expanding the pool of potential beneficiaries. The only question is how extensively it must be broadened before the subsidy can no longer be said to be specific.

162. Despite arguing against the relevancy of an expanded group of beneficiaries at length in paras. 8.65-8.71 of its report, the Panel then concluded its discussion by advising the United States that it can indeed save the ETI Act by expanding it. The Panel states that "a way to cure export contingency in this case would be . . . by making the subsidy available irrespective of

whether a product of national origin is sold in the domestic market or abroad."[153] The Panel fails to acknowledge that this proposal simply would add an additional category to extraterritorial income, contrary to its position that expansion is not a cure.

163. The United States respectfully submits that a tax exclusion available for foreign sales is not export-contingent. The Appellate Body should hold that it is equally permissible to exclude from tax income derived from foreign sales (including exports) as it would be to exclude from tax income from a category that consists of income from both domestic sales and export sales.

3. The Panel Misconstrued the ETI Act By Considering Its Exclusion Only as It Relates to U.S.-Produced Goods

164. In addition to creating two new doctrines that cannot be found in the text of Article 3.1(a) – the reverse national treatment and the no-export-subset doctrines – the Panel contorted its analysis of the ETI Act to fit its theories. The Panel chose to bifurcate the Act between its application to U.S. goods and non-U.S. goods and between exports and non-exports when the Act simply does not make such distinctions. The Act provides even-handed treatment to U.S. and foreign goods and manufacturers, according the same treatment irrespective of where a product is produced. Exporting is but one way of satisfying the Act's conditions, but no taxpayer is *required* to export in order to earn excluded income under the Act. Under the Act, taxpayers are free to manufacture merchandise in the United States or abroad, and the EC supplied no evidence indicating that any taxpayer *must* manufacture in the United States and export its products in order to earn excluded income under the ETI Act. This is a matter left to

[153] ETI Panel Report, para. 8.72.

the discretion of taxpayers. Thus, when the actual text of the Act is considered, it is evident that it is the Panel and not the Act that has created an export contingency.

165. As described above in the "Factual Background" section, the Act makes no distinction between U.S.-made products and foreign-made products. Income from the sale of both is equally covered by the Act. Section 3 of the Act, amending IRC § 943(a)(1)(A), explicitly states that qualifying goods may be produced within or without the United States. Likewise, the Act does not distinguish between foreign and domestic producers. Both are fully eligible to earn excluded extraterritorial income.[154]

166. The Act's legislative history makes clear that it was purposefully drafted to provide tax relief based on export-neutral criteria:

> [Congress] relied on the WTO Appellate Body's interpretation of the meaning of ''contingent'' for purposes of the Agreement on Subsidies and Countervailing Measures in crafting this legislation. It is the Committee's intent and belief that the exclusion of extraterritorial income from U.S. gross income is not dependent on such income arising from export activities. Accordingly, the Committee has determined that it is appropriate to treat all foreign sales alike, whether the goods were manufactured in the United States or abroad. A taxpayer would receive the same U.S. tax treatment with respect to its foreign sales regardless of whether it exports.[155]

167. The Act's exclusion of extraterritorial income is available to a range of foreign transactions, regardless where goods are manufactured. As the legislative history of the Act explains, exporting is but one way of earning extraterritorial income:

> The Committee emphasizes that the extraterritorial income excluded by this legislation from the scope of U.S. income taxation is parallel to the foreign-source

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[154] The Act, § 3, amending IRC § 943(a)(1)(A).

[155] *House Report*, page 17.

> income excluded from tax under most territorial tax systems. Under neither the U.S. tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems. While exporters may be among those who are eligible for the exclusion, this fact does not make that exclusion ''export contingent.'' If it did, every general exclusion from tax applicable to, among others, exporters would become a prohibited export subsidy.[156]

168. The United States is not aware of a single instance in which a taxpayer is obligated to produce a particular item in the United States and export in order to trigger application of the ETI Act's exclusion. The EC has failed to introduce any evidence demonstrating that there is in fact a single business that is compelled under the ETI Act to manufacture within the United States and export.[157] That U.S. manufacturers may benefit by exporting from the United States is a choice they are free to make, just as they are free to handle production in a foreign jurisdiction where they may equally benefit under the Act. To whatever extent exporting is involved in

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[156] *Id.*, page 18; *see also Senate Report*, page 5.

[157] The Panel purported to find support for bifurcating the Act and ignoring fundamental aspects of the Act in the reports arising out of the *Canada Aircraft* dispute. The Panel quoted the Appellate Body's statement that the existence of non-export-contingent subsidies in Canada's aircraft regime "does not necessarily mean that the same is true for all of TPC's contributions. It is enough to show that one or some of TPC's contributions do constitute subsidies 'contingent . . . in fact . . . upon export performance." ETI Panel Report, para. 8.64, quoting *Canada Aircraft (AB)*, para. 179. However, that report is distinguishable. The *Canada Aircraft* dispute involved a claim of *de facto* export contingency regarding severable payments to the Canadian aircraft industry. Each payment had to be considered on its own unique facts and conditions. In contrast, the instant dispute concerns a facial, *per se*, *de jure* challenge to a broad and essentially untested tax law. There is no evidence here, as there was in *Aircraft*, demonstrating that a governmental benefit is conditioned on export performance. It was, therefore, error for the Panel to fail to consider the Act *in toto* and to focus instead on how the Act incidentally distinguishes between domestic goods sold outside the United States and domestic goods sold within the United States.

relation to the Act at all, it is merely incidental to the neutral criteria establishing the scope of the exclusion.

169. Notwithstanding the export-neutrality of the Act, the Panel found an export contingency by creating an artificial construct that appears to derive from the EC's flawed analysis of the ETI Act. The EC argued that there are two distinguishable subsidies in the Act. The EC claimed that the Act confers benefits first "in respect of the export of U.S. produced goods" and second to "transactions involving foreign produced goods."[158] Although the Panel claimed not to rely on this outcome-determinative approach,[159] it nonetheless proceeded to examine the Act as if it has one category of treatment for U.S.-produced goods and one for foreign-produced goods (and as if it had one for U.S. exports and one for domestic sales).[160] The Panel considered the Act as severable components rather than a unitary whole and thereby concluded that "the scheme [*i.e.*, the Act] is *de jure* dependent or contingent upon export in relation to *US-produced goods*."[161]

170. The Panel's almost single-minded focus on the notion that goods produced in the United States give rise to excluded income under the Act only if they are exported does not take account of the fact that goods and production are not geographically fixed. Businesses decide where they want to manufacture goods or even if they want to manufacture at all (as opposed to finding another, perhaps foreign, manufacturer to handle production). Indeed, the Panel acknowledged that under the ETI Act "US manufacturers may earn extraterritorial income without exporting, as

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[158] *First EC 21.5 Submission*, ETI Panel Report, Annex A-1, para. 64.
[159] ETI Panel Report, n. 62.
[160] *Id.,* paras. 8.60-8.64.
[161] *Id.*, para. 8.60 (emphasis added).

they have the option to produce and sell outside the United States"[162] and that "the subsidy is also available under the scheme with respect to goods produced outside the United States."[163]

171. Instead of examining the effects on goods after they have been manufactured, the Panel should have examined the Act based on its effect on taxpayers and the decisions they may make. The language of Article 3.1(a) confirms that the proper inquiry is whether the subsidy recipient (*i.e.*, the taxpayer) must "perform" export activities in order to earn excluded extraterritorial income under the Act. The term "export performance" in Article 3.1(a) focuses on actions that potential beneficiaries must take in order to obtain a subsidy. It is a forward-looking analysis of whether a governmental financial contribution requires potential recipients to export. It is not a backward looking analysis that examines whether a product that happens to be made in a certain way, time, or place will have to be exported to satisfy an export-neutral principle. That taxpayers may choose to export does not give rise to an export-contingency under Article 3.1(a).[164]

172. For the foregoing reasons, the Appellate Body should reverse the Panel's finding that the Act's exclusion is contingent upon export performance within the meaning of Article 3.1(a).

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[162] *Id.*, para. 8.61.

[163] *Id.*, para. 8.62.

[164] WTO rules focus on government action, not private action. *See EC Bananas*, para. 216 ("The requirement of Article III:4 is addressed to "relative competitive opportunities created by the government in the market, not to the actual choices made by enterprises in that market."); *see also Japan - Measures Affecting Consumer Photographic Film and Paper* ("*Japan Film*"), WT/DS44/R, Report of the Panel adopted 22 April 1998, para. 10.52 ("[T]he term measure in Article XXIII:1(b) and Article 26.1 of the DSU, as elsewhere in the WTO Agreement, refers only to policies or actions of governments, not those of private parties.").

C. The Panel Erred in Finding that the ETI Act Is Not a Measure to Avoid Double Taxation Under the Fifth Sentence of Footnote 59

173. With regard to the analysis of the applicability of the fifth sentence of footnote 59 of the SCM Agreement, the Appellate Body need reach this issue only if it affirms the Panel's findings that the ETI Act confers a subsidy that is export-contingent. With respect to this issue, too, the Panel employed a non-textual approach that is inconsistent with prior Appellate Body reports and the correct method of treaty interpretation under public international law. Whereas the Panel created two new corollaries to the Appellate Body's Article 1 comparison test, and introduced two novel doctrines regarding the meaning of Article 3.1(a), it went even farther with respect to the fifth sentence of footnote 59. The Panel read into the fifth sentence of footnote 59 detailed criteria for qualification as a measure to avoid double taxation, and, in so doing, established a new double taxation avoidance code. This "interpretive" exercise constitutes an extraordinary extrapolation from just one sentence of treaty language on the part of a body which, according to Article 3.2 of the DSU, is limited to clarifying provisions of covered agreements

174. The Panel articulated four new principles and a new standard of review that cannot be found in the fifth sentence of footnote 59. The Panel held that a measure to avoid double taxation:

- Must encompass all income subject to tax in a foreign jurisdiction;
- Must exclude all income that is not subject to tax in a foreign jurisdiction;
- Must contain a "permanent establishment" requirement; and
- May not be instituted by a WTO member having an extensive system of bilateral tax treaties.

The Panel indicated that no one factor is by itself dispositive, but did not preclude that a failure to meet any one of the above principles could result in a measure being deemed to be beyond the scope of the fifth sentence of footnote 59.

175. The Panel further confused matters by applying a "reasonable legislator" standard – a standard of review heretofore unrecognized by the WTO. In effect, the Panel said that it cannot define what is or is not a measure to avoid double taxation, but it will know one when it sees one. Surely more is needed where a fundamental right of a sovereign nation is at issue.

176. In this section, the United States will demonstrate that the ETI Act is a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59. That sentence was incorporated into the SCM Agreement to reflect the difficulties that arise for the multilateral trading system in this area and the resulting latitude granted to Members to prevent and fashion relief for double taxation. The United States then proceeds to show why the Panel's four new principles and new standard of review are incorrect.

177. In addition, the United States respectfully requests that if the Appellate Body were to sustain the Panel's ultimate finding regarding the fifth sentence of footnote 59, the Appellate Body do so on the basis of standards that are clear and easily understood. One of the most troubling aspects of the Panel's analysis is that is has left the United States – and other WTO Members – uncertain of what the limits of the fifth sentence of footnote 59 are. At this stage in the dispute, the United States respectfully submits that it is entitled to clear standards to follow if the Appellate Body decides that the ETI Act in its current form is not a measure to avoid double taxation.

1. The ETI Act Is a Measure to Avoid Double Taxation Under Footnote 59

178. Before discussing the meaning of the fifth sentence of footnote 59 and why the ETI Act falls within its scope, the United States first explains how the footnote fits into the SCM Agreement in general and how it relates to Article 3.1(a) in particular.

a. Measures Deemed Not to Be Export Subsidies in Annex I Are Not Prohibited by the SCM Agreement

179. To clarify the meaning of Article 3.1(a), the drafters of the SCM Agreement attached at Annex I an "Illustrative List of Export Subsidies." The drafters specified in Article 3.1(a) that this Illustrative List identifies practices that come within the provision's prohibition.[165] At the same time, the drafters also made clear that practices identified by the Illustrative List as *not* constituting an export subsidy are *not* prohibited by Article 3.1(a) or any other provision of the Agreement. They did so by means of footnote 5 of the Agreement, which also is attached to Article 3.1(a). Footnote 5 states that "[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement."

180. Under this structure, if a type of measure is deemed to be an export subsidy by the Illustrative List, it is prohibited by Article 3.1(a); if a measure is deemed *not* to be an export subsidy by the Illustrative List, it is *not* prohibited by *any provision* of the SCM Agreement.

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[165] Article 3.1(a) states in relevant part that "the following subsidies, within the meaning of Article 1, shall be prohibited: (a) subsidies contingent in law or in fact, whether solely or as one of several other conditions, upon export performance, *including those illustrated in Annex I*" (emphasis added).

b. Paragraph (e) Governs Export-Specific Income Tax Measures

181. Paragraph (e) of Annex I sets forth a general prohibition against foregoing or reducing taxes otherwise to be collected on export income. It states that "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes" is an export subsidy. By its terms, paragraph (e) applies to measures resulting in the non-taxation of income that have, as the EC put it, "a special, precise or clearly defined relationship or connection to exports."[166] This means that paragraph (e) applies to income tax exemptions, remissions, or deferrals that are directly connected to, narrowly or singularly tailored to, or overtly tied to income derived from export transactions.

182. The essence of paragraph (e) is a ban against export-specific income tax benefits or relief. It applies to measures that forego taxes directly or solely on income derived from export transactions. In order for paragraph (e) to apply, the tax benefits at issue must be export-contingent within the meaning of Article 3.1(a).

c. Footnote 59 Qualifies Paragraph (e)

183. Footnote 59 explains and qualifies the application of paragraph (e). Footnote 59, which is attached to paragraph (e),[167] identifies certain practices that, although they involve the failure to collect direct taxes on income earned in export transactions, nonetheless fall outside the scope of paragraph (e). As noted above, by virtue of footnote 5, measures identified by footnote 59 as measures that are not export subsidies are not prohibited by the SCM Agreement.

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[166] *First EC 21.5 Submission*, ETI Panel Report, Annex A-1, para. 153.

[167] Unlike footnote 58, which applies to more than one paragraph of Annex I, footnote 59 is connected only to paragraph (e).

184. One type of measure identified in footnote 59 as not prohibited by the SCM Agreement is deferral with interest. The first sentence of the footnote states that "[t]he Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected." This sentence makes clear that, despite the otherwise unequivocal pronouncement in paragraph (e) that "[t]he full or partial . . . deferral specifically related to exports, of direct taxes" is a prohibited export subsidy, paragraph (e) does not apply to a deferral scheme if "appropriate interest" is charged.[168] While the Appellate Body in its *FSC* report declined to comment on the meaning of the first sentence of footnote 59 because the FSC did not involve deferral, the Appellate Body did acknowledge that the first sentence is "specifically related to" and "qualifies" paragraph (e).[169]

185. Another area in which footnote 59 identifies measures that are not prohibited export subsidies is with respect to measures to avoid the double taxation of foreign-source income.[170] The fifth sentence of the footnote states that "[p]aragraph (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." The fifth sentence of footnote 59 therefore permits measures to avoid double taxation even though such a measure might otherwise

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[168] The rationale for this is appears to be that charging "appropriate interest" sufficiently negates benefits that may be conferred on exports.

[169] *FSC (AB)*, para. 97. The United States does not contend that the Act involves deferral, but discusses the first sentence of footnote 59 to illustrate the overall meaning and significance of the footnote.

[170] In *FSC (AB)*, the Appellate Body declined to examine the meaning of the fifth sentence of footnote 59, finding that the United States had not raised the issue before the Panel. *FSC (AB)*, paras. 101-103.

constitute an export-specific exemption, remission, or deferral of direct taxes under paragraph (e).

d. The Meaning of the Fifth Sentence of Footnote 59

186. Footnote 59 does not define "double taxation" or indicate what types of measures appropriately serve to "avoid" it, but the ordinary meaning of this language would encompass measures to prevent the same income from being subjected to tax twice. This understanding of the fifth sentence of footnote 59 derives from definitions of the terms used: "avoid" means "keep off; prevent; obviate",[171] "double" means "twice as much or as many" or "occurring twice",[172] and "taxation" means "the imposition or levying of taxes".[173]

187. The fifth sentence of footnote 59 does not apply to all types of income, but only to "foreign-source income". The footnote does not define this term either, but its ordinary meaning is as follows: (1) "income" means "the (amount) of money or other assets received or due to be received from employment, business, investments, etc.";[174] (2) "foreign" means "carried on or taking place abroad" or "situated outside the country; not in one's own land";[175] and (3) "source" means "a place or thing from which something material is obtained or originates."[176] Thus, for purposes of footnote 59, foreign-source income would appear to include income arising, at least

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[171] *The New Shorter Oxford English Dictionary* (1993).
[172] *Id.*
[173] *Id.*
[174] *Id.*
[175] *Id.*
[176] *Id.*

in part, outside the borders or territory of the WTO Member instituting a measure to avoid double taxation.

188. Foreign-source income raises the possibility of double taxation because such income can be subjected to taxation both by the country that is the source of income (sometimes referred to as the country of source) and by the country in which the taxpayer resides (sometimes referred to as the country of residence). It also can arise because two countries claim that the same taxpayer is a resident subject to their taxing jurisdiction or that the same income arises, at least in part, within their borders.

189. The issue of double taxation of foreign-source income obviously is significant in the context of export transactions which, by definition, involve the transfer of goods or services from one country to another. Some portion of the income generated by an export transaction can be said to be "foreign" because the destination of the goods, the location of the purchaser, the transfer of title, the making of payment, or the activities giving rise to the sale may be outside the seller's country of residence. A foreign country that can lay claim to being the "source" of income earned outside of the seller's country of residence might seek to tax such income. At the same time, the seller's country of residence might make the same claim with respect to that same income.

190. Because export transactions can give rise to problems of double taxation, the fifth sentence of footnote 59 permits WTO Members to refrain from taxing foreign-source income earned in export transactions. The fifth sentence expressly limits the reach of paragraph (e), which prohibits direct tax exemptions, remissions, or deferrals that are made available

"specifically in relation to exports." As the fifth sentence states, "*Paragraph (e) is not intended to limit a Member* from taking measures to avoid double taxation of foreign-source income ... ." (emphasis added).

e. Measures to Avoid Double Taxation Under Footnote 59

191. There does not appear to be any dispute between the EC and the United States as to whether a system of non-taxation of foreign-source income is an acceptable means of avoiding double taxation (nor did the Panel appear to quarrel with this position). This mutual position derives from the fact that it is a well-established international taxation principle that because two countries may claim the right and ability to tax the same income – thereby leaving taxpayers with an undue burden – the respective countries must take action to rectify a potential injustice.[177]

192. While the WTO has not defined the types of measures that may be used to avoid double taxation of foreign-source income, two general categories of measures are well-accepted and used around the world for this purpose: the exemption (or non-taxation) method and the credit method. As noted in the Factual Background section above, both methods have been used by the

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[177] As the EC has stated:

> When a resident of a country earns income from outside the country (foreign-source income), the claim of that country to tax the income based on its worldwide residence jurisdiction may overlap the claim of a foreign country to tax revenue based on source jurisdiction. Consequently, foreign-source income earned by a resident of a country may be taxed by both the country of source and the country of residence, absent relief provisions to prevent double taxation. The necessity for relief is clear on grounds of equity and economic policy.

Annex EC-2, page 1.

OECD and the United Nations in their model tax treaties. Indeed, the EC cited both to the Panel as establishing proper ways of avoiding double taxation.[178]

193. The OECD and the U.N. model treaties expressly acknowledge that countries may use either exemption (non-taxation) or credits to avoid double taxation of foreign-source income.[179] As the Commentary to the OECD Model Convention explains, both the exemption method and the credit method serve to avoid double taxation in the context of foreign-source income.[180] The Commentary further makes clear that countries are free to adopt one or both methods and the means by which they are implemented may vary from country to country.[181]

f. The ETI Act Was Designed to Avoid Double Taxation

194. The ETI Act expressly relies on the exemption method to avoid double taxation of foreign-source income. The legislative history accompanying the Act makes the point explicitly: "Because the exclusion of such extraterritorial income is a means of avoiding double taxation, no foreign tax credit is allowed for income taxes paid with respect to such excluded income."[182] The legislative history further explains that, in shifting from a worldwide tax system to a more

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[178] Annex EC-2, page 2.

[179] *See, e.g., OECD Model Tax Convention*, page C(23)-14.

[180] *OECD Model Tax Convention,* page C(23)-3 ("Articles 23A and 23B apply to the situation in which a resident of State R [residence] derives income from, or owns capital in, the other Contracting State S [source] . . . and that such income or capital, in accordance with the Convention, may be taxed in such other State S.").

[181] *OECD Model Tax Convention*, page C(23)-14 ("In view of the wide variety of fiscal policies and techniques in the different States regarding the determination of tax, especially deductions, allowances and similar benefits, it is preferable not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique.").

[182] *House Report*, pages 10 and 13; *see also Senate Report*, pages 2 and 6.

territorial approach, the United States was, through the Act, embracing an exemption (or non-taxation) method of avoiding double taxation typically employed under territorial systems. The Act's exclusion takes the place of foreign tax credits, which ordinarily serve under the IRC as the mechanism for avoiding double taxation. The legislative history states:

> It is important to note that each type of system [worldwide versus territorial] generally uses a different method to avoid double taxation of foreign-source income. Although this is an oversimplification, in a worldwide system, the ''credit method'' typically is used; that is, a tax credit is provided for taxes paid to foreign governments on income earned abroad. In a territorial system, the ''exemption method'' is used; that is, income earned abroad is simply not subject to tax. While tax policy arguments can be used to justify the superiority of one method over the other, both methods are accepted internationally, and it also is accepted internationally that a country is free to use either method or both.[183]

195. The Act achieves avoidance of double taxation through the exclusion of extraterritorial income. In addition, section 114(d) of the IRC, as added by the Act, provides that "no credit shall be allowed under this chapter for any income, war profits and excess profits taxes paid or accrued to any foreign country or possession of the United States with respect to extraterritorial income which is excluded from gross income under subsection (a)."

196. By creating a general exclusion from U.S. taxation for extraterritorial income in section 114(a), and then establishing limited exceptions that allow for tax on a portion of such income in section 114(b), the Act provides a partial exclusion for foreign-source income within the meaning of the fifth sentence of footnote 59. As noted above, the ordinary meaning of the term "foreign-source income" is profits or proceeds arising outside the borders or territory of the WTO Member instituting a measure to avoid double taxation. The essential characteristics that

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[183] *House Report*, page 13.

would indicate whether profits or proceeds arise outside the borders or territory of a country might include one or more of the following: the goods or services in question are sold outside the territory of the taxing authority, the purchaser is located outside the territory of the taxing authority, title to the merchandise is transferred outside the territory of the taxing authority, payment is made or issued outside the territory of the taxing authority, or the activities giving rise to the sale occur (at least in part) outside the territory of the taxing authority.

197. "Extraterritorial income" under the Act involves these foreign attributes. The central feature of the Act is the provision of a tax exclusion for income from foreign sales.[184] With regard to the types of transactions that may generate excluded income, the Act provides that the goods involved must be used, consumed, or disposed of outside the United States.[185] As such, the purchasers of these goods typically will be located outside the United States, they generally will authorize or make payment for the goods in another country, and in many instances title will pass in that country as well. The goods may be produced outside the United States,[186] and certain required levels of foreign economic activities must be performed with respect to the sales and distribution functions associated with qualifying transactions.[187]

198. It is because of these considerations that income excluded under the Act may properly be characterized as extraterritorial. "Extraterritorial income" under the Act is income derived from foreign transactions. As such, it comes within the ordinary meaning of "foreign-source."

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[184] The Act § 3, amending IRC § 114(e), defines "extraterritorial income" as the proceeds generated from qualifying foreign sales.

[185] The Act § 3, amending IRC § 943(a)(1)(B).

[186] The Act § 3, amending IRC § 943(a)(1)(A).

[187] The Act § 3, amending IRC § 942(b).

g. The Act's Exclusion Is Akin to Territorial Exemptions Under EC Member State Tax Systems

199. The exclusion established by the Act was designed to parallel aspects of the territorial tax systems of many EC member States. The Act's legislative history makes this plain:

> The Committee emphasizes that the extraterritorial income excluded by this legislation from the scope of U.S. income taxation is parallel to the foreign-source income excluded from tax under most territorial tax systems. Under neither the U.S. tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems. While exporters may be among those who are eligible for the exclusion, this fact does not make that exclusion ''export contingent.'' If it did, every general exclusion from tax applicable to, among others, exporters would become a prohibited export subsidy.[188]

200. Like the Act, EC territorial tax systems do not tax a portion of income generated by foreign sales. Among EC tax systems that apply the territorial principle of taxation, the form and extent of each country's application of that principle vary. A pure territorial tax system exempts all income earned outside the country's borders. However, no EC country provides a blanket exemption for foreign-source income. In fact, as the EC explained to the *FSC* Panel, EC member States providing an exemption for foreign-source income do so only partially, and most generally treat foreign-source income as an exception to the general rule that the worldwide income of a domestic corporation is subject to taxation in its country of residence.[189] Just as the Act moves

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[188] *House Report*, page 18; *see also Senate Report*, page 5.
[189] EC Annex-2, page 2.

the United States toward a more territorial approach to its system of taxation, EC systems are a mix of worldwide and territorial principles.

2. The Panel Erroneously Imposed on the United States the Burden of Proving that the ETI Act Is a Measure to Avoid Double Taxation Under Footnote 59

201. As the complaining party, the EC was obligated to present adequate arguments and supporting evidence to establish a *prima facie* case with respect to each of the elements necessary to demonstrate the violation alleged.[190] If the balance of evidence is inconclusive, the complainant fails to establish its claims.[191]

202. The Panel, however, improperly shifted the burden of proof from the EC to the United States with respect to the question of whether the ETI Act is a measure to avoid double taxation under footnote 59. The Panel stated "that the nature of the last sentence of footnote 59 is such that the party asserting that its measure falls within the scope of that sentence bears the burden of establishing that the measure fulfils the conditions set out in that sentence."[192] The Panel also

[190] *European Communities - Measures Affecting Meat and Meat Products (Hormones)* ("*EC Hormones*"), WT/DS26/AB/R, WT/DS48/AB/R, Report of the Appellate Body adopted 13 February 1998, para. 109; *see also United States - Measure Affecting Imports of Woven Wool Shirts and Blouses from India* ("*U.S. Wool Shirts*"), Report of the Appellate Body adopted 23 May 1997, page 16 ("a party claiming a violation of a provision of the WTO Agreement by another Member must assert and prove its claim"); and *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, Report of the Appellate Body adopted 16 January 1998, page 27 (noting that the Panel had "properly require[d] the [complaining party] to establish a *prima facie* case" before proceeding to the next step of its evaluation of the claim at issue).

[191] *See, e.g., India - Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*, WT/DS90/R, Report of the Panel, as affirmed by the Appellate Body, adopted 22 September 1999, para. 5.120.

[192] ETI Panel Report, para. 8.90.

stated "that it is for the Member seeking to justify its measure under the last sentence of footnote 59 to invoke this provision and to bear the burden of proof by establishing an affirmative *prima facie* case that the conditions in that sentence of the footnote are fulfilled."[193]

203. It is true that there are instances where a responding party may have to bear the burden of establishing an affirmative defense – for example, under GATT Article XX. However, the relationship between violations under other provisions of the GATT and GATT Article XX is fundamentally different from the relationship between the fifth sentence of footnote 59 and Article 3.1(a) of the SCM Agreement.

204. Shifting the burden of proof from the complaining party to the responding party is appropriate with regard to GATT Article XX because that provision establishes "General Exceptions" that apply only where a violation otherwise is established under a separate GATT article. In contrast, the last sentence of footnote 59 is inextricably linked to SCM Article 3.1(a) and it serves to define the scope of Article 3.1(a). A violation of Article 3.1(a) cannot be established where the challenged measure is a measure to avoid double taxation under footnote 59.

205. This situation is analogous to the one confronted by the Appellate Body in *EC Hormones*. There, the Appellate Body was called upon to examine the relationship between Articles 3.1, 3.2, and 3.3 of the Agreement on Sanitary and Phytosanitary Measures ("SPS Agreement"). The latter two articles create exceptions to the general requirement of Article 3.1 that WTO Members base their sanitary measures on international standards. The Appellate Body stated, however,

[193] ETI Panel Report, note 188.

that it was improper for the panel in that case to have placed on the responding party the burden of establishing that its measure fell within Articles 3.2 and 3.3 merely because they were deemed to be "exceptions." The Appellate Body found that where related provisions define key elements of the violations alleged, they form part of the elements of the *prima facie* showing a complaining party must make. As the Appellate Body explained:

> It appears to us that the Panel has misconceived the relationship between Articles 3.1, 3.2, and 3.3, . . . , which is qualitatively different from the relationship between, for instance, Articles I or III and Article XX of the GATT 1994. Article 3.1 of the SPS Agreement simply excludes from its scope or application the kinds of situations covered by Article 3.3. of that Agreement, that is, where a Member has projected for itself a higher level of sanitary protection than would be achieved by a measure based on an international standard. Article 3.3. recognizes the autonomous right of a Member to establish such higher level of protection, provided the Member complies with certain requirements in promulgating SPS measures to achieve that level. The general rule in a dispute settlement proceeding requiring a complaining party to establish a *prima facie* case of inconsistency with a provision of the SPS Agreement before the burden of showing consistency with that provision is taken on by the defending party, is *not* avoided by simply describing that same provision as an "exception." In much the same way, merely characterizing a treaty provision as an "exception" does not by itself justify a "stricter" or "narrower" interpretation of that provision than would be warranted by examination of the ordinary meaning of the actual treaty words, viewed in context and in light of the treaty's object and purpose, or, in other words, by applying the normal rules of treaty interpretation. It is also well to remember that a *prima facie* case is one which, in the absence of effective refutation by the defending party, requires a panel, as a matter of law, to rule in favour of the complaining party presenting the *prima facie* case.[194]

[194] *EC Hormones*, para. 104 (emphasis in original). In addition, in *U.S. Wool Shirts*, page 16, the Appellate Body found that the complainant bore the burden of proving a violation of Article 6 of the Agreement on Textiles and Clothing. Although the complainant in that case – India – alleged that Article 6 was an "exception" to basic WTO principles, the Appellate Body found that because Article 6 was part of a "balance of rights and obligations", the burden of proof remained with the complainant.

206. The Appellate Body's reasoning applies with equal force here. Article 3.1(a) simply excludes from its scope of application the kinds of situations covered by the fifth sentence of footnote 59 of that Agreement. Even if footnote 59 were characterized as an "exception," such characterization would not shift the burden of proof or dictate a narrower or stricter approach to treaty interpretation.[195] In addition, footnote 59 merely "recognizes the autonomous right of a Member"[196] to take measures to avoid double taxation of foreign-source income. Unlike GATT Article XX, which is implicated only after a violation under another GATT article is established, the fifth sentence of footnote 59 narrows the scope of the very provision alleged to have been violated, SCM Article 3.1(a). As the fifth sentence recognizes, a measure to avoid double taxation does not represent a "subsidy," for it tends to restore, not disturb, even-handed treatment of the affected commerce.

207. Thus, the EC bears the burden of proof on all aspects of its export subsidy claim, including proving that ETI is not a measure to avoid double taxation under the fifth sentence of footnote 59. The Panel erred when it found to the contrary.

3. The Panel's Four New Principles and New Standard of Review Cannot Be Derived from the Ordinary Meaning of the Fifth Sentence of Footnote 59

208. In finding that the fifth sentence of footnote 59 does not apply to the ETI Act, the Panel ignored the fact that the ETI Act conforms to widely accepted tax norms and is similar to other double taxation relief measures found around the world. The Panel's erroneous analysis was

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[195] *Id.*
[196] *Id.*

compounded by its decision to divine four new principles regarding the meaning of the fifth sentence and a new standard of review, none of which can be found in its text. We address each below.

a. Contrary to the Panel's Assertion, a Measure to Avoid Double Taxation Need Not Apply to All Doubly Taxed Income

209. The Panel is simply incorrect when it criticizes the ETI Act's exclusion as being too narrow because it does not apply to all income that potentially may be subject to double taxation.[197] Nothing in the fifth sentence of footnote 59 states that a measure to avoid double taxation must be comprehensive or all-encompassing. The fifth sentence was written so as to provide WTO Members with flexibility in fashioning their double tax relief mechanisms, expressly providing that the export subsidy prohibition "is not intended to *limit* a Member from taking measures ... ." (emphasis added). The fifth sentence does not say that such relief cannot be partial in nature – *i.e.*, offsetting only a portion of the foreign taxes imposed – and it does not say that a single double tax avoidance measure must apply to all foreign income that may be subject to tax by any country anywhere in the world.

210. Indeed, if the Panel's statement were correct, then none of the leading methods for double tax avoidance would come within the safe harbor of the fifth sentence of footnote 59. The failure to reach all types of income potentially subject to international double taxation is characteristic of both foreign tax credits and territorial exemptions.

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[197] ETI Panel Report, para. 8.104.

211. Tax credits almost always provide partial relief. They typically are limited in terms of the foreign taxes that may be credited, and they generally are capped at a specified maximum amount of relief allowed. In addition, different countries employ differing definitions of foreign-source income, which can result in different countries applying credits in divergent instances. For example, if a U.S. corporation with business in Germany earned income classified as U.S.-source income by the United States but as German-source income by Germany, that income would be subject to income taxation by both the United States and Germany without any foreign tax credit available to avoid double taxation. Thus, foreign taxes on what the WTO might consider "foreign source income" may not be creditable under the tax systems of the United States and other countries.

212. Similarly, territorial exemptions do not apply in all instances. The same overlap of taxing jurisdiction can occur under territorial tax systems where the country of residence does not consider the income to be foreign source and, therefore, does not apply its exemption to it.

213. The tax systems in many European countries also have various conditions limiting the availability of double taxation relief through exemption. For example, some nations allow exemption only where the taxpayer in question has a subsidiary or branch in a foreign jurisdiction. However, other countries impose tax on something less than a subsidiary or branch, resulting in this income being excluded from the reach of a territorial tax exemption.

214. The Panel provided no indication of its basis for creating this all-income-must-be-included requirement. The Panel did not indicate that it emanated directly from the text of the

fifth sentence of footnote 59, and the Panel did not state that it had relied on any international tax conventions that might have the effect of customary public international law.

215. The Panel again seems to be troubled by the manner in which the United States drew boundaries around excluded extraterritorial income, citing types of income that are not covered by the Act's exclusion. But whether the Panel would have drawn those lines differently is irrelevant under the footnote. What matters is whether the Act avoids double taxation of foreign-source income. The Panel's new principle that a measure to avoid double taxation must cover all income potentially subject to tax in a foreign jurisdiction has no basis in law or practice.

b. Contrary to the Panel's Assertion, a Measure to Avoid Double Taxation Need Not Apply With Strict Precision

216. The Panel's discussion of the second of its principles – *i.e.*, that a measure to avoid double taxation may not include income that is not subject to tax in a foreign jurisdiction – is riddled with inconsistencies.

217. On the one hand, the Panel concludes that "the Act includes as 'extraterritorial income' . . . income which would, in our view, not necessarily be treated as taxable in other jurisdictions."[198] On the other hand, the Panel states that "[w]e have a degree of sympathy for the US argument that 'precision' in the relief of double taxation is 'probably impossible' given the many differences in taxation systems from one country to another and the many different ways that international commerce can be structured. Indeed, we do not view footnote 59 as requiring that a measure 'to avoid' the double taxation of foreign-source income must avoid double

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[198] ETI Panel Report, para. 8.97.

taxation entirely, exclusively, or precisely."[199] The Panel goes on to say that it "believe[s] that the Act probably pushes close to the outer limit of the income that might be subject somewhere by some other jurisdiction to taxation" and that "we do not preclude that the broad scope of the Act might nevertheless be justified as a 'prophylactic,' 'preventive' measure to avoid double taxation."[200]

218. With respect to the term "to avoid," the Panel appears to have overlooked the fact that one of its essential meanings is "to prevent."[201] The Panel notes this in its report, but seems to give it short shrift.[202] The Panel somehow concludes that the choice of the term "to avoid" rather than "that avoid" means that the overriding purpose of a challenged measure must be double taxation relief. It is not enough that a measure provide "incidental relief."[203] However, the fifth sentence of footnote 59 does not speak in terms of the rationale of measures to avoid double taxation. Rather, by choosing words such as "is not intended to limit" and "to avoid," the drafters of footnote 59 signaled that they were affording Members broad flexibility in fashioning double taxation relief and they recognized the enormous complexities and widely divergent issues that are involved in doing so.

219. This understanding of footnote 59 is supported by the widely accepted view that the exemption method may offer more relief to taxpayers than is actually needed strictly to eliminate double taxation dollar-for-dollar – *i.e.*, exemption occurs where no foreign tax has been levied, or

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[199] ETI Panel Report, para. 8.95.
[200] ETI Panel Report, para. 8.103.
[201] *The New Shorter Oxford English Dictionary* (1993).
[202] ETI Panel Report, para. 8.94.
[203] *Id.*

is levied at a lower rate, and consequently it allows for a tax savings relative to the tax imposed under the tax system of the country providing exemption. This point goes to the heart of the distinction between credits and exemption. While tax credits are capped by the amount of foreign taxes paid (and, therefore, result in total tax of at least the rate imposed by the residence country), the overall tax liability of a given taxpayer under the exemption method is determined by the tax rate applied by the source country. Thus, if the source country applies a *lower* rate, then a taxpayer *will pay less* than if the income were earned exclusively within the country of residence.

220. That the exemption method may result in an overall tax savings relative to the prevailing rate in the country of residence in no way undermines the validity of the method under accepted international tax norms. Neither the OECD nor the U.N. model treaty suggests that any minimum level of foreign tax should be required under an exemption system. In fact, the OECD Commentary specifically recognizes that the state of residence must "give exemption whether or not the right to tax is in effect exercised by the other States."[204] The Commentary explains that this method is the most practical, "since it relieves the State of residence from undertaking investigation of the actual taxation position of the other States."[205]

[204] *OECD Model Tax Convention*, page C(23)-11.
[205] *Id.*

c. Contrary to the Panel's Assertion, a Measure to Avoid Double Taxation Need Not Have a "Permanent Establishment" Requirement

221. The Panel also maintains that the ETI Act's exclusion applies to income that is not subject to double taxation because it does not require that taxpayers have a "permanent establishment" in a foreign jurisdiction.[206] In articulating this third new principle with respect to the meaning of the fifth sentence of footnote 59, the Panel again is writing new law.

222. There is absolutely no international consensus that countries should or must rely on the concept of a "permanent establishment" in imposing tax. There are divergent views and practices among countries as to what brings a non-resident enterprise within a country's taxing authority. Remarkably, the Panel has laid down this important and far-reaching principle even though nothing in the SCM Agreement, let alone footnote 59, in any way imposes a "permanent establishment" requirement.

223. The United States provided the Panel with a number of examples of countries that do not rely on a "permanent establishment" standard in defining their taxing jurisdiction,[207] a point the Panel appears to have recognized.[208] These countries reserve the right to tax businesses even if they do not have a branch or subsidiary or some other entity that may be deemed a "permanent establishment" within the country. With respect to these countries, double taxation may arise in the absence of a "permanent establishment" because they may be taxing income also taxed by the country of residence.

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[206] ETI Panel Report, para. 8.100.
[207] *See U.S. Response to Panel Questions*, ETI Panel Report, Annex F-3, paras. 27-29.
[208] ETI Panel Report, para. 8.100.

224. For its part, the United States does not subscribe to the requirement that a non-resident enterprise must have a "permanent establishment" within the United States in order to be subject to U.S. taxation. Instead, the United States looks to see if there is a sufficient amount of business activity occurring within the United States with respect to a given transaction or series of transactions to find that a taxpayer has engaged in "a trade or business in the United States."[209] Income "effectively connected" with that trade or business is subject to U.S. taxation. In short, the United States itself does not require the existence of a permanent establishment to assert taxing jurisdiction.

225. The ETI Act takes account of the different approaches for determining tax jurisdiction throughout the world. It recognizes that countries rely on different standards that can turn on subtle factual distinctions in determining whether income is subject to their tax regimes. The Act therefore requires that transactions giving rise to extraterritorial income must have a variety of foreign attributes that can result in a nexus to a foreign taxing regime.

[209] A U.S. trade or business has been found to exist where a foreign individual's export business in the United States solicited orders, inspected merchandise, made purchases, completed sales, and maintained an office and a bank account. *United States v. Balanovski*, 236 F.2d 298 (2nd Cir. 1956), *cert. denied*, 352 U.S. 968 (1957) (Exhibit US-10). The mere ownership and active management of US real estate has been found to constitute a US trade or business. *See De Amodio v. Commissioner*, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3rd Cir. 1962) (Exhibit US-11); *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd*, 221 F.2d 227 (9th Cir. 1955) (Exhibit US-12). Moreover, the US taxing jurisdiction generally reaches a broader category of income with respect to a US trade or business ("effectively connected" income) than the category of taxable income attributable to a US permanent establishment. *See* Rev. Rul. 91-32, 1991-1 C.B. 107 (Exhibit US-13); Rev. Rul. 81-78, 1981-1 C.B. 604 (Exhibit US-14), amplified by Rev. Rul. 84-17, 1984-1 C.B. 308 (Exhibit US-15).

226. The United States does not dispute that a "permanent establishment" requirement in a measure to avoid double taxation is permissible under footnote 59, but it cannot be mandatory. The Panel's adoption of its "permanent establishment" principle, however, denies WTO Members the ability to take measures to avoid double taxation that may befall enterprises that are taxed even though they do not have a "permanent establishment" in a foreign jurisdiction. The Panel seems to be saying that this is one form of double taxation that may not be remedied.

227. However, footnote 59 stands for the proposition that WTO Members are not limited in their ability to avoid double taxation. Because the Panel's "permanent establishment" principle is inconsistent with footnote 59, it should be rejected.

d. Contrary to the Panel's Assertion, It Is Irrelevant that WTO Members Have Tax Treaties

228. Of all the Panel's principles, its fourth – namely, that a country cannot institute a measure to avoid double taxation if it has an extensive system of bilateral tax treaties[210] – appears to be most directly inconsistent with the text of the fifth sentence of footnote 59.

229. There can be no doubt that footnote 59 allows WTO Members to choose to rely on more than one method of double taxation relief. The fifth sentence of footnote 59 states that "Paragraph (e) is not intended to limit the ability of *a Member* from taking *measures* to avoid the double taxation of foreign-source income ... ." (emphasis added). The text of the sentence makes plain that a single "Member" may institute multiple double tax avoidance "measures."[211]

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[210] ETI Panel Report, para. 8.105.

[211] The term "measure" has been found to be a rather broad term in other contexts. As one panel has explained, "GATT panels dealing with the related issue of what may constitute 'all
(continued...)

This language is particularly flexible, imposing no *limit* on WTO Members in fashioning double tax relief *measures*. The notion that a Member may be limited to choosing between one method of double taxation relief is inherently antithetical to the words the drafters employed in the footnote.

230. Moreover, the notion that a Member must rely solely on one method ignores common practices in international taxation.[212] Most, if not all, WTO Members employ a mix of credits, exemptions, and treaties, in varying proportions, for the relief of double taxation. The OECD and the UN model treaties acknowledge that countries will use a combination of methods.[213] Footnote 59 similarly leaves the choice of methods to WTO Members.

231. U.S. bilateral tax treaties provide relief from double taxation in conjunction with or parallel to U.S. domestic legal provisions. As a general rule, bilateral tax treaties are entered into to *supplement* domestic legal measures designed to avoid double taxation. Almost every country entering into such a treaty has its own mechanism for avoiding double taxation, and the treaty

[211] (...continued)
laws, regulations and requirements' . . . under GATT Article III:4 ... . Panels have taken a broad view of when a governmental action is a law, regulation or requirement ... . Given that the scope of the term *requirement* would seem to be narrower than that of measure, the broad reading given to the word *requirement* . . . supports an even broader reading of the word measure in Article XXIII:1(b)." *Japan Film*, para. 10.51.

[212] In this regard, the EC previously has acknowledged that both the credit and the exemption method are proper methods of avoiding double taxation, and that it is internationally accepted that both methods may be used in combination. Annex EC-2, page 2.

[213] *See, e.g., OECD Model Tax Convention*, page C(23)-14 ("In view of the wide variety of fiscal policies and techniques in the different States regarding the determination of tax, especially deductions, allowances and similar benefits, it is preferable not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique.").

operates to adjust these domestic mechanisms in some way – *i.e.*, in terms of methodology or scope of application – to tailor them to the particular situation at hand. Thus, a treaty might provide relief to taxpayers where the laws of the treaty party otherwise would not. However, a treaty does not preclude the need for a domestic measure to avoid double taxation.

232. Even where a country has a large number of tax treaties, it is unlikely that they will cover all situations. The United States has 56 bilateral income tax treaties. This means that there are 90 WTO Members with which the United States has no income tax treaty. Because income tax treaties apply only to persons who reside in one treaty-partner country and who conduct business in the other treaty country, a U.S. resident individual or company conducting business in a country without a U.S. income tax treaty would be required to rely only on U.S. domestic tax law, including the Act, to avoid international double taxation.

e. Footnote 59 Does Not Entail a "Reasonable Legislator" Standard

233. The final error in the Panel's analysis of footnote 59 occurred when it stated that it analyzed the Act through the lens of a "reasonable legislator" in order to determine whether it is a measure to avoid double taxation. Footnote 59 does not prescribe this unique standard of review, and it was error for the Panel to rely on it.

234. Essentially, the Panel determined that it could substitute its judgment for that of the U.S. Congress in determining the purpose for which the ETI Act was enacted. The United States cited legislative history to the Panel in which the U.S. Congress stated that one of the purposes of the

Act is to serve as a measure to avoid double taxation,[214] but the Panel said that it did not believe that it was possible for the Congress to have constructed the Act as it did in order to achieve this end. Specifically, the Panel said, "Put simply, the question we have posed is whether legislators concerned with avoiding the double taxation of foreign-source income might reasonably have been expected to draft legislation such as the Act. In our view, . . . the answer is no."[215]

235. The Panel's action in this respect appears to have ignored the teaching of the Appellate Body in the *EC Hormones* case, in which the Appellate Body stated that neither a deferential nor a *de novo* standard of review was appropriate under the SPS Agreement.[216] The Appellate Body noted that the SPS Agreement did not supply its own standard of review and, absent such a particularized standard, Article 11 of the DSU governs.[217] That provision states in pertinent part that "a panel should make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of and conformity with relevant covered agreements." The Appellate Body cautioned that panels should confine themselves to making an "objective assessment" and stated that "many panels in the past refused to undertake *de novo* review, wisely, since under current practice and systems, they are in any case poorly suited to engage in such a review."[218]

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[214] *See, e.g.*, *First U.S. 21.5 Submission*, ETI Panel Report, Annex A-2, para. 188, *citing House Report*, page 10, and *Senate Report*, page 2.

[215] ETI Panel Report, para. 8.106.

[216] *EC Hormones*, para. 116.

[217] *Id.,* paras. 114-16.

[218] *Id.,* para. 117.

236. The fact that the Panel applied an erroneous standard of review is not a mere theoretical consideration, because it appears to have led the Panel to its flawed findings. The Panel made clear that it felt that a key element to be weighed was the "purpose" of the Act.[219] In deciphering the "purpose" of the Act, the Panel examined whether "the relationship between the measure and its asserted purpose" is "reasonably discernible."[220] The Panel cited to no treaty text and no prior panel or Appellate Body reports in establishing this "reasonably discernible" standard. Instead, it borrowed the Appellate Body's GATT Article III:2 analysis. Citing *Japan Alcoholic Beverages* and other reports involving GATT Article III:2, the Panel said it would concentrate its review on "the overall structure, design, and operation" of the ETI Act.[221]

237. The United States does not believe that the Panel's "reasonable legislator" test actually involved an analysis of the design, architecture and structure of the Act. Nevertheless, the Panel's invocation of a *Japan Alcoholic Beverages* type of analysis is inappropriate here. The Appellate Body's discussion of GATT Article III:2 in that case noted the special relationship between that provision and GATT Article III:1, which guards against measures that "afford protection to domestic production."[222] The Panel ignored the fact that footnote 59 is altogether different from GATT Article III and that the Appellate Body in *Alcoholic Beverages* rejected the notion that GATT Article III:1 creates an intent test. The Appellate Body specifically said that

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[219] ETI Panel Report, para. 8.94.
[220] *Id.*, para. 8.95.
[221] *Id.*, para. 8.95, note 197.
[222] *Japan - Taxes on Alcoholic Beverages* ("*Japan Alcoholic Beverages*"), WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, Report of the Appellate Body adopted 1 November 1996, pages 17-18.

"[t]his is not an issue of intent. It is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do."[223] In constructing its "design, architecture, and structure" analysis, the Appellate Body was attempting to outline how to provide an objective assessment of whether a measure acts "to afford protection to domestic production" within the context of Article III:2. The Appellate Body emphasized that it was irrelevant whether protectionism was an intended objective; what mattered was "how the measure in question is applied."[224]

238. The United States believes a similar distinction is germane here. It is not for the Panel to substitute its judgment for that of a national legislature as to whether a measure is intended to avoid double taxation. The question is whether the measure does or does not serve to avoid double taxation. For the reasons set forth above, the United States respectfully submits that the ETI Act does just that. Absent evidence to the contrary, the Panel had no basis to rule otherwise.

239. For the foregoing reasons, the Appellate Body should reverse the Panel's finding that the ETI Act does not constitute a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59.

4. The Appellate Body Should Provide Clear Guidance

240. In the event that the Appellate Body sustains the Panel's finding that the ETI Act is not a measure to avoid double taxation, the United States requests that the Appellate Body provide clear guidance with respect to the particular aspects of the Act that the Appellate Body considers

[223] *Id.,* page 26.
[224] *Id.*

deficient under the fifth sentence of footnote 59. The Panel's approach – in which it seemed to look at the ETI Act in its entirety and found against it without identifying dispositive issues – provides insufficient guidance at this stage of the proceedings. The United States believes that it is imperative for it to be informed of the precise reasons the ETI Act is or is not compatible with WTO rules.

241. The Panel's discussion, if not augmented, would provide the United States with little information about how to conform to the fifth sentence of footnote 59. By telling the United States that the Act is both overbroad and yet also too narrow, by telling the United States that the fifth sentence does not require precision yet the Act is not precise enough, and by telling the United States that it does not have to show a necessity for the Act but condemning it as unnecessary because of the existence of bilateral tax treaties, the Panel has provided the United States with no intelligible standard to follow should it need to take further implementing action. Only an analysis that identifies exactly what aspect or aspects of the ETI Act prevent it from being regarded as a measure to avoid double taxation would serve to achieve the preferred outcome under the DSU, namely a mutually acceptable resolution of this dispute.[225]

[225] DSU Article 3.7.

D. Should the Appellate Body Reverse the Panel and Find that the ETI Act Is a Measure to Avoid Double Taxation Within the Meaning of the Fifth Sentence of Footnote 59, It Should Complete the Panel's Analysis and Find that the ETI Act Is Not a Prohibited Subsidy by Virtue of Footnote 5 of the SCM Agreement

242. Should the Appellate Body reverse the Panel and find that the ETI Act is a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59, it should complete the Panel's analysis and find that the ETI Act is not a prohibited subsidy by virtue of footnote 5 of the SCM Agreement.

243. The first and fifth sentences of footnote 59 refer to practices that are not export subsidies within the meaning of footnote 5. The first sentence of footnote 59 makes clear that deferral of taxation "specifically in relation to exports" is permissible where "appropriate interest is charged". Likewise, the fifth sentence of footnote 59 permits a measure to avoid double taxation even though it might otherwise constitute an export-specific tax exemption, remission, or deferral of direct taxes pursuant to paragraph (e).

244. Measures to avoid double taxation, therefore, come within the meaning of footnote 5. That footnote provides that "[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited ... ." The ordinary meaning of "referred" is "to assign to a thing, or class of things, as being properly included or comprehended in this; to regard as naturally belonging, pertaining, or having relation to; to attach or attribute to."[226] It also can mean something as simple as "a reference in a book".[227] Footnote 5 thus indicates that a measure need

[226] *The New Shorter Oxford English Dictionary* (1993).
[227] *Id.*

only be included or mentioned in Annex I in such a way as to be properly assigned or classified as not being an export subsidy. Footnote 5 does not require that the words "is not an export subsidy" appear in the Illustrative List's description of the measure in question.

245. In so arguing, the United States is not relying on the principle of *a contrario sensu*, the doctrine of assuming that the opposite conclusion may be drawn from an affirmative rule or statement.[228] Rather, the fact that the fifth sentence of footnote 59 explicitly provides a narrowing of paragraph (e) makes clear that the drafters of the SCM Agreement intended that measures to avoid double taxation should not be treated as prohibited export subsidies.

246. This is a distinction made by the panel in the *Brazil Aircraft* case.[229] The panel in that dispute first found that "in its ordinary meaning, footnote 5 relates to situations where a measure is referred to as *not* constituting an export subsidy."[230] In addition, the panel observed that the ordinary meaning of footnote 5 "could extend more broadly to cover cases where the Illustrative List contained some other form of affirmative statement that a measure is not subject to the Article 3.1(a) prohibition."[231] The panel then indicated that this reasoning applied to the first and fifth sentences of footnote 59.[232] Thus, following this reasoning, measures to avoid double

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[228] For purposes of this appeal, it is not necessary that the Appellate Body resolve the issue of the applicability of this principle to Annex I.

[229] *Brazil - Export Financing Programme for Aircraft - Recourse by Canada to Article 21.5 of the DSU,* WT\DS46\RW, Report of the Panel, as modified by the Appellate Body, adopted 4 August 2000.

[230] *Id.*, para. 6.36.

[231] *Id.*

[232] *Id.* In contrast, the panel found that there is no basis to assume that measures that merely fall outside the scope of illustrative export subsidies in Annex I are *not* export subsidies for purposes of footnote 5. *Id.*

taxation are "referred" to in Annex I as not being export subsidies and, therefore, are not prohibited under Article 3.1(a) or any other provision of the SCM Agreement.

E. The Panel Erred in Finding that the ETI Act Is Inconsistent with U.S. Obligations under Articles 8 and 10.1 of the Agreement on Agriculture

247. With respect to the Panel's findings that the ETI Act is inconsistent with Articles 8 and 10.1 of the Agreement on Agriculture, the only issue in dispute between the parties was whether the Act's exclusion constituted an export subsidy within the meaning of Article 1(e) of the Agreement. The EC argued that because, in its view, the ETI Act conferred a subsidy within the meaning of the SCM Agreement, there was no reason that they were not also conferred within the meaning of the Agreement on Agriculture.[233] The United States argued that, in this case, because the ETI Act does not constitute an export subsidy under the SCM Agreement, it also does not constitute an export subsidy under Article 1(e) of the Agreement on Agriculture.[234] The Panel took a similar approach, stating that "we consider that our reasoning and conclusions with respect to Articles 1.1 and 3.1(a) of the *SCM Agreement*, are also applicable as regards whether the Act gives rise to subsidies contingent upon export performance within the meaning of Article 1(e) ... ."[235] Thus, the Panel's finding that the ETI Act involves an export subsidy for purposes of Article 1(e) was based entirely on its finding that the ETI Act constitutes an export subsidy for purposes of the SCM Agreement.[236]

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[233] ETI Panel Report, para. 8.112.
[234] *Id.*, para. 8.113.
[235] *Id.*, para. 8.121.
[236] *Id.*

248. As demonstrated above, the Panel's finding that the ETI Act constitutes an export subsidy for purposes of the SCM Agreement was in error. As a result, the Panel's finding that the ETI Act constitutes an export subsidy for purposes of the Agreement on Agriculture also was in error, and invalidates the Panel's findings with respect to Articles 8 and 10.1 of that Agreement.

F. The Panel Erred in Finding That the ETI Act is Inconsistent With Article III:4 of GATT 1994

249. The Panel erroneously found that the provisions of the ETI Act that establish parameters for defining "qualifying foreign trade property" (1) "affect the internal use" in the United States of imported goods and like domestic products" and (2) accord "less favorable treatment" to imported products than to like products of United States origin. In reaching these findings, the Panel failed to establish a meaningful causal link between these provisions and the alleged discrimination.

1. The Measure at Issue

250. IRC section 943(a)(1)(C), as amended by Section 3 of the ETI Act (the "50 percent rule"), provides that no more than 50 per cent of the fair market value of qualifying foreign trade property may be attributable to articles produced outside the United States and direct labor costs incurred outside the United States. This standard can be satisfied without any portion of the fair market value of the property being derived from U.S. sources. For example, a product could be manufactured wholly outside the United States using only foreign articles and labor. As long as these two components together account for less than 50 per cent of the fair market value, the product would be qualifying foreign trade property. A typical example of such a situation would

be a product in which over 50 per cent of the fair market value consists of other types of inputs, such intangible property.

2. The Meaning of Article III:4

251. Article III:4 provides in relevant part that:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use ... .

252. A violation of Article III:4 requires the existence of (a) a law, regulation or requirement affecting the internal sale, offering for sale, or distribution of an imported product; and (b) treatment accorded in respect of the law, regulation or requirement that is less favorable to the imported product than to like products of national origin.[237] The defining requirement of "no less favorable treatment" has been interpreted to ensure "effective equality of opportunities between imported products and domestic products."[238] In order to establish either element of the violation, a panel must demonstrate causation either "by necessary implication from the words actually used in the text"[239] (a *de jure* test) or based on reasonable implications drawn from the

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[237] *Japan Film*, para. 10.369.

[238] *Canada - Certain Measures Affecting the Automotive Industry* ("*Canada Autos (Panel)*"), WT/DS/139R, WT/DS142/R, Report of the Panel, as modified by the Appellate Body, adopted 19 June 2000, para. 10.78. In *Japan Alcoholic Beverages*, page 17, the Appellate Body stated that "[A]rticle III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products."

[239] ETI Panel Report, para. 8.159.

actual operation of the measure in fact (a *de facto* test). In its decision, the Panel relied exclusively on a *de jure* test.[240]

3. The Panel Improperly Found That the 50 Percent Rule "Affects" the Use of Imported Products in the United States

a. The Panel Failed to Demonstrate a Necessary Relationship Between the 50 Percent Rule and the Use of Imported Products in the United States

253. In order to establish a *de jure* finding of effect between a measure and imported products a panel must establish, from the text of the measure itself, an incontrovertible linkage between the text and the imported products whose internal use allegedly is affected by the measure. This the Panel failed to do. While the scope of "affecting" is "broad" and "wider in scope than such terms as 'regulating' or 'governing,'"[241] it is not unlimited. The relationship between the measure at issue and the alleged effect on the internal use of imported products cannot be so attenuated that any adverse effect on imported products may be incidental to the measure. The Appellate Body should provide guidance for panels by setting forth criteria for determining whether an incontrovertible linkage exists between a challenged measure and its alleged effect on the "internal use" of imported products. The United States believes that these criteria should focus upon whether the measure in question is directed, on the one hand, toward particular

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[240] *Id.* The United States submits that since the Panel relied exclusively on a *de jure* test, the Appellate Body should rule that the ETI Act does not violate Article III:4 if it determines that the Panel erroneously found a violation using *de jure* methodology. Should the Appellate Body nevertheless decide to complete the work of the Panel by examining the ETI Act on a *de facto* basis, the United States submits that the EC has presented insufficient evidence to support a *de facto* claim. *First U.S. 21.5 Submission,* ETI Panel Report, Annex A-2, paras. 216-217, *U.S. Oral Statement*, ETI Panel Report, Annex D-3, paras. 172-173.

[241] *EC Bananas,* para. 220.

categories of imports or imports in general or, on the other hand, is a measure of general application. Other things being equal, a higher degree of proof of actual discrimination should be required when the relationship between the measure at issue and particular imports is only indirect. No such proof of actual discrimination was offered by the EC or considered by the Panel in this case.[242]

b. Unlike Earlier Cases Involving Measures That Dealt With Discriminatory Treatment Accorded to Imports, the ETI Act's 50 Percent Rule Is a Measure of General Application That Is Not Directed Against Imports

254. Past cases involving Article III:4 clearly are distinguishable from the present case in that the measures found to be discriminatory in those cases were directed at particular categories of imports (*Italian Agricultural Machinery,*[243] *Canada Autos (Panel), EC Bananas*) or else at imports in general (*U.S. Section 337*,[244] *EC Parts and Components*[245]).

255. By contrast, the ETI Act deals with the taxation of income earned by U.S. taxpayers from the sale, lease, or rental of property for foreign use. Its entire focus is on income derived from property for use outside the United States, regardless whether that property is manufactured,

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[242] *See* ETI Panel Report, paras. 8.131, 8.133-8.134. The Panel misconstrued U.S. submissions on this point by mistakenly considering the submissions as pertaining to the "like products" issue rather than the issue of "effects on use". *First U.S. 21.5 Submission*, ETI Panel Report, Annex A-2, para. 218, *U.S. Oral Statement*, ETI Panel Report, Annex D-3, paras. 169-171.

[243] *Italian Discrimination Against Imported Agricultural Machinery*, Report of the Panel adopted 23 October 1958, BISD 7S/60.

[244] *United States - Section 337 of the Tariff Act of 1930*, Report of the Panel adopted 7 November 1989, BISD 36S/345.

[245] *EEC - Regulation on Imports of Parts and Components,* Report of the Panel adopted 16 May 1990, BISD 37S/132.

produced, grown, or extracted within or outside the United States.[246] The ETI Act does not deal with, among other things, income derived from sales of products for ultimate use within the United States, regardless whether the products are imported into the United States or incorporate imported components. Within this general framework, the ETI Act, like other measures of general application, establishes various parameters and limitations on its application. Among these limitations is the 50 percent rule on certain foreign value.

256. In its analysis of the 50 percent rule, the Panel erroneously equated it with a domestic content or domestic value-added requirement. This characterization is plainly incorrect because the provision neither refers to U.S. content nor predicates eligibility for the tax exclusion upon manufacture in the United States. The Panel has distorted the plain text of the 50 percent rule by drawing an artificial and arbitrary distinction between qualifying foreign trade property produced outside the United States and that produced within the United States, and by subjecting only the second category of property to separate scrutiny under Article III:4. That sort of inaccurate line-drawing is completely at variance with the object and purpose of the ETI Act, which is to treat all qualifying foreign trade property as a single category, subject to the same rules.

c. The Panel Improperly Held That "Less Favorable" Treatment of Imports Necessarily Exists Even When a Requirement Can Be Satisfied by Other Means

257. The Panel erred in finding that the 50 percent rule "affects" the internal "use" of imported products. The Panel stated that "*even if* the measure allows for other means to obtain the advantage, such as the use of domestic inputs other than products . . . it is a measure which

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[246] IRC §943(a)(1).

'affects' the use of imported products even if ways – other than the use of goods – exist to impute permissible fair market value."[247] In so finding, the Panel improperly extended the findings of *Canada Autos (Panel)* to a very different situation. In *Canada Autos (Panel),* the Canadian Value Added requirement mandated minimum percentages of domestic Canadian content. Although the requirement was expressed in terms of value added, and could be met by domestic inputs other than articles, the requirement mandated *Canadian* content. The 50 percent rule of the ETI Act is clearly distinguishable: it does not mandate *any* U.S. content. While the preference for domestic products is readily apparent in the Canadian Value Added requirement, the relationship, if any, in the ETI Act between the 50 percent rule and the impact on the conditions of competition is so attenuated that it constitutes legal error for the Panel to find as a matter of law that the limitation necessarily affects the conditions of competition.

4. The Panel Erred in Finding that the 50 Percent Rule Accorded Treatment "Less Favorable" to Imported Products Than to Like Products of United States Origin

a. The Panel Failed to Follow the Methodology Set Forth by the Appellate Body in *Korea Beef*

258. In *Korea Beef*,[248] the Appellate Body modified a panel finding that the dual retail system, which required domestic and foreign beef to be sold in separate establishments, accorded less favorable treatment to imported beef than to domestic beef. While affirming the outcome of the

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[247] ETI Panel Report, para. 8.148, (emphasis in original), citing *Canada -Autos (Panel)*, para. 10.82.

[248] *Korea - Measures Affecting Imports of Fresh, Chilled and Frozen Beef,* WT/DS161/AB/R, WT/DS169/AB/R, Report of the Appellate Body adopted 10 January 2001, para. 141.

panel report, the Appellate Body criticized the panel's analysis.[249] The Appellate Body found that several findings of the panel did not "*necessarily* reduce the opportunity for the imported product to compete 'directly' or on 'an equal footing' with the domestic product," and "may be simply *incidental effects* of the dual retail system without decisive implications for the issue of consistency with Article III:4."[250] The Appellate Body then proceeded to examine the actual effects of the imposition of the dual retail system. It found that most small retailers that had sold both domestic imported and domestic beef prior to the implementation of the dual retail system requirement (which forced them to choose between selling only domestic beef or only foreign beef), chose to sell only domestic beef.[251] The Appellate Body found that the "direct practical effect" of the dual retail system was "the drastic reduction of commercial opportunity."[252] The Appellate Body then found that,

> the reduction of access to normal retail channels is, *in legal contemplation*, the effect of the measure. In these circumstances, the intervention of some element of private choice does not relieve Korea of responsibility under the GATT 1994 for the *resulting* establishment of competitive conditions less favorable for the imported product than for the domestic product.[253]

The Appellate Body noted that it was not basing its finding on the trade effects of the measure, in terms of actual imports of beef.[254]

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[249] *Id*.
[250] *Id*. (emphasis added).
[251] *Id*., para. 145.
[252] *Id*.
[253] *Id*., para. 146 (emphasis added).
[254] *Id*., para. 147.

259. In *Korea Beef*, the Appellate Body rejected speculative conclusions by the panel as to possible competitive effects that might result from the dual retail system, and focused, instead on the actual effects of the measure: the reduction of retail outlets for imported beef. While not formally characterizing its finding as being either *de jure* or *de facto*, the Appellate Body rejected a purely formalistic *de jure* approach, such as that adopted by the ETI Act Panel.

260. In the instant case, the Panel employed speculative methodology of the type condemned by the Appellate Body in *Korea Beef* to find that the 50 percent rule necessarily placed imported products at a comparative disadvantage in the U.S. market to like domestic products. The Panel unreasonably assumed that despite the myriad ways in which qualifying foreign trade property could be produced, producers would necessarily source their production in the United States. The Panel compounded this flawed analysis by further incorrectly assuming that, having decided to produce goods in the United States, producers would inherently prefer U.S. components to imported components as a means of meeting the 50 percent rule.[255] Unlike the stark choice faced by small retail beef distributers in *Korean Beef* of having to exit the distribution market for either domestic beef or imported beef, producers of goods in the United States are not required to use U.S. components in order to satisfy the rule. The fact that a particular producer might so choose would be incidental to the rule, not a legally necessary consequence of it.

b. The Panel's Findings Are Not Supported by Article III:4

261. Under the Panel's reasoning, a measure of general application, not linked to imports, would violate Article III:4 if there were any conceivable situation, regardless of how remote the

[255] ETI Panel Report, para. 8.156.

possibility, that might result in an import being treated less favorably than a like domestic product. Under the Panel's reasoning, a single hypothetical situation of a domestic manufacturer preferring a domestic over an imported input could be ascribed to an alleged inherent advantage accorded by the rule. Such a conclusion not only goes beyond the finding of *Canada Autos (Panel),* and is contrary to the careful methodology employed by the Appellate Body in *Korea Beef,* but is unreasonable on its face. Accordingly, the Appellate Body should reverse the finding of the Panel that the 50 percent rule violates Article III:4 of GATT 1994.

G. The Panel Erred in Finding That the ETI Act's Transition Rules Are Inconsistent with the Full Withdrawal of the FSC Subsidies

262. The Panel erred in concluding that the transition rules contained in the ETI Act prevented the United States from having fully withdrawn the FSC subsidies pursuant to the recommendations and rulings of the DSB. Transition rules are essential to the orderly shift from one set of tax rules to another. In requiring a sovereign country to subject its taxpayers to such a shift, the WTO rules cannot have been intended to further require that the country deny its taxpayers the right to an orderly shift through transition relief consistent with its practice.

263. The Act repealed the FSC provisions. The Act provided that no new FSCs could be created after 30 September 2000.

264. The Act provided limited transition relief to lessen the disruption that otherwise would be caused by the fundamental changes in the tax law reflected in the Act. Under the transition rules, taxpayers are allowed one additional year (through 31 December 2001) to continue the operation of FSCs in place as of 30 September 2000. In addition, the FSC provisions continue to apply to any transaction pursuant to a binding contract entered into before 1 October 2000.

265. The provision of transition relief is customary in the United States (and in other countries) when tax laws upon which taxpayers have relied in structuring transactions are changed. Without such transition rules, taxpayers lose confidence that the tax treatment they expect will in fact prevail. The absence of such certainty affects the ability of taxpayers to plan for their businesses, either in the long term or even in the shorter term. Failure to maintain a consistent practice of transition relief would result in significant and inefficient transaction costs as taxpayers are required to factor the risk of tax changes into their transactional planning. These are costs that could be avoided.

266. Accordingly, the Panel's findings regarding the ETI Act's transition rules should be reversed.

V. CONCLUSION

267. For the foregoing reasons, the United States respectfully requests the Appellate Body to:

(a) reverse the Panel's finding that the ETI Act is inconsistent with Article 3.1(a) of the SCM Agreement;

(b) reverse the Panel's finding that the United States has acted inconsistently with its obligation under Article 3.2 of the SCM Agreement;

(c) reverse the Panel's finding that the United States has acted inconsistently with its obligations under Articles 8 and 10.1 of the Agreement on Agriculture;

(d) reverse the Panel's finding that the ETI Act is inconsistent with Article III:4 of the GATT 1994;

(e) reverse the Panel's finding that the United States has failed to implement the recommendations and rulings of the DSB to fully withdraw the FSC subsidies found to be inconsistent with Article 3.1(a) of the SCM Agreement; and

(f) reverse the Panel's finding that the United States has nullified or impaired the benefits accruing to the EC under the SCM Agreement, the Agreement on Agriculture and the GATT 1994.