

ANNEX E

Oral Statements of the Third Parties

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ANNEX E-1

ORAL STATEMENT BY CANADA

(14 March 2001)

Mr. Chairman, Members of the Panel.

Thank you for the opportunity to provide Canada's views in this proceeding. We would take this opportunity to highlight briefly some of the key points made in our written submission.

As we stated in our submission, we agree with the EC that the *FSC Repeal and Extraterritorial Income Exclusion Act of 2000* does not bring the United States into compliance with the DSB recommendations and rulings in this dispute.

In support of this position, we would advance two principal arguments.

First, in our view, the FSC replacement scheme provides a "subsidy" to US-based enterprises within the meaning of Article 1.1 of the SCM Agreement.

Second, the subsidy provided under the FSC replacement scheme to US-based enterprises is contingent upon export performance, in violation of SCM Article 3.1(a).

Turning briefly to the first argument:

In our view, there is a "financial contribution" to US-based enterprises within the meaning of Article 1.1(a)(ii) of the SCM Agreement. The FSC replacement scheme continues to provide a financial contribution to US-based enterprises by excluding from taxation domestic income that they earn from export transactions.

As the Appellate Body stated earlier in this dispute, the "foregoing" of revenue "otherwise due" implies that less revenue has been raised by the government than would have been raised in a different situation, and that the government has given up an entitlement to raise revenue that it would otherwise have raised.

The basis for comparison must be the tax rules applied by the Member in question. In this case, the income earned by US-based enterprises on export transactions, which is part of the income excluded from taxation under the definition of "extraterritorial income", would otherwise be subject to tax in the absence of the FSC Replacement scheme. Moreover, as the EC has noted, the income earned from export transactions under the FSC replacement scheme corresponds arithmetically to the exempt foreign source income of the FSC scheme. The United States continues to provide subsidies to US-based enterprises earning this type of income.

The revenue or tax that would otherwise be due on "income earned from export transactions", which is part of the income excluded from taxation under the FSC replacement scheme, would be the tax applicable to such income under US law. Thus, in our view, the United States is providing a financial contribution to US-based enterprises earning this type of income by foregoing revenue that would otherwise be due within the meaning of Article 1.1(a)(ii) of the SCM Agreement. Moreover,

as noted in our submission, since income earned from export transactions cannot by definition face double taxation, the exclusion from taxation provided for this income under the FSC replacement scheme can only reduce US tax otherwise payable.

In addition, the financial contribution clearly confers a “benefit” to US-based enterprises earning domestic income from export transactions.

Therefore, in our view, there is a “subsidy” within the meaning of SCM Article 1.1, since there is both a “financial contribution” and a “benefit.” Both components of the definition have been met.

Turning to our second point:

Canada also submits that the “subsidy” provided to US-based enterprises is “contingent upon export performance.” In order to benefit from the subsidy, the Act states that goods must not be sold “for ultimate use in the United States.” As noted in our written submission, we agree with the EC that this is another way of saying, with respect to domestic goods, that the goods must be exported. As such, the subsidy is *de jure* export contingent.

The FSC replacement scheme, when applied to income earned from exports of domestic goods of US-based enterprises, results in the permanent reduction of US taxes otherwise payable. The export-contingent nature of the scheme leaves no doubt that the only way that income derived from the sale of a domestic good can qualify under the scheme is if the good is exported.

In conclusion, Canada respectfully requests that the Panel find that the United States has not complied with the recommendations and rulings of the DSB and that the United States continues to provide prohibited export subsidies under the FSC replacement scheme, inconsistently with Article 3.1(a) of the *SCM Agreement*.

Thank you.

ANNEX E-2

THIRD PARTY STATEMENT BY INDIA

(14 March 2001)

India is appreciative of this opportunity to present its views on this dispute.

The issue before this Panel is whether the FSC Repeal and Extraterritorial Exclusion Act of 2000 (hereinafter "FSC Replacement Act") is consistent with the recommendations and rulings of the DSB to withdraw the FSC measure found to be a prohibited export subsidy and thus inconsistent with the US obligations under Articles 3.1(a) and 3.2 of the Agreement on Subsidies and Countervailing Measures (SCM Agreement) and under Articles 10.1 and 8 of the Agreement on Agriculture.

We confine our presentation to the claims under the SCM Agreement, especially Article 3.1(a).

US failed to withdraw the original FSC subsidies "without delay"

India invites the Panel's attention to the transitional provisions of the FSC Replacement Act. Section 5(c)(1) (A) of this Act provides that for any FSC in existence on 30 September 2000 and at all times thereafter, the Act shall not be applicable to any transaction occurring:

- before 1 January 2002; or
 - after 31 December 2001, pursuant to a binding contract
- with unrelated parties; and
 - in effect on 30 September 2000.

It is submitted that the above provisions of the FSC Replacement Act would allow the US companies to continue to benefit from the WTO incompatible FSC scheme beyond the expiry of the reasonable period of time. Therefore, India requests the Panel to find that the US has failed to withdraw the FSC subsidies as required by Article 4.7 of the SCM Agreement and recommendations and rulings of the DSB, and has also failed to comply with its obligations under Article 21 of the DSU.

DSB Rulings and SCM Agreement

On 24 February 2000, the Appellate Body upheld the Panel's finding that various exemptions for certain types of income under the US Internal Revenue Code of 1986 (Code) earned by foreign sales corporations (i.e., FSC scheme), taken together, constituted a prohibited export subsidy under Article 3.1(a) of the SCM Agreement. The Appellate Body agreed with the Panel that having decided to tax foreign-source income, the US could not exclude certain types of this income from taxation without foregoing government revenue that would otherwise be due, and, therefore, without providing a financial contribution under Article 1.1(a)(1)(ii) of the SCM Agreement. Having also agreed with the Panel that the FSC measure provided a "benefit" to the recipients of the exemption, the Appellate

Body agreed that the FSC measure represented a “subsidy” within the meaning of Article 1.1 of the SCM Agreement. Finally, the Appellate Body upheld the Panel’s finding that the “subsidy” was contingent upon export performance and, therefore, prohibited under Article 3.1(a) of the SCM Agreement.

The Appellate Body recommended that the DSB request the United States to bring the FSC measure into conformity with its WTO obligations.

The Appellate Body emphasised that its ruling was in no way a judgement on the consistency or the inconsistency of the relative merits of the tax system chosen by the US. The Appellate Body observed that:

"[a] Member of the WTO may chose any kind of tax system it wishes - so long as, in so choosing, that Member applies that system in a way that is consistent with its WTO obligations. Whatever kind of tax system a Member chooses, that Member will not be in compliance with its WTO obligations if it provides, through its tax system, subsidies contingent upon export performance that are not permitted under the covered agreements." (para 179 of AB report)

These findings and conclusions of the Appellate Body were adopted by the DSB on 20 March 2000.

FSC Replacement Act

The US has enacted the FSC Replacement Act and amended its Internal Revenue Code relating to taxation of FSCs purporting to comply with the recommendations and rulings of the DSB. The Act excludes "extraterritorial income" from gross income on which tax liability is calculated. "Extraterritorial income" is defined as gross income attributable to "foreign trading gross receipts". Foreign trading gross receipts include gross receipts from sale, exchange, lease or rental of "qualifying foreign trade property", and related and subsidiary services.

Under Section 114 of the Code as amended by the Act, not all-extraterritorial income is eligible for exclusion from tax liability. Only the "qualifying foreign trade income" is eligible for such exclusion. Such income encompasses (1) income earned from export transactions by the US based companies; and (2) foreign source income earned by US company through a branch or subsidiary abroad. The income earned from the export transaction is excluded from tax.

Under Article 1.1(a)(1)(ii) of the SCM Agreement, a financial contribution by the Government exists where government revenue that is otherwise due is foregone or not collected. The term “otherwise due” implies a comparison between the revenues due under the contested measure and revenues that would be due in some other situation. As stated by the panel and Appellate Body in the examination of the original FSC measure, the basis of comparison is the tax rules applied by the US. (AB report, para 90).

The effect of the exclusion is to reduce tax liability of the beneficiary corporation. This represents a departure from the rules of taxation that would “otherwise” apply to such gross income. Accordingly, government revenue otherwise due is foregone or not collected within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement. A benefit is also conferred under Article 1.1(b) in the form of a reduction in tax liability.

It is submitted that the “subsidy” provided to US-based enterprises is clearly “contingent upon export performance”, as in order to benefit from the “subsidy”, goods must not be sold “for ultimate use in the United States.” (Section 942(a)(2)(A) of the FSC Replacement Act). India agrees with Canada and the EC that this is simply “another way of saying that they must be exported”, and

that these words are sufficient to make the subsidy de jure export contingent. As stated by the Appellate Body in Canada – Certain Measures Affecting the Automotive Industry (DS139-142):

"a subsidy is ... properly held to be de jure export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be de jure export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfilment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure."
(para 100 of the AB Report)

US argues that this extraterritorial income is excluded from the definition of "gross income" as a measure to avoid double taxation. In this connection it is submitted that the income earned from export transactions is income that would generally be taxable only in the US, since it arises from economic activities taking place in the US. The fact that the proceeds of sales are from foreign sources does not transform the export income into "foreign income" for tax purposes. Exporting goods in a foreign country does not create a sufficient nexus to trigger taxation in the importing country, even when one takes into account the "foreign economic processes" required under the FSC Replacement Act. It is submitted that such processes do not create a taxable presence abroad and, therefore, would not be considered as foreign business income subject to double taxation. Therefore, no double taxation needs to be relieved with respect to this component of "extraterritorial" income.

India therefore submits that by maintaining these provisions in the FSC Replacement Act, the US is continuing to provide prohibited export subsidies inconsistent with Article 3.1(a) of the SCM Agreement.

Conclusion

Therefore, India respectfully requests the Panel to find that the US has not complied with the recommendations and rulings of the DSB and that the US continues to provide prohibited export subsidies under the FSC Replacement Act inconsistent with Articles 3.1(a) of the SCM Agreement.

ANNEX E-3

ORAL STATEMENT BY JAPAN

(14 March 2001)

I. INTRODUCTION

1. Japan wishes to focus its comments on two specific legal issues: the violations by the United States of its obligations under Article 3.1(a) of the SCM Agreement and under Article III:4 of GATT 1994. By focusing on these two issues, however, it does not mean that Japan agrees with the United States on other issues raised by the EC before the panel.

2. Japan recognizes the principle confirmed by the Appellate Body in *Japan-Alcohol*¹ case that, as far as the rights and obligations under WTO Agreement are concerned, every sovereign Member has the authority to administer its own taxation system as it wishes, provided that its actions are consistent with the Member's obligation under the WTO Agreement. While respecting such sovereignty of Members, Japan would like to express its views to the extent that it considers relevant for the Panel's deliberation on certain issues concerning the proper interpretation of relevant provisions of the SCM Agreement and the GATT 1994, particularly as those provisions relate to the specific measure of the United States, the new tax law to replace the old FSC provisions (hereinafter referred to as "the FSC Replacement Scheme").

II. THE FSC REPLACEMENT SCHEME STILL CONFERS THE BENEFIT TO THE EXPORTS, AND STILL FALLS WITHIN ARTICLE 1 OF THE SCM AGREEMENT

3. In defence of the FSC Replacement Scheme, the United States asserts that the Scheme "modified the normative benchmark" that was in place under the previous FSC regime, in order to comply with the ruling of the Panel and the Appellate Body; the Replacement Scheme therefore does not constitute a subsidy within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement; the Replacement Scheme is a measure to avoid double taxation.

A. THE ACT DOES NOT PROVIDE THE NORMATIVE BENCHMARK AS THE UNITED STATES ALLEGES

4. The United States extensively asserts in its first submission that the Act creates a new normative benchmark which replaces the old one, and this new benchmark excludes "Extraterritorial Income" from the "Gross income", thereby rendering "extraterritorial income" outside the territorial limit of the US taxing authority. Moreover, the United States asserts that the replacement of the benchmark for taxation is within the sovereign authority of Member states which is not affected by any provision of the WTO Agreement.

5. Japan nevertheless believes that the concept of "otherwise due" of Article 1 of SCM Agreement and the normative benchmark which the Appellate Body employed for determining whether it is "otherwise due", must reflect the real nature of the exclusion and its relations with the underlying subsidy. In this case, the relevant normative category should be all foreign trade income, which includes export income. Since the United States has not excluded this entire category of

¹ *Japan – Taxes on Alcohol Beverages* WT/DS8/AB/R, p.16

income from taxation, but only a part, then it is within the category of foreign trade income to which the “otherwise due” criteria must be applied. Therefore, the question is whether tax is “otherwise due” in connection with foreign trade income under the US system.

6. Under the FSC Replacement Scheme, within the category of foreign trade income, the majority of foreign trade income is taxable. Thus, the taxation of most foreign trade income establishes that, from a normative standpoint, income tax on foreign trade income is “otherwise due” under the US tax system. It is only by virtue of the FSC Replacement Scheme that a small portion of that income (i.e., “qualifying foreign trade income”) is excluded.

7. In this regard, Japan would like to draw the Panel’s attention to the submission of Canada. As Canada correctly points out in footnote 19 of Canada’s submission, “the foreign tax credit provisions of the US Internal Revenue Code have not been repealed by the FSC Replacement Act and still provide the basic approach used by the United States to relieve double taxation with respect to income subject to tax in other countries.”²

8. Being a third party, Japan has not received a copy of rebuttal submission of the United States. So Japan has not learned of the US rebuttal on this point. But based on the materials and argument disclosed to Japan so far, the United States is yet to establish that the Act provides a new benchmark for the taxation of foreign income in the United States in place of the old one. Unless proven otherwise by the United States, Japan believes that the Act still confers a subsidy within the meaning of SCM Agreement Article 1.1(a)(1)(ii), and the “exclusion” from the Gross Income provided under the Act does not create a new benchmark as the United States alleges, but instead closely emulate the tax exemption that was available to FSCs under the previous scheme.

B. THE US DEFENCE BASED ON FOOTNOTE 59 LEAVES MANY ELEMENTS OF THE REPLACEMENT SCHEME UNACCOUNTED FOR

9. Now I would like to address the argument of the United States based on Footnote 59. As I mentioned at the outset of this statement, Japan fully respects the sovereign authority of Members to administer their respective system of taxation. In the following, I would therefore only like to point out the elements of the Replacement Scheme that are worthy of close scrutiny, and leave the final judgment to the Panel.

10. First, based on references to anecdotal legislative history connected to the passage of the FSC Replacement Scheme, the United States implies that the primary objective of the programme is to assist US companies in avoiding double taxation. If the intention of the programme were simply to avoid double taxation, the FSC Replacement Scheme would apply to 100 per cent of foreign trade income bar legitimate exceptions such as those for prevention of tax evasion. Instead, the programme allows companies to exclude only a small portion of foreign trade income from taxation. If the programme were genuinely designed to avoid double taxation, why then would the programme only solve this problem for only a small portion of a company’s exports, as opposed to all sales that might be subject to double taxation?

11. Second, if the Replacement Scheme is indeed a measure to avoid the double taxation, how could it be reconciled with the US stating in its submission that “the only requirement is that these persons be subject to US taxation”?³ Judging from this US statement, the existence of double taxation does not seem to be a prerequisite to obtain benefits under the programme. In other words, a company may benefit from the FSC Replacement Scheme, whether or not the company is subject to double taxation. The phrase “measures to avoid” suggests a strong linkage between the measures and the elimination of double taxation. The United States has so far failed to fully account for such

² *Canada Third Party Submission to 21.5 Panel*, para. 33

³ *US First Submission to 21.5 Panel*, para 34

absence of clear linkage between its claim under Footnote 59 and what it claims in its own submission.

12. Finally, while Footnote 59 does sanction “measures to avoid the double taxation,” this Footnote does not confer upon Members *carte blanche* to introduce any measure under the name of “a measure to avoid double taxation” As is the case with any exception permitted under the WTO Agreement, exceptions are permitted only to the extent necessary so as not to deviate from the generally binding principles applicable to all Members, which in this case includes, prohibition of export subsidies.

13. If the United States is to invoke Footnote 59 in justifying the Act as a measure to avoid double taxation, it must be demonstrated that the measures introduced under the Act contain clear linkage, both in letter and substance, to what is necessary for avoiding the double taxation. Thus the scrutiny for the invocation of exceptions must be conducted not only for the titles or categories of income used in the law in question, but also for the substance of those elements and the law – which is in this case a number of conditions attached to so-called “Extraterritorial Income” including the conditions attached to Qualifying Foreign Trade Property.

14. Such scrutiny leaves us puzzled as to why the Act attaches such conditions as:

“qualifying foreign income” would have had to be earned by an “eligible corporation,” from the sale, lease, or rental of goods - when such “eligible corporations” may be generating taxable income through activities other than the sale, lease, or rental of goods.

Or

not more than 50 per cent of the fair market value of which is attributable to foreign content - when the double taxation could occur irrespective of how much is attributable to domestic content.

15. In the eye of Japan, the United States has not met the burden of proof in demonstrating the clear linkage between the Act and what it claims under Footnote 59. Unless the United States meets this burden, the US effort to interpret footnote 59 to immunize measures that provide export subsidies, provided those measures also may possibly assist some companies in avoiding double taxation, should be rejected.

III. ADDING A SEPARATE CATEGORY OF ACTIVITIES THAT CAN ALSO BENEFIT FROM THE SUBSIDY DOES NOT ELIMINATE THE BENEFIT CONDITIONED ON EXPORTS.

16. Article 3.1(a) of the SCM Agreement explains that where export performance is solely or *one of several other* conditions, the subsidy will be prohibited. The fundamental point of Article 3.1(a) is whether export performance itself is one of the underlying conditions for receiving benefits. The addition of *another* category of activities eligible for subsidy benefits does not change the benefit for exports.

17. The United States tries to defend the FSC Replacement Scheme through such a device, by adding a new category to the old benefits for exports. This new category simply means that the FSC Replacement Scheme now provides subsidies to more than one category of activities: one directly related to export income, and another related to foreign-produced goods. Since eligibility for benefits under the FSC Replacement Scheme for foreign produced goods is a separate and independent condition from eligibility for direct export from the United States, two benefits are distinct. The benefit contingent on exporting goods is analytically unrelated to the subsidy related to foreign-

produced goods. That the benefit is also available to the foreign-produced goods category does not in any way make the subsidy, as it is available to exporters, consistent with the SCM Agreement.

18. The panel should reject any argument that the addition of a foreign-produced category to the activities eligible for the FSC tax exemption somehow transforms the FSC Replacement Scheme from a prohibited subsidy into a generally available and permissible subsidy. If Members needed simply to add some new category of activity, no matter how inconsequential, to an export subsidy to remove the subsidy from the scope of Article 3.1(a), then any Member could easily circumvent the disciplines of Article 3.

19. The United States argues that Article 3.1(a) requires a finding that when there are several conditions that establish eligibility for an export subsidy, export performance must be a *required* condition. According to the United States, the phrase “several other conditions” in Article 3.1(a) means a “series of conditions precedent, all of which must be satisfied.”⁴ The implication is that if the conditions are alternative, and a company may obtain the benefit of the subsidy without satisfying the export performance condition, then the entire programme somehow escapes scrutiny as providing an export subsidy to companies.

20. This interpretation of Article 3.1(a) must be rejected. First, the US argument has no basis in the text. The United States reads into the text the critical requirement that “all” of the conditions must be met. But the text provides no such language or idea. Rather, the text of Article 3.1(a) speaks only of conditioning the benefit on exports, which may be one of several requirements.

21. Second, this interpretation ignores the context of Article 3.1(a) as creating a discipline against export subsidies. The mere fact that a company happens to export does not trigger the discipline. But when a government offers some benefit conditioned on the fact of exportation, then the discipline must apply. The mere existence of other conditions, and other categories of activities that will allow company to benefit from the subsidy by means other than exports, does not magically render the programme WTO-consistent as a whole. The export condition remains an export condition. That others may also benefit does not change the export condition.

22. Third, the US argument would render Article 3.1(a) largely meaningless. Under the US interpretation, a programme could provide benefits to 99 companies meeting the export condition, and a single company meeting some other non-export condition. Yet the programme itself would be permissible, because not every recipient received benefits based on the export condition. This approach makes no sense as a means to discipline export subsidies, and cannot reflect the purpose of Article 3.1(a).

23. Finally, as both the EC and Canada correctly pointed out in their submissions⁵, the Appellate Body for the *Canada-Autopact* case made clear that “a subsidy is held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure.” Japan believes that the very language used in the conditions attached to the “foreign trade income” under the Act cannot escape the disciplines of this test.

24. In this dispute, the crux of the EC’s challenge relates to the fact that the FSC Replacement Scheme still authorizes a category of activity – exports -- to qualify for subsidy benefits. The fundamental purpose of this Article 21.5 proceeding is to examine whether the same commercial activities – exports -- are still eligible for subsidy benefits under the FSC Replacement Scheme. If so, then the fundamental problem from the initial panel proceeding has not changed, and the Replacement Scheme still violates Article 3.1(a).

⁴ *US First Submission to Article 21.5 Panel*, para. 135.

⁵ *EC First Submission to 21.5 Panel*, para. 84, *Canada Third Party Submission to 21.5 Panel*, para. 40.

IV. THE FSC REPLACEMENT SCHEME'S 50 PER CENT RULE IS INCONSISTENT WITH ARTICLE III OF GATT 1994

25. The United States argues the FSC Replacement Scheme does not require the use of domestic product, and therefore must be consistent with Article III of GATT 1994. This argument, however, misses the essential point of Article III. A measure violates Article III whenever an imported product is accorded less favourable treatment than the domestic product. A measure can accord "less favourable" treatment whether or not there is a specific legal requirement to use domestic goods. Article III prohibits government measures that create legal incentives that disrupt the "effective equality of opportunities between imported products and domestic products."⁶

26. The scope of the FSC Replacement Scheme is wider than just domestic products, but the measure nevertheless covers domestic products. As long as such disparity in treatment between imported products and domestic products exists, the violation of Article III occurs. The FSC Replacement Scheme creates such a disparity. Under this tax programme, an eligible corporation may increase its use of domestic product to any level without affecting whether the income can be deemed "qualifying foreign income," and thus may generate tax benefits. In sharp contrast, an eligible corporation does not have such flexibility with regard to foreign content. Once the foreign content exceeds 50 per cent of the fair market value of the income, the income can no longer be deemed "qualifying foreign income," and the tax benefit is lost. This differential treatment, which skews the incentive to use domestic products over foreign products, violates the "effective equality of competitive opportunities" guaranteed by Article III.

27. Adding new ways to impute value does not change this fundamental problem. The United States may be correct in stating that the FSC Replacement Scheme does not impose any legal "limitation" requiring only products to be used in determining the value. Eligible corporations, when imputing the value, may use not only products but also services, labor, intellectual property rights, and other intangibles, or even elect to forfeit the qualification as "qualifying foreign income", if it so wishes. These additional features, however, do not change the fundamental fact that the FSC Replacement Scheme creates an incentive to use domestic goods, thereby giving domestic goods preferential status under the law. The disparity between imported products and domestic products does not disappear just because these alternative means of imputing the value is introduced. The FSC Replacement Scheme therefore violates Article III:4.

V. CONCLUSION

28. After a rather lengthy dispute settlement process, the largely unchanged US FSC scheme is before the panel once again. The already long process was made even longer by the US-EC Procedural Agreement of September 29th. Japan believes that the need to reach this temporary Agreement, which was applicable only to this specific case, highlights the urgent need for all Members of the WTO to engage in a process leading to permanent resolution of the outstanding issues. Otherwise, this dispute may continue indefinitely, requiring additional derogations from the normal DSU procedures for resolving disputes.

29. For all of the foregoing reasons, this Panel should determine that the United States has not complied with the recommendations of the original Panel and the Appellate Body.

⁶ *Canada – Certain Measures Affecting the Automotive Industry*, WT/DS139/R, WT/DS142/R, Report of the Panel, as modified by the Appellate Body, adopted 19 June 2000, para. 10.78.