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UNITED STATES – TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS"

RECOURSE TO ARTICLE 21.5 OF THE DSU BY THE EUROPEAN COMMUNITIES

AB-2001-8

Report of the Appellate Body

WORLD TRADE ORGANIZATION
APPELLATE BODY

United States – Tax Treatment For "Foreign Sales Corporations"

Recourse To Article 21.5 of the DSU by the European Communities

United States, *Appellant/Appellee*
European Communities, *Appellant/Appellee*

Australia, *Third Participant*
Canada, *Third Participant*
India, *Third Participant*
Japan, *Third Participant*

AB-2001-8

Present:

Feliciano, Presiding Member
Ganesan, Member
Taniguchi, Member

I. Introduction

1. The United States appeals certain issues of law and legal interpretations in the Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations" – Recourse to Article 21.5. of the DSU by the European Communities* (the "Panel Report").[1] The Panel was established to consider a complaint by the European Communities concerning the consistency of the United States FSC Replacement and Extraterritorial Income Exclusion Act (the "ETI Act") [2] with the *Agreement on Subsidies and Countervailing Measures* (the "*SCM Agreement*"), the *Agreement on Agriculture*, and the *General Agreement on Tariffs and Trade 1994* (the "GATT 1994"). The ETI Act is a measure taken by the United States with a view to complying with the recommendations and rulings of the Dispute Settlement Body (the "DSB") in *United States – Tax Treatment for "Foreign Sales Corporations"* ("*US – FSC*").[3] Pertinent aspects of the ETI Act are described in Section II below, as well as in paragraphs 2.1-2.8 of the Panel Report.

[1] WT/DS108/RW, 20 August 2001.

[2] United States Public Law 106-519, 114 Stat. 2423 (2000).

[3] The recommendations and rulings of the DSB resulted from the adoption, by the DSB, of the Appellate Body Report in *US – FSC*, WT/DS108/AB/R, adopted 20 March 2000 (the "original Appellate Body Report"). In this Report, we refer to the panel that considered the original complaint brought by the European Communities as the "original panel" and to its report as the "original panel report".

2. In *US – FSC*, the original panel concluded that the "FSC measure", consisting of Sections 921-927 of the United States Internal Revenue Code (the "IRC") and related measures establishing special tax treatment for foreign sales corporations, was inconsistent with the United States' obligations under the *SCM Agreement* and under the *Agreement on Agriculture*.[4] The Appellate Body upheld the original panel's finding that the FSC measure was inconsistent with United States' obligations under the *SCM Agreement* and modified the Panel's findings under the *Agreement on Agriculture*.

3. On 20 March 2000, the DSB adopted the reports of the original panel and the Appellate Body. The DSB recommended that the United States bring the FSC measure into conformity with its obligations under the covered agreements and that the FSC subsidies found to be prohibited export subsidies within the meaning of the *SCM Agreement* be withdrawn without delay, namely, "at the latest with effect from 1 October 2000."[5] At its meeting on 12 October 2000, the DSB acceded to a request made by the United States to modify the time-period for complying with the DSB's recommendations and rulings in this dispute so as to expire on 1 November 2000.[6] On 15 November 2000, with a view to such compliance, the United States promulgated the ETI Act.[7] The background of this dispute is set out in further detail in the Panel Report.[8]

4. The European Communities considered that the ETI Act did not comply with the recommendations and rulings of the DSB and that it was not consistent with the United States' obligations under the *SCM Agreement*, the *Agreement on Agriculture*, and the GATT 1994. The European Communities therefore requested that the matter be referred to the original panel pursuant to Article 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU").[9] On 20 December 2000, in accordance with Article 21.5 of the DSU, the DSB referred the matter to the original panel.[10] The Panel Report was circulated to the Members of the World Trade Organization (the "WTO") on 20 August 2001.

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[4] Original Panel Report, *US – FSC*, WT/DS108/R, adopted 20 March 2000, as modified by the Appellate Body Report, WT/DS108/AB/R, para. 8.1.

[5] *Ibid*., para. 8.8.

[6] WT/DSB/M/90, paras. 6-7. See also Panel Report, para. 1.3.

[7] Panel Report, para. 1.5.

[8] *Ibid*., paras. 1.1-1.13.

[9] WT/DS108/16, 8 December 2000.

[10] WT/DS108/19, 5 January 2001.

5. The Panel concluded that:

(a) the [ETI] Act is inconsistent with Article 3.1(a) of the *SCM Agreement* as it involves subsidies "contingent… upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement* by reason of the requirement of "use outside the United States" and fails to fall within the scope of the fifth sentence of footnote 59 of the *SCM Agreement* because it is not a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59 of the *SCM Agreement*;

(b) the United States has acted inconsistently with its obligation under Article 3.2 of the *SCM Agreement* not to maintain subsidies referred to in paragraph 1 of Article 3 of the *SCM Agreement*;

(c) the [ETI] Act, by reason of the requirement of "use outside the United States", involves export subsidies as defined in Article 1(e) of the *Agreement on Agriculture* for the purposes of Article 10.1 of the *Agreement on Agriculture* and the United States has acted inconsistently with its obligations under Article 10.1 of the *Agreement on Agriculture* by applying the export subsidies, with respect to both scheduled and unscheduled agricultural products, in a manner that, at the very least, threatens to circumvent its export subsidy commitments under Article 3.3 of the *Agreement on Agriculture* and, by acting inconsistently with Article 10.1, the United States has acted inconsistently with its obligation under Article 8 of the *Agreement on Agriculture*;

(d) the [ETI] Act is inconsistent with Article III:4 of the *GATT 1994* by reason of the foreign articles/labour limitation as it accords less favourable treatment within the meaning of that provision to imported products than to like products of US origin; and

(e) the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies inconsistent with Article 3.1(a) of the *SCM Agreement* and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 *SCM Agreement*.[11]

6. The Panel also concluded that to the extent the United States had acted inconsistently with the *SCM Agreement*, the *Agreement on Agriculture* and the GATT 1994, the United States had nullified or impaired benefits accruing to the European Communities under those agreements.[12]

7. On 15 October 2001, the United States notified the DSB of its intention to appeal certain issues of law covered in the Panel Report and legal interpretations developed by the Panel, pursuant to

[11]Panel Report, para. 9.1.

[12]*Ibid*., para. 9.2.

paragraph 4 of Article 16 of the DSU, and filed a Notice of Appeal pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*").[13]

8. By letter of 22 October 2001, the United States requested the Appellate Body pursuant to Rule 16(2) of the *Working Procedures* to modify the timetable set out in the Working Schedule for Appeal for the filing of the appellant's submissions by the United States. The United States stated that suspected bioterrorist attacks had compromised the ability of the United States to conduct the necessary consultations with the United States Congress with regard to this appeal.[14] According to the United States, the effect of these circumstances was such that adhering to the original timetable would result in manifest unfairness to the United States. In its letter of 23 October 2001, the European Communities did not object to the request made by the United States, but requested that, in order to preserve the balance of procedural rights afforded to the participants in this appeal, the Appellate Body extend the deadline for the filing of the European Communities' appellee's submission by 14 days. In a letter dated 23 October 2001, the Division of the Appellate Body hearing the appeal accepted that the circumstances identified by the United States constituted "exceptional circumstances" within the meaning of Rule 16(2) of the *Working Procedures* and that maintaining the deadline for submission of the appellants' submission would result in "manifest unfairness" to the United States. Accordingly, the Division agreed to modify the Working Schedule for this appeal to allow the United States an additional seven days for the filing of its appellant's submission. In the same letter, the Division also extended by seven days the deadlines for the filing of the other appellant's submissions, the appellee's submission, and the third participants' submissions.

9. On 1 November 2001, the United States filed its appellant's submission.[15] On 6 November 2001, the European Communities filed its other appellant's submission.[16] On 16 November 2001, the European Communities and the United States each filed an appellee's submission.[17] On the same day, Australia, Canada, India and Japan each filed a third participant's submission.[18]

[13]WT/DS108/21, 15 October 2001.

[14]In its letter, the United States explained that, due to the delivery of the bacterium anthrax to the United States Congress, several buildings had been temporarily closed, including buildings housing the offices of United States Senate officials with jurisdiction over the issues arising in this appeal.

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

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

[17]Pursuant to Rules 22 and 23(3) of the *Working Procedures*.

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

10. The oral hearing in this appeal was held on 26 and 27 November 2001. The participants and third participants presented oral arguments and responded to questions put to them by the Members of the Division hearing the appeal.

11. At the oral hearing, the Division requested the United States to reduce to writing, by 28 November 2001, certain of its responses to questioning.[19] The Division also authorized the European Communities and the third participants, if they wished, to respond in writing by 30 November 2001.[20] In response to this request, the United States filed an additional written memorandum on 28 November 2001. The European Communities filed a response to this additional written memorandum on 30 November 2001.

II. Background

A. *Overview of United States Rules of Taxation*

12. In our Report in *US – FSC*, we provided certain general background information relating to United States rules of taxation. We said:

> For United States citizens and residents, the tax laws of the United States generally operate "on a worldwide basis". This means that, generally, the United States asserts the right to tax all income earned "worldwide" by its citizens and residents. A corporation organized under the laws of one of the fifty American states or the District of Columbia is a "domestic", or United States, corporation, and is "resident" in the United States for purposes of this "worldwide" taxation system. …
>
> The United States generally taxes any income earned by foreign corporations within the territory of the United States. The United States generally does not tax income that is earned by foreign corporations outside the United States. However, [under Section 882(a) IRC], such "foreign-source" income of a foreign corporation generally will be subject to United States taxation when such income is "effectively connected with the conduct of a trade or business within the United States". …[21] (footnotes omitted)

13. This statement continues to describe the United States tax system and is relevant for the purposes of this appeal also. In addition, we note that, under Sections 1 and 11 IRC, the United States imposes a tax on the "taxable income" of its citizens and residents. According to Section 63(a) IRC, taxable income is equal to "gross income minus the deductions allowed" under the IRC.

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[19]Pursuant to Rule 28(1) of the *Working Procedures*.

[20]Pursuant to Rule 28(2) of the *Working Procedures*.

[21]Appellate Body Report, *supra*, footnote 3, paras. 6-7.

Section 61(a) IRC provides that gross income is "all income from whatever source derived". When a United States citizen or resident is subject to tax, in the United States, on income which is also subject to tax in a foreign State, the United States grants the taxpayer tax credits, subject to certain limitations, in respect of the amount of foreign taxes paid.[22]

14. The provisions of the IRC relating to these rules of taxation have not been modified by the ETI Act, although the application of these rules has been altered by the adoption of the ETI Act.

B. *ETI Act*

15. A detailed description of the measure at issue in this appeal is contained in paragraphs 2.2 to 2.8 of the Panel Report. Nevertheless, we consider it useful, at this stage, to provide an overview of the fundamental aspects and key provisions of the ETI Act.

16. The ETI Act consists of five sections. At issue in this dispute are, first, certain elements of Sections 2 and 5, which relate to foreign sales corporations and, second, certain elements of Section 3. Section 3, entitled "Treatment of Extraterritorial Income", amends the IRC by inserting into it a new Section 114, as well as a new Subpart E, which is in turn composed of new Sections 941, 942 and 943. The remaining sections of the ETI Act are not relevant for purposes of this dispute.[23]

17. As we have said, the ETI Act was promulgated by the United States with a view to complying with the recommendations and rulings of the DSB in *US – FSC*. Section 2 of the ETI Act repeals the provisions of the IRC relating to FSCs.[24] Section 5(b) prohibits foreign corporations from electing to be treated as FSCs after 30 September 2000 and provides for the termination of inactive FSCs. Nevertheless, Section 5(c) creates a "transition period" for certain transactions of existing FSCs. Specifically, under Section 5(c)(1) of the ETI Act, the repeal of the provisions of the IRC relating to FSCs "shall not apply" to transactions of existing FSCs which occur before 1 January 2002 or to any other transactions of such FSCs which occur after 31 December 2001, pursuant to a binding contract between the FSC and an unrelated person which is in effect on 30 September 2000. These provisions are the subject of the European Communities' claim that the United States has not fully withdrawn the FSC subsidies, in accordance with Article 4.7 of the *SCM Agreement*.

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[22] Section 901(a) IRC.

[23] Section 1 relates to the short title of the ETI Act, while Section 4 sets forth a number of "technical and conforming" amendments.

[24] Subpart C of part III of Subchapter N of chapter 1, consisting of Sections 921-927 IRC.

18. Sections 114, 941, 942 and 943 IRC were inserted into the IRC by virtue of Section 3 of the ETI Act, and create new rules under which certain income is excluded from United States taxation. We refer to these new rules as the "ETI measure" (or sometimes simply as the "measure"), which we outline below. In these proceedings, the claims brought by the European Communities under Article 3.1 of the *SCM Agreement*, Articles 3.3, 8 and 10.1 of the *Agreement on Agriculture* and Article III:4 of the GATT 1994 contest various elements of this measure.

19. The tax treatment provided by the ETI measure is available to United States' citizens and residents, including natural persons, corporations and partnerships. In addition, the provisions of the ETI measure also apply to foreign corporations which elect to be treated, for tax purposes, as United States corporations.[25] The ETI measure permits all these taxpayers to elect to have qualifying income taxed in accordance with the provisions of that measure. This election may be made by taxpayers on a transaction-by-transaction basis.

20. Generally, income from specific transactions will qualify for treatment in accordance with the provisions of the ETI measure if it is income attributable to gross receipts: (i) from specific types of transaction; (ii) involving "qualifying foreign trade property" ("QFTP"); and (iii) if the "foreign economic process requirement" is fulfilled with respect to each such transaction.[26] Turning to the first of these conditions, the rules contained in the ETI measure apply, in particular, to income arising from sale, lease or rental transactions. The ETI measure also applies to income earned from the performance of services "related or subsidiary to" qualifying sales or lease transactions, as well as to income earned from the performance of certain other services.[27]

21. The second condition is that these transactions involve QFTP. Section 943(a)(1) IRC defines QFTP as property which is: (A) manufactured, produced, grown or extracted within or outside the United States; (B) held primarily for sale, lease or rental, in the ordinary course of business, for direct use, consumption, or disposition outside the United States; and (C) not more than 50 percent of the

[25]Section 3 of the ETI Act, Section 943(e) IRC.

[26]Under the ETI Act, the need to satisfy these three conditions is subject to a number of exceptions. We examine certain of these exceptions below, to the extent that they are pertinent to our analysis of the issues on appeal.

[27]The detailed rules of the ETI measure provide that foreign trading gross receipts may be earned through (i) any sale, exchange, or other disposition of qualifying foreign trade property; (ii) any lease or rental of qualifying foreign trade property; (iii) any services which are related and subsidiary to (i) and (ii); (iv) for engineering or architectural services for construction projects located (or proposed for location) outside the United States; and (v) for the performance of managerial services for a person other than a related person in furtherance of activities under (i), (ii) or (iii). (Section 3 of the ETI Act, Section 942(a) IRC) We will generally refer to sale and lease transactions as a shorthand reference to the transactions described in (i) and (ii) of this footnote.

fair market value of which is attributable to: (i) articles manufactured, produced, grown, or extracted outside the United States; and (ii) direct costs for labour performed outside the United States.[28]

22. The third condition is that the "foreign economic process requirement" must be fulfilled with respect to each individual transaction.[29] This requirement is fulfilled if the taxpayer (or any person acting under contract with the taxpayer) participated outside the United States in the solicitation, negotiation, or making of the contract relating to the transaction. Furthermore, a specified portion of the "direct costs" of the transaction must be attributable to activities performed outside the United States.[30]

23. Section 942(a) IRC designates as "foreign trading gross receipts" the receipts generated in transactions satisfying all three of these conditions. Under Section 114(e) IRC, "extraterritorial income" is the gross income attributable to foreign trading gross receipts and, under Section 941(b) IRC, "foreign trade income" is the taxable income attributable to foreign trading gross receipts.

24. Section 114(a) IRC provides that a taxpayer's gross income "does not include extraterritorial income". Section 114(b) IRC adds that this exclusion of extraterritorial income from gross income "shall not apply" to that portion of extraterritorial income which is not "qualifying foreign trade income" ("QFTI"). Accordingly, the *only* portion of extraterritorial income which is excluded from gross income – and, thereby, from United States taxation – is QFTI.

25. QFTI is an amount which, if excluded from the taxpayer's gross income, will result in a reduction of the taxable income of the taxpayer from the qualifying transaction. Pursuant to Section 941(a)(1) and (2) IRC, QFTI is calculated as the greatest of, or the taxpayer's choice of, the following three options: (i) 30 percent of the foreign sale and leasing income derived by the taxpayer from such transaction[31]; (ii) 1.2 percent of the foreign trading gross receipts derived by the taxpayer

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[28]Section 3 of the ETI Act, Section 943(a)(1) IRC. Section 943(a)(3) and (4) IRC set forth specific exclusions from this general definition.

[29]Section 3 of the ETI Act, Section 942(b) IRC.

[30]The relevant activities are: (i) advertising and sales promotion; (ii) processing of customer orders and arranging for delivery; (iii) transportation outside the United States in connection with delivery to the customer; (iv) determination and transmittal of final invoice or statement of account or the receipt of payment; and (v) assumption of credit risk. A taxpayer will be treated as having satisfied the foreign economic process requirement when at least 50 percent of the total costs attributable to such activities is attributable to activities performed outside the United States, or, for at least two of these five categories of activity, when at least 85 percent of the total costs attributable to such category of activity is attributable to activities performed outside the United States. (Section 3 of the ETI Act, Section 942(b)(2)(A)(ii), (b)(2)(B) and (b)(3) IRC)

[31]Foreign sales and leasing income is defined in Section 941(c)(1) IRC.

from the transaction[32]; or (iii) 15 percent of the foreign trade income derived by the taxpayer from the transaction.[33]

III. Arguments of the Participants and Third Participants

A. *Claims of Error by the United States – Appellant*

1. Subsidies Contingent Upon Export under the *SCM Agreement*

(a) Article 1.1(a)(1)(ii) of the *SCM Agreement*: Revenue Foregone that is "Otherwise Due"

26. The United States requests us to reverse the Panel's finding that the ETI Act confers a subsidy within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*. More specifically, the United States contends that the Panel "misapplied" the comparison test established in the original Appellate Body Report.[34]

27. The United States argues, first, that the Panel ignored the fact that the definition of "gross income" is not contained in Section 61 of the IRC alone, but depends also on other sections of the IRC and, more particularly, on Section 114(a) and (b) IRC. Second, the Panel erroneously created a distinction between a "specific" and a "general" tax exclusion. The Panel stated that a Member may exclude a category of income from taxation only if it excludes "all of the income" in that category. The United States contends that such an analysis improperly incorporates the concept of specificity, found in Article 2 of the *SCM Agreement*, into the definition of "subsidy" in Article 1. Third, the Panel created another erroneous standard by stating that a tax exclusion must have "some kind of overall rationale and coherence" if it is to avoid foregoing revenue that is otherwise due. Such a proposition is inconsistent with the Appellate Body's prior statement that a Member is free to tax or not tax the categories of revenues that it chooses. Fourth, the United States appeals what it considers to be a failure by the Panel to apply the original panel's "but for" test, a test which the Appellate Body had upheld. The United States submits that "but for" the exclusion of qualifying foreign trade income, *all* extraterritorial income would be excluded from "gross income". Finally, the Panel erred in finding that extraterritorial income excluded by the ETI Act necessarily would be taxed if the ETI Act did not exist. The United States submits that merely classifying income as "gross income" does not *per se* mean that it would necessarily be taxed, since "gross income" may also be subject to deferral, deductions or foreign tax credits.

[32] Foreign trading gross receipts are defined in Section 942(a) IRC.

[33] Foreign trade income is defined in Section 941(b) IRC.

[34] United States' appellant's submission, para. 107.

28. In its additional written memorandum, the United States emphasizes that, in determining the relevant benchmark rules of taxation in this case, the "basic issue … is the allocation of income earned in an international transaction between the domestic and foreign portions of such income."[35] The longstanding "normative" principles of the United States permit taxpayers "to structure their affairs in a manner that separates the foreign-allocated portion of foreign sales income from the domestic portion and subjects only the domestic portion to domestic taxation."[36] Traditionally, the United States has permitted the foreign portion of such income to be allocated outside its taxing jurisdiction through the use of a foreign-incorporated subsidiary of a United States taxpayer. The foreign portion of the income earned by such subsidiaries is not subject to United States taxation.[37] The direct allocation, under the ETI Act, of income earned in an international transaction between the domestic and foreign portions of such income simplifies the method for allocating such income outside United States' taxing jurisdiction. The ETI Act allows such allocation to be made in respect of transactions carried out directly by a United States taxpayer – without the use of a foreign subsidiary. Thus, while the ETI Act reformulates, through a fundamental revision of Sections 61 and 114 of the IRC, the method by which the United States implements its normative benchmark principles, it is consistent with such principles.

(b) Article 3.1(a) of the *SCM Agreement*: Export Contingency

29. The United States also asks us to reverse the Panel's finding that the ETI Act involves a subsidy contingent upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*. The United States argues that the Panel incorrectly transformed Article 3.1(a) into a "reverse national treatment" requirement under which domestic sales must be afforded no less favourable treatment than exports or other foreign sales.[38] However, no such requirement is present in the text of Article 3.1(a) and the availability of a subsidy to purely domestic transactions is irrelevant under Article 3.1(a).

[35]United States' additional written memorandum, p. 1.

[36]*Ibid*., p. 3.

[37]Subject to the anti-abuse rules contained in Subpart F of the IRC. (United States' additional written memorandum, p. 2)

[38]United States' appellant's submission, para. 142.

30. According to the United States, the Panel artificially bifurcated and improperly examined the ETI Act as if it had one category of treatment for United States-produced goods and a different one for foreign-produced goods. In so doing, the Panel created a distinction not found in the ETI Act, which was purposefully drafted to provide tax relief based on export-neutral criteria.

31. The United States maintains that the ETI Act is export-neutral in that it permits income to be earned without exporting. Article 3.1(a) does not prohibit subsidies that benefit exporters if conferred through export-neutral principles. In finding the ETI Act to be export-contingent, the Panel improperly held that a measure violates Article 3.1(a) if exportation is *one* way of obtaining a subsidy. However, exportation constitutes a prohibited contingency only where exportation is a *mandatory* condition. Finally, according to the United States, the Panel erroneously found that an export-contingent subsidy cannot be cured by expanding the universe of eligible recipients.

(c) Footnote 59 to the *SCM Agreement*: Double Taxation of Foreign-Source Income

32. The United States further requests us to set aside the Panel's findings that the ETI Act is not a measure to avoid double taxation under the fifth sentence of footnote 59 to the *SCM Agreement*. The Panel erroneously created detailed criteria for a measure to qualify under the fifth sentence of footnote 59 and, in so doing, improperly established "a new double taxation avoidance code".[39]

33. At the outset, the United States submits that the Panel incorrectly imposed on the United States the burden of proving that the ETI Act is a measure to avoid double taxation. The Panel ignored the Appellate Body's finding in *EC Measures Concerning Meat and Meat Products (Hormones)* ("*EC – Hormones*")[40] that related provisions which define key elements of the violations alleged form part of the elements of the *prima facie* case that a complainant must make.

34. The United States alleges that in finding that the ETI Act is not a measure to avoid double taxation, the Panel articulated four new principles that cannot be found in the fifth sentence of footnote 59. First, the Panel incorrectly stated that such a measure must apply to *all* income that is potentially subject to double taxation. Second, the Panel found that such a measure cannot encompass income that might *not* be treated as taxable in other jurisdictions. Third, the Panel held that a *bona fide* measure to avoid double taxation must contain a "permanent establishment" requirement. Fourth, the Panel erred in stating that a country which has an extensive system of bilateral tax treaties could not adopt a measure to avoid double taxation.

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[39] United States' appellant's submission, para. 173.

[40] Appellate Body Report, WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, DSR 1998:I, 135.

35. The United States claims that in addition, the Panel wrongly created a new standard for reviewing conformity with the fifth sentence of footnote 59: the "reasonable legislator" standard. The United States sees this as a substitution by the Panel of its judgment for that of a national legislature as to whether a measure is intended to avoid double taxation.

36. In the view of the United States, the fifth sentence of footnote 59 does not define "double taxation" or indicate the types of measure that are permissible to "avoid" double taxation. The sentence also does not define "foreign-source income". Two general categories of measures are nevertheless well-accepted and used throughout the world for the avoidance of double taxation: the exemption (or non-taxation) method and the tax credit method. The United States emphasizes that international tax conventions recognize that countries are free to use one or the other or both methods, and that the methods used vary from country to country.

37. The United States submits that the ETI Act achieves avoidance of double taxation through the exclusion of extraterritorial income from gross income. The ETI Act's legislative history expressly identifies double taxation avoidance as a primary objective of the ETI Act, and the ETI Act was designed to parallel certain aspects of the territorial systems of many member States of the European Communities. "Extraterritorial income" under the ETI Act is income derived from foreign transactions, and, as such, it falls within the ordinary meaning of the phrase "foreign-source income" under footnote 59 to the *SCM Agreement*.

38. Should we reverse the Panel's finding and hold that the ETI Act is a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59, the United States requests us to complete the analysis and find that, by virtue of footnote 5 to the *SCM Agreement*, the ETI Act is not a prohibited export subsidy.

2. Export Subsidies under the *Agreement on Agriculture*

39. The United States also asks us to reverse the Panel's finding that the ETI Act is inconsistent with the United States' obligations under Articles 8 and 10.1 of the *Agreement on Agriculture*. The Panel's finding that the ETI Act constitutes an export subsidy under Article 1(e) of the *Agreement on Agriculture* is based entirely on its finding under the *SCM Agreement*. Because the Panel's finding of an export subsidy under the *SCM Agreement* is in error, the United States submits that the Panel's finding of an export subsidy under the *Agreement on Agriculture* is also in error.

3. Article III:4 of the GATT 1994

40. The United States appeals the Panel's finding that, by reason of its "fair market value rule," the ETI Act accords less favourable treatment to imported products than to like United States' products and is, therefore, inconsistent with Article III:4 of the GATT 1994.

41. The United States recalls that the "no less favourable treatment" standard under Article III:4 has been interpreted by panels and the Appellate Body to require effective equality of opportunities between imported products and domestic products. Since it applied an exclusively *de jure* test in its analysis, the Panel could have found an inconsistency with Article III:4 only if it demonstrated, in 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".[41] The United States considers that the Panel did not establish such a linkage.

42. The United States contends that an analysis under Article III:4 should focus upon whether the measure in question is directed, on the one hand, toward particular categories of imports or imports in general, or, on the other hand, whether it is a measure of "general application". Unlike measures in past cases involving Article III:4, the ETI Act focuses entirely on income derived from property for use outside the United States; within this general framework, the ETI Act establishes various parameters and limitations on its application, one of which is the fair market value rule.

43. The United States submits that in its analysis of the fair market value rule, the Panel erroneously equated this rule with a domestic content or domestic value-added requirement. This characterization is "plainly incorrect"[42] because the ETI Act does not refer to United States' content nor does it predicate eligibility for the tax exclusion upon manufacture in the United States. The United States emphasizes that, in fact, the fair market value rule can be satisfied without any portion of the fair market value of a product being derived from United States' sources.

44. The United States argues that, in finding the fair market value rule to be inconsistent with Article III:4 of the GATT 1994, the Panel failed to establish a meaningful causal link between that rule and the alleged discrimination against imports and improperly extended the findings of the panel report in *Canada – Certain Measures Affecting the Automotive Industry* ("*Canada – Autos*")[43] to a very different situation. Moreover, the Panel ignored the findings of the Appellate Body in *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef* ("*Korea – Various Measures on*

[41] United States' appellant's submission, para. 253.

[42] *Ibid.*, para. 256.

[43] Panel Report, WT/DS139/R, WT/DS142/R, adopted 19 June 2000, as modified by the Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R.

Beef ").[44] Whereas in *Korea – Various Measures on Beef*, the Appellate Body rejected speculative conclusions by the panel as to possible competitive effects that might result from the differential treatment established under the relevant measure and focused, instead, on the actual effects of the measure, the Panel in this case employed similar speculation in finding that the fair market value rule necessarily places imported products at a comparative disadvantage *vis-à-vis* like domestic products in the United States' market. The Panel unreasonably assumed that despite the variety of 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 using United States components to imported components as a means of meeting the fair market value requirement.

4. Withdrawal of the FSC Subsidies

45. The United States, finally, requests us to set aside the Panel's finding that the ETI Act's transition rules are inconsistent with the full withdrawal of the FSC subsidies. Providing transitional relief is customary in the United States (and in other countries) when tax laws upon which taxpayers have relied in structuring transactions are changed. The United States contends that failure to maintain a consistent practice of transition relief would impose significant and unjustified additional transaction costs on taxpayers.

B. *Arguments of the European Communities – Appellee*

1. Subsidies Contingent Upon Export under the *SCM Agreement*

(a) Article 1.1(a)(1)(ii): Revenue Foregone that is "Otherwise Due"

46. The European Communities considers that the United States' appeal does not focus on the Panel's reasoning on the existence of a financial contribution within the meaning of Article 1 of the *SCM Agreement*, but rather criticizes certain isolated elements of the Panel's findings and responds to arguments which the Panel did not even make.

47. According to the European Communities, the Panel did *not* base its conclusion on the notion that Section 61 of the IRC was the normative benchmark, or say that any exception to it would be a subsidy. Rather, in analyzing the ETI Act, the Panel looked at the "overall situation as an integrated whole."[45] In the view of the European Communities, the United States is also wrong to criticize the

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[44] Appellate Body Report, WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001.

[45] Panel Report, para. 8.23.

Panel for distinguishing between broad and specific exclusions, and for observing that even if income attributable to foreign transactions might be a "category," the United States is not in fact excluding *all* of that "category". The European Communities similarly rejects the criticism by the United States that the Panel wrongly created an "overall rationale and coherence corollary" to the *SCM Agreement*. Rather, the Panel examined the "overall rationale and coherence" of the ETI Act only after concluding that the ETI Act resulted in the foregoing of revenue otherwise due.

48. In its response to the United States' additional written memorandum, the European Communities considers that the United States is arguing that the domestic tax rules against which the ETI Act must be assessed are the rules that apportion income between domestic and foreign sources so that each part can be taxed differently, and that the ETI Act operates as a "rule of thumb" to achieve a result similar to that which would be achieved under the normal United States' source rules. The European Communities submits that the ETI Act benefits are nevertheless subsidies when regarded as derogations from the source rules. The European Communities also points out that the ETI Act source rules differ from other source rules of the United States tax code and that taxpayers can elect to their advantage which system to use on a case-by-case basis.

49. As to the alleged failure of the Panel to apply the "but for" test, the European Communities recalls that, as the Appellate Body pointed out in paragraph 91 of its original Report, the "but for" test is not treaty language and could be easily circumvented by a Member through manipulation of its tax system. In any case, the Panel did in fact apply the "but for" test when it stated that, in the absence of the ETI Act, extraterritorial income would be "gross income" and thus would be taxed.[46] The European Communities adds that even if there may be some cases where a taxpayer could avoid paying some tax in the absence of the ETI Act, it is nonetheless clear that the ETI Act shelters income from tax that would otherwise (at least in many cases) be taxed.

(b) Article 3.1(a) of the *SCM Agreement*: Export Contingency

50. The European Communities submits that a subsidy contingent upon export performance *necessarily* treats export sales better than domestic sales. Such "better treatment" is the very rationale for prohibiting export-contingent subsidies. The European Communities disputes the United States' argument that the criteria set out in the ETI Act are "export neutral" simply because there is an alternative to exporting for qualifying for the tax exemption. The ETI Act embodies a bundle of two *sole* contingencies for two categories of beneficiaries, each of which stipulates a *sole* means to obtain the tax subsidy. For one of these categories of beneficiaries, namely those producing goods within the United States, it is necessary to export if they are to obtain the subsidy. For a measure to

[46] Panel Report, para. 8.25.

be inconsistent with Article 3.1(a) of the *SCM Agreement*, it is sufficient to demonstrate that in one, or in some cases, the receipt of the subsidy is contingent upon export performance. The European Communities insists that the prohibition of export-contingent subsidies under Article 3.1(a) of the *SCM Agreement* is absolute and must be respected in all cases.

51. The European Communities adds that the alleged "alternative" for obtaining the ETI benefit, that is, the relocation of production abroad by United States producers, is not one that realistically will be used. This confirms that, in analyzing the Act, it is proper to focus on the alternatives available for goods which *have already been produced*, or continue to be produced, in the United States. In this context, the only means for such producers to obtain the ETI tax benefit is to export such goods.

52. The European Communities also agrees with the Panel's reasoning that the former FSC measure cannot be cured merely by extending it to non-export transactions. The Panel correctly found that, as regards the measure at issue – the ETI Act – the only way to eliminate the export contingency would be to extend the availability of the subsidy to include *domestic* sales as well.

(c) Footnote 59 to the *SCM Agreement*: Double Taxation of Foreign-Source Income

53. According to the European Communities, the Panel made clear that the issue of burden of proof was academic and had no impact on the other findings of the Panel, and that even if the European Communities bore the burden of proving that the ETI Act did not fall within the scope of the fifth sentence of footnote 59, it had discharged that burden. In any event, the European Communities also agrees with the Panel’s finding on the burden of proof relating to this issue.

54. The European Communities supports the view of the Panel that, although it may not be possible to design a measure that "entirely, exclusively or precisely" avoids double taxation and, therefore, such precision is not required by the fifth sentence of footnote 59, a Member has nevertheless an obligation to identify the type of income that may be subject to double taxation and to approximate the boundaries of its measure to it. The United States has made no attempt to do this. Rather, the United States includes in the exempted category under the ETI Act income that could not legitimately be taxed in another jurisdiction.

55. The European Communities contests the United States' claim that the Panel has imposed a "permanent establishment" requirement as a necessary feature of a double taxation measure. The Panel did not articulate any such principle; indeed, it stated the opposite. The United States further alleges that the Panel held that a country could not institute a measure to avoid double taxation if it has an extensive system of bilateral tax treaties. However, in the view of the European Communities, the Panel merely considered relevant the fact that the ETI Act does not target those situations where such bilateral agreements were not in place.

56. The European Communities also contends that the United States' objection relating to the application of an alleged "reasonable legislator" standard is without merit. The Panel did not apply any such standard. Rather, the Panel considered whether the character of the ETI Act as a measure to avoid the double taxation of foreign-source income was "reasonably discernible". In the view of the European Communities, the Panel’s test was legally correct and its assessment of the facts is beyond the scope of appellate review.

57. With respect to the meaning of "foreign-source" income in the fifth sentence of footnote 59, the European Communities observes that income derives from economic activities. Therefore, foreign-source income means income derived from foreign economic activities. "Income" is not the same as "payment". The fact that a payment comes from abroad does not mean that the income is generated abroad. The ETI Act, however, does not require that the economic activities giving rise to the excluded income take place abroad. Therefore, the definition of extraterritorial income in the ETI Act bears no relation to the determination of foreign-source income, and the ETI Act is not a measure falling within the scope of footnote 59. Furthermore, the European Communities notes, the ETI Act is optional for United States taxpayers, as they can choose between the ETI Act and the other source rules of the IRC.

58. For all these reasons, the European Communities considers that the Panel correctly found that the ETI Act is not a measure to avoid the double taxation of foreign-source income and is therefore not covered by the fifth sentence of footnote 59 to the *SCM Agreement*. It follows that the Appellate Body need not reach the issue of footnote 5 to the *SCM Agreement*. In any event, the European Communities does not consider that the phrase "measures referred to in Annex I as not constituting export subsidies" in footnote 5 includes measures falling within the scope of the fifth sentence of footnote 59. Thus, footnote 5 to the *SCM Agreement* does not assist the United States.

2. Export Subsidies under the *Agreement on Agriculture*

59. The European Communities notes that the United States' arguments under the *Agreement on Agriculture* depend entirely on its arguments under the *SCM Agreement*. Accordingly, the European Communities requests us to uphold the Panel's finding under the *Agreement on Agriculture* for the same reasons it has asked the Appellate Body to uphold the Panel's finding under the *SCM Agreement*.

3. Article III:4 of the GATT 1994

60. The European Communities observes that the United States' appeal with regard to Article III:4 of the GATT 1994 is limited to the Panel's interpretation of the terms "affecting" and "less favourable treatment" within this provision. The word "affecting" has, since the inception of GATT 1947, consistently been interpreted broadly, and was interpreted by the Appellate Body in *European Communities – Regime for the Importation, Sale and Distribution of Bananas* ("*EC – Bananas III*")[47] as meaning to "have an effect on" the conditions of competition. The Panel applied the same interpretation and correctly concluded that the fair market value rule "affects" the use of imported products because it modifies the conditions of competition between domestic and imported goods. Whereas use of domestic "articles" will contribute to qualifying for the tax exemption, the use of foreign "articles" will never do so.

61. Thus, the European Communities considers that the Panel correctly found that less favourable treatment is accorded by reason of the fair market value rule. All other conditions being equal, United States producers will always have an *incentive* to use inputs of domestic origin. In certain cases, due to the cost structure of their production, use of domestic inputs will be necessary in order to obtain the tax benefit. The European Communities agrees with the Panel that such an incentive is sufficient to establish inconsistency with Article III:4 of the GATT 1994.

4. Withdrawal of the FSC Subsidies

62. The European Communities contends that the United States does not address any of the Panel's reasons or rely upon any provision of the covered agreements in support of its appeal on this issue. The United States' sole argument seems to be that transition rules are essential to the orderly shift from one set of tax rules to another. The European Communities responds that the findings in the original proceeding took this fact into account and, in stipulating that the FSC subsidies must be

[47] Appellate Body Report, WT/DS27/AB/R, adopted 25 September 1997, DSR 1997:II, 591.

withdrawn at the latest with effect from 1 October 2000, allowed the United States a grace period to introduce the required changes.

C. *Claims of Error by the European Communities – Appellant*

1. Article 10.3 of the DSU: Third Party Rights

63. The European Communities requests us to reverse the Panel's finding that third parties are not entitled to receive *all* of the parties' written submissions to the meeting of the Panel, but only the *first* written submissions. The European Communities submits that Rule 9 of the Working Procedures adopted by the Panel, and the Panel's subsequent denial of the European Communities' request to change this rule, conflict with Article 10.3 of the DSU and the rights of third parties set out therein.

64. The European Communities recognizes that panels have a certain discretion to establish their own working procedures. However, panels may not derogate from binding provisions of the DSU. Article 10.3 provides that third parties shall receive "the submissions"; it does not draw any distinction between different types of submissions. Rule 9 of the Panel's Working Procedures, and the practice in Article 21.5 proceedings of requiring that only the first written submissions be provided to the third parties, are also inconsistent with Article 10.1 of the DSU, which requires panels "fully" to take into account the interests of Members, including third parties.

65. Furthermore, the European Communities submits that the approach taken by the Panel to third party rights in this case fails to ensure that third parties will be fully informed about the arguments exchanged by the time of the substantive panel meeting. The European Communities disagrees with the Panel's conclusion that, since Article 10.3 of the DSU refers to the "first meeting" of the panel and since panels "ordinarily" meet twice, the DSU intends to limit third party access to the first written submissions of the parties in *all* cases. Rather, Article 10.3 is intended to ensure that third parties are familiar with the current state of the debate and can meaningfully contribute to it. The European Communities observes that nothing in the DSU requires a panel to hold two meetings and that Article 10.3 is drafted in general terms to be applicable in all cases, regardless of how many meetings are held.

2. Conditional Appeals

66. Should we reverse the Panel's findings, the European Communities requests us to address claims in respect of which the Panel exercised judicial economy. The conditional appeals made by the European Communities relate to the following claims that it made before the Panel:

> (a) that the tax exemption accorded, under the ETI Act, to income earned in transactions relating to goods produced *outside* the United States is contrary to Article 3.1(a) of the *SCM Agreement* in that it is contingent on export performance by virtue of the "fair market value rule";[48]
>
> (b) that the ETI Act provides subsidies which are specifically related to exports within the meaning of item (e) of the Illustrative List of Export Subsidies in Annex I to the *SCM Agreement*;[49]
>
> (c) that the "fair market value rule" in the ETI Act renders the subsidies granted in respect of goods produced in the United States (and the subsidies granted in respect of goods produced outside the United States if they are not contrary to Article 3.1(a)), contingent upon the use of United States' goods over imported goods, contrary to Article 3.1(b) of the *SCM Agreement*;[50] and
>
> (d) that the United States, by failing to withdraw the FSC subsidies and to comply with the rulings and recommendations of the DSB by the end of the period of time allowed by the DSB, has also failed to comply with its obligations under Article 21 of the DSU.[51]

67. The European Communities requests us to consider these claims only if we reverse the findings which led the Panel to exercise judicial economy. In such case, the European Communities refers us to the arguments made by it before the Panel in respect of these claims.

D. *Arguments of the United States – Appellee*

1. Article 10.3 of the DSU: Third Party Rights

68. The United States claims that the Panel did not err when it declined to find that the rights of third parties include access to the parties' rebuttal submissions, and requests us to uphold the Panel's findings. Article 10.3 of the DSU does not require that *anything* submitted by the parties prior to the single meeting with the Panel must be made available to third parties. Rather, the Panel correctly concluded that Article 10.3 presupposes a context where there is more than one panel meeting.

69. To the United States, Article 10.3 is ambiguous when considered in the context of anything other than standard panel procedures. The Panel merely construed an ambiguous provision in accordance with the principles of Article 31 of the *Vienna Convention on the Law of Treaties*

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[48] European Communities' first submission to the Panel, para. 119; Panel Report, p. A-23.

[49] *Ibid*., para. 158; p. A-29.

[50] *Ibid*., paras. 183-184; p. A-34.

[51] *Ibid*., para. 246; p. A-44.

("*Vienna Convention*").[52] The Appellate Body has held that the DSU, and in particular its Appendix 3, leave panels a margin of discretion to deal with specific situations that may arise in a particular case. In the view of the United States, the Panel's decision in this case was reasonable and was well within its margin of discretion.

2. Conditional Appeals

70. The United States submits that the conditions on which the European Communities appeals the various remaining issues are unclear. The European Communities states that the Appellate Body would need to consider them if it reversed "*any* of the findings of the Panel on the claims that the Panel did address."[53] (emphasis added) However, the United States considers it difficult to comprehend how the Appellate Body’s reversal of certain findings would trigger a consideration of *all* of the claims identified by the European Communities, because considerations of judicial economy would continue to apply. Moreover, the Appellate Body's reversal of certain findings by the Panel would be dispositive of one or more such claims.

71. With respect to each of the European Communities' claims, the United States refers to the arguments made in its submissions to the Panel. With respect to the European Communities' claims under Article 3.1(b) of the *SCM Agreement*, the United States adds that the European Communities erroneously alleges that Article 3.1(b) is violated if there is "even a slight bias in favour of domestic goods"[54] or if a contingency on the use of domestic over imported goods "is not precluded."[55] The United States recalls that the European Communities advanced a similar standard in the *Canada – Autos*[56] case, and neither the panel nor the Appellate Body accepted it.

E. *Arguments of the Third Participants*

1. Australia

72. Australia agrees with the Panel's findings that the ETI Act provides prohibited export subsidies contrary to Article 3.1(a) of the *SCM Agreement*. Australia therefore requests us to uphold the Panel's conclusions that the United States has not implemented the recommendations and rulings of the DSB.

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[52]Done at Vienna, 23 May 1969, 1155 U.N.T.S. 331; 8 International Legal Materials 679.

[53]European Communities' other appellant's submission, para. 4.

[54]European Communities' second submission to the Panel, para. 160; Panel Report, p. C-30.

[55]European Communities' response to Question 35 posed by the Panel, para. 101; Panel Report, p. F-17.

[56]Panel Report, *supra*, footnote 43; Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000.

2. Canada

73. Canada asks us to sustain the Panel's findings under the *SCM Agreement*. Under the United States tax rules, if income fails to qualify as excluded extraterritorial income within the meaning of the ETI Act, it remains subject to taxation. Accordingly, there is a foregoing of government revenue otherwise due within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*. Canada also agrees with the findings of the Panel that the subsidy is *de jure* contingent on export performance by reason of the requirement in the ETI Act of use outside the United States. Furthermore, the Panel correctly determined that "the parameters of the ETI Act do not even roughly approximate the parameters of a measure to avoid the double taxation of foreign-source income"[57]; accordingly, the ETI Act falls outside the scope of footnote 59. Finally, Canada requests us to reverse the finding of the Panel that third parties are not entitled to receive all the main parties' submissions preceding a single panel meeting.

3. India

74. India requests that we uphold the Panel's findings under the *SCM Agreement*. The United States argues that when virtually any type of income could be excluded from tax, such exclusion would form part of the prevailing domestic standard for taxation, and would therefore not involve the foregoing of revenue. According to India, such an interpretation would render Article 1.1(a)(1)(ii) meaningless and would seriously undermine the WTO disciplines on subsidies.

75. India also considers that the Panel was correct in finding that the ETI Act grants subsidies contingent upon export performance. While it might be true that by expanding the scope of the subsidy, certain non-exporting firms could qualify for tax benefits under the ETI Act, the fact remains that United States-based producers must export in order to obtain the subsidy.

76. India considers that for a measure to fall within the scope of footnote 59, it is not sufficient that such a measure may incidentally serve in a particular set of circumstances to avoid double taxation. If this were so, any WTO Member could grant export subsidies and escape sanction under WTO rules simply by declaring that its measures are measures to avoid double taxation.

4. Japan

77. Japan believes that the Panel's findings under the *SCM Agreement* should be upheld. The ETI Act excludes only a limited portion of a potential category of foreign trade income from taxation and the narrow character of this exclusion gives rise to the foregoing of revenue otherwise due in

[57] Panel Report, para. 8.96.

terms of Article 1.1(a)(1)(ii) of the *SCM Agreement*. The subsidy in this case is contingent upon export. Mere co-existence of one class of activities eligible for benefits under the Act does not change the status of the subsidy for the other class to which the benefits are available only upon exportation.

78. Japan also requests us to uphold the Panel's finding that the ETI Act is not a measure to avoid double taxation within the meaning of the fifth sentence of footnote 59 to the *SCM Agreement*. The mere fact that some income excluded from taxation under the Act may potentially be subject to double taxation is not sufficient to make it a measure to "avoid the double taxation of foreign-source income" within the meaning of footnote 59.

79. Japan recalls that a measure violates Article III:4 of the GATT 1994 when an imported product is accorded less favorable treatment than the like domestic product. A measure can accord less favorable treatment even where there are no specific legal requirements to use domestic goods. Notwithstanding the fact that the ETI Act covers goods produced both within and outside the United States, the scope of the exclusion permitted under the ETI Act for United States-produced goods is wider than the exclusion permitted for foreign-produced goods. In Japan's view, so long as such disparity in treatment between imported products and domestic products exists, Article III:4 of the GATT 1994 is violated.

IV. Issues Raised in this Appeal

80. This appeal raises the following issues:

(a) whether the Panel erred in finding, in paragraphs 8.30 and 8.43 of the Panel Report, that the ETI measure – which is described in paragraphs 12-25 of this Report – involves the foregoing of revenue which is "otherwise due" and thus gives rise to a "financial contribution" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*;

(b) whether the Panel erred in finding, in paragraphs 8.75 and 9.1(a) of the Panel Report, that the ETI measure includes subsidies "contingent … upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement*;

(c) whether the Panel erred in finding, in paragraphs 8.107 and 9.1(a) of the Panel Report that the ETI measure, viewed as a whole, does not fall within the scope of footnote 59 of the *SCM Agreement* as a measure taken to avoid the double taxation of foreign-source income;

(d) whether the Panel erred in finding, in paragraphs 8.122 and 9.1(c) of the Panel Report, that the ETI measure involves export subsidies inconsistent with the United States' obligations under Articles 3.3, 8 and 10.1 of the *Agreement on Agriculture*;

(e) whether the Panel erred in finding, in paragraphs 8.158 and 9.1(d) of the Panel Report, that the ETI measure is inconsistent with the United States' obligations under Article III:4 of the GATT 1994 because it accords less favourable treatment to imported products as compared with like products of United States origin;

(f) whether the Panel erred in finding, in paragraphs 8.170 and 9.1(e) of the Panel Report, that the United States has not fully withdrawn the subsidies found, in *US – FSC*, to be prohibited export subsidies under Article 3.1(a) of the *SCM Agreement*, and in finding that the United States has, therefore, failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 of the *SCM Agreement*; and

(g) whether the Panel erred in its interpretation of Article 10.3 of the DSU in declining, in its decision of 21 February 2001, reproduced in paragraph 6.3 of the Panel Report, to rule that all the written submissions of the parties filed prior to the only meeting of the Panel must be provided to the third parties.

V. Article 1.1 of the *SCM Agreement*: "Foregoing Revenue" that is "Otherwise Due"

81. The Panel found that the ETI measure "results in the foregoing of revenue which is 'otherwise due' and thus gives rise to a financial contribution within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*."[58]

82. In appealing this finding, the United States asserts that the Panel misinterpreted and misapplied the applicable legal standard under Article 1.1(a)(1)(ii), and also mischaracterized the relevant provisions of the IRC.[59] The United States argues that the Panel failed to apply properly the appropriate comparison, as outlined by the Appellate Body in *US – FSC*, which involves comparing a contested tax measure against a "prevailing domestic standard". According to the United States, the ETI measure establishes a general rule of United States taxation whereby the income excluded from

[58] Panel Report, para. 8.43. (footnote omitted)

[59] We observe that the United States does not appeal the Panel's finding, in paragraph 8.48 of the Panel Report, that the financial contribution it found to exist under Article 1.1(a)(1)(ii) of the *SCM Agreement* confers a "benefit" within the meaning of Article 1.1 of that Agreement.

taxation is "outside U.S. taxing jurisdiction".[60] The United States emphasizes that the ETI measure involves the allocation of income from certain foreign sales transactions according to its source. The allocation of such income into domestic and foreign portions, it states, is "a longstanding normative principle of our system of taxation."[61] The United States argues that the ETI measure reformulates the method by which the United States implements this principle, although still in a manner that is consistent with this principle. In this connection, the United States mentions that, traditionally, it has permitted the foreign portion of income from certain foreign sales transactions to be allocated outside the United States' taxing jurisdiction, and excluded from tax, through the use of a foreign-incorporated subsidiary of a United States taxpayer.

83. Furthermore, according to the United States, a Member may *exclude* from taxation a category of income, consistently with the *SCM Agreement*, even if it does not exclude *all* of the income in that category. The United States contends that when a particular category of income is excluded from taxation, a Member may choose to exclude, for revenue and other policy considerations, only a portion of that category of income.

84. The United States also contends that the Panel erred in its identification of the relevant domestic standard because it misconstrued the concept of "gross income" and ignored other provisions of the IRC that are relevant to this dispute. Consequently, the Panel erred in finding that, in the absence of the ETI measure, extraterritorial income would be "gross income" and would be taxed. According to the United States, under the IRC, "gross income" is the starting point for calculating taxable income, but "gross income" by itself is *not* necessarily subject to tax because a taxpayer can make "deductions " from it. The Panel thus erred in determining that the prevailing rule of taxation in the United States is that "gross income" is taxable.

[60]United States' appellant's submission, para. 71. See also United States' additional written memorandum, p. 4.

[61]United States' additional written memorandum, p. 2.

85. Before turning to examine the Panel's finding under Article 1.1(a)(1)(ii), certain preliminary observations regarding the *SCM Agreement* and Article 1.1 thereto should be made. Article 1.1 of the *SCM Agreement* sets out a *definition* of a "subsidy" for the purposes of that Agreement. Although this definition is central to the applicability and operation of the remaining provisions of the Agreement, Article 1.1 itself does not impose any obligation on Members with respect to the subsidies it defines. It is the provisions of the *SCM Agreement* which follow Article 1, such as Articles 3 and 5, which impose obligations on Members with respect to subsidies falling within the definition set forth in Article 1.1. As we said in our Report in *Canada – Measures Affecting the Export of Civilian Aircraft – Recourse by Brazil to Article 21.5 of the DSU* ("*Canada – Aircraft (Article 21.5 – Brazil)*"):

> … *the granting of a subsidy is not, in and of itself, prohibited under the SCM Agreement. Nor does granting a "subsidy", without more, constitute an inconsistency with that Agreement*. The universe of subsidies is vast. Not all subsidies are inconsistent with the *SCM Agreement*.[62] (emphasis added)

86. In other words, Article 1.1 of the *SCM Agreement* does not prohibit a Member from foregoing revenue that is otherwise due under its rules of taxation, even if this also confers a benefit under Article 1.1(b) of the *SCM Agreement*. However, if a Member's rules of taxation constitute or provide a subsidy under Article 1.1, and this subsidy is specific under Article 2, the Member must abide by the obligations set out in the *SCM Agreement* with respect to that subsidy, including the obligation not to "grant [] or maintain" any subsidy that is prohibited under Article 3 of the Agreement. It was in this context that we said in our Report in *US – FSC*, that, in principle, a Member is free not to tax any particular category of income it wishes, even if this results in the grant of a "subsidy" under Article 1.1 of the *SCM Agreement*, provided that the Member respects its WTO obligations with respect to the subsidy.[63]

87. The issue we examine under Article 1.1 with respect to the disputed measure is, therefore, a threshold issue that, by itself, does not determine whether the United States has acted inconsistently with its obligations under the *SCM Agreement*. With this in mind, we now turn to examine Article 1.1(a)(1)(ii) of the *SCM Agreement*. Pursuant to this provision, there is a "financial contribution by a government" where "government revenue that is otherwise due is foregone or not collected". We considered the meaning of this phrase in our Report in *US – FSC*, where we stated:

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[62] Appellate Body Report, WT/DS70/AB/RW, adopted 4 August 2000, para. 47.

[63] *Supra*, footnote 3, para. 90.

> … 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, or, that is, "otherwise". Moreover, the word "foregone" suggests that the government has given up an entitlement to raise revenue that it could "otherwise" have raised. This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues. There must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised "otherwise". We, therefore, agree with the Panel that the term "otherwise due" implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question. … What is "otherwise due", therefore, depends on the rules of taxation that each Member, by its own choice, establishes for itself.[64] (italics in original, underlining added)

88. There are several elements in this statement that bear repeating. The first is that, under Article 1.1(a)(1)(ii), a "financial contribution" does not arise simply because a government does not raise revenue which it could have raised. It is true that, from a *fiscal* perspective, where a government chooses not to tax certain income, no revenue is "due" on that income. However, although a government might, in a sense, be said to "forego" revenue in this situation, this alone gives no indication as to whether the revenue foregone was "otherwise due". In other words, the mere fact that revenues are not "due" from a fiscal perspective does not determine that the revenues are or are not "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.

89. A second element which emerges from our earlier Report is that the treaty phrase "otherwise due" implies a comparison with a "defined, normative benchmark". The purpose of this comparison is to distinguish between situations where revenue foregone *is* "otherwise due" and situations where such revenue is *not* "otherwise due". As Members, in principle, have the sovereign authority to determine their own rules of taxation, the comparison under Article 1.1(a)(1)(ii) of the *SCM Agreement* must necessarily be between the rules of taxation contained in the contested measure and other rules of taxation of the Member in question. Such a comparison enables panels and the Appellate Body to reach an objective conclusion, on the basis of the rules of taxation established by a Member, by its own choice, as to whether the contested measure involves the foregoing of revenue that would be due in some other situation or, in the words of the *SCM Agreement*, "otherwise due".

90. In our Report in *US – FSC*, we recognized that it may be difficult to identify the appropriate normative benchmark for comparison under Article 1.1(a)(1)(ii) because domestic rules of taxation

[64] Appellate Body Report, *supra*, footnote 3, para. 90.

are varied and complex.[65] In identifying the appropriate benchmark for comparison, panels must obviously ensure that they identify and examine fiscal situations which it is legitimate to compare. In other words, there must be a rational basis for comparing the fiscal treatment of the income subject to the contested measure and the fiscal treatment of certain other income. In general terms, in this comparison, like will be compared with like. For instance, if the measure at issue involves income earned in sales transactions, it might not be appropriate to compare the treatment of this income with employment income.

91. In identifying the normative benchmark, there may be situations where the measure at issue might be described as an "exception" to a "general" rule of taxation. In such situations, it may be possible to apply a "but for" test to examine the fiscal treatment of income absent the contested measure. We do not, however, consider that Article 1.1(a)(1)(ii) always *requires* panels to identify, with respect to any particular income, the "general" rule of taxation prevailing in a Member. Given the variety and complexity of domestic tax systems, it will usually be very difficult to isolate a "general" rule of taxation and "exceptions" to that "general" rule. Instead, we believe that panels should seek to compare the fiscal treatment of legitimately comparable income to determine whether the contested measure involves the foregoing of revenue which is "otherwise due", in relation to the income in question.[66]

92. In addition, it is important to ensure that the examination under Article 1.1(a)(1)(ii) involves a comparison of the fiscal treatment of the relevant income for taxpayers in comparable situations. For instance, if the measure at issue is concerned with the taxation of foreign-source income in the hands of a domestic corporation, it might not be appropriate to compare the measure with the fiscal treatment of such income in the hands of a foreign corporation.

93. Against this background, we turn to the ETI measure. This measure lays down rules of taxation for United States citizens and residents, including both natural and legal persons. These rules also apply to foreign corporations which elect to be treated, for tax purposes, as United States corporations.[67] The ETI measure permits these taxpayers to elect to have the income they earn from

[65] Appellate Body Report, *supra*, footnote 3, para. 91.

[66] We recognize that a Member may have several rules for taxing comparable income in different ways. For instance, one portion of a domestic corporation's foreign-source income may not be subject to tax in any circumstances; another portion of such income may always be subject to tax; while a third portion may be subject to tax in some circumstances. In such a situation, the outcome of the dispute would depend on which aspect of the rules of taxation was challenged and on a detailed examination of the relationship between the different rules of taxation. The examination under Article 1.1(a)(1)(ii) of the *SCM Agreement* must be sufficiently flexible to adjust to the complexities of a Member's domestic rules of taxation.

[67] Section 943(e) IRC. Thus, although the ETI measure applies to foreign corporations, these corporations are deemed for these purposes to be United States corporations and not foreign corporations. In our discussion below, we treat these foreign corporations as United States corporations.

certain transactions, involving certain property, taxed according to the rules set forth in the measure.[68] The property involved must be "qualifying foreign trade property" ("QFTP"), which, *inter alia*, must be "manufactured, produced, grown, or extracted within or outside the United States" and must be held primarily for use "outside the United States".[69] The measure applies, *inter alia*, to income earned from transactions involving the sale or lease of QFTP, and to income earned through the performance of certain services, including the performance of services "related and subsidiary" to the sale or lease of QFTP.[70] However, subject to limited exceptions, the measure applies to the income arising in a transaction only if the transaction also satisfies the "foreign economic process requirement" set out in Section 942(b) IRC. This requirement will be satisfied, generally speaking, where at least some of the activities comprising the transaction take place outside the United States.

94. Under the ETI measure, certain income earned by United States citizens and residents through certain relevant transactions, involving QFTP, is known as "extraterritorial income".[71] Section 114(a) IRC excludes extraterritorial income from "gross income" and from the operation of the rules applicable to "gross income" under Sections 61 and 63 IRC. However, Section 114(b) provides that this exclusion of extraterritorial income from gross income applies solely to that portion of extraterritorial income which is defined as "qualifying foreign trade income" ("QFTI"). The amount of QFTI is determined using one of the three formulae set forth in Section 941(a)(1) IRC.

95. In sum, therefore, under the ETI measure, a portion of income – QFTI – earned by United States citizens and residents is excluded from "gross income" under Section 114(a) and (b) IRC and, thereby, this income is excluded from taxation in the United States. Where a taxpayer elects to use the ETI measure, it must give up any tax credits it has obtained through taxation of its income in a foreign jurisdiction that are attributable to the QFTI excluded from taxation.[72]

96. The Panel reached the conclusion that the exclusion of QFTI from gross income means that the measure involves the foregoing of revenue on this portion of income, and also that revenue is otherwise due on this income. The Panel reasoned that United States taxpayers would "ordinarily" be

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[68]Section 942(a)(3) IRC. We have outlined the United States rules of taxation, including the ETI measure, in Section II of this Report.

[69]Qualifying foreign trade property is defined in Section 943(a)(1) and (2) IRC, while Section 943(a)(3) and (4) identifies property that is excluded from the definition.

[70]The transactions giving rise to income covered by the measure are described in Section 942(a)(1) IRC. We recall that we refer to sale and lease transactions as a shorthand reference to the "sale, exchange or other disposition" of QFTP, and to the "lease or rental" of this property. See Section 942(a)(1)(A) and (B) IRC.

[71]Section 114(e) IRC, read together with Section 942(a) IRC.

[72]See *infra*, paras. 104 and 181-183.

subject to tax on all income earned in transactions covered by the measure and that the measure "effectively carves … out" certain income from this other, "ordinary", situation of taxation.[73]

97. In examining the Panel's findings, we observe that the United States argues that, under the ETI measure, QFTI is confined to the *foreign-source income* earned by United States citizens and residents in transactions covered by the measure. For the purposes of reviewing the Panel's findings under Article 1.1(a)(ii) of the *SCM Agreement*, we will assume, *arguendo*, without trying to reach any conclusion on the issue at this stage, that the United States correctly characterizes QFTI as foreign-source income.[74] For these purposes, we assume, also *arguendo*, that the United States correctly maintains that the measure is merely a continuation of the "longstanding" principle of the United States rules of taxation that seeks to allocate income between domestic- and foreign-source income.

98. As we said earlier, under Article 1.1(a)(1)(ii) of the *SCM Agreement*, the normative benchmark for determining whether revenue foregone is otherwise due must allow a comparison of the fiscal treatment of comparable income, in the hands of taxpayers in similar situations. Accordingly, in identifying the normative benchmark for comparison in these proceedings, we must look to the United States' other rules of taxation applicable to the foreign-source income of United States' citizens and residents earned through the sale or lease of property, or through the performance of "related" services.[75] In so doing, we must ascertain whether, and to what extent, the United States imposes tax on foreign-source income of United States citizens and residents, including the income covered by the measure at issue which the United States considers to be foreign-source income. In other words, our inquiry under Article 1.1(a)(1)(ii) is not simply ended at this stage of analysis because the measure involves an allocation of income between domestic- and foreign-source income. Rather, we must compare the way the United States taxes the portion of the income covered by the measure, which it treats as foreign-source, with the way it taxes other foreign-source income under its own rules of taxation.

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[73] Panel Report, paras. 8.25-8.26.

[74] We examine below the merits of the United States' characterization of QFTI as "foreign-source income", which the United States is entitled to exempt to avoid double taxation of this income, when we review the Panel's findings regarding footnote 59. See *infra*, paras. 121-186.

[75] We recall that the measure applies to certain foreign corporations that elect to be treated as United States corporations. For the purpose of United States taxation, these corporations are deemed to be United States corporations. (s*upra*, para. 93 and footnote 67 thereto) Thus we do not examine the United States' fiscal treatment of the foreign-source income of *foreign* corporations including foreign subsidiaries of United States corporations – that do *not* elect to be treated as United States corporations. We do not, therefore, examine the rules of taxation for the foreign-source income of foreign subsidiaries of United States corporations. See United States' appellant's submission, paras. 34-36.

99. Under Sections 1 and 11 IRC, the United States imposes tax on the "taxable income" of each United States citizen and resident. According to Section 63(a) IRC, taxable income means "gross income minus the deductions allowed" under the IRC. Under Section 61(a) IRC, gross income means "*all income from whatever source derived*". (emphasis added) Thus, Sections 61(a) and 63(a) IRC do not distinguish between income depending on whether the income is treated by the United States as domestic- or foreign-source.[76] Rather, these provisions treat "all income from whatever source" in identical fashion so that, in principle, foreign-source gross income of United States' citizens and residents, less allowable deductions, is subject to tax as taxable income.

100. However, where a portion of the taxable income of a United States citizen or resident is subject to tax in a foreign jurisdiction, the United States *credits* the taxpayer, subject to certain limitations, with the amount of foreign taxes paid or deemed to have been paid by that taxpayer.[77] Thus, the tax payable to the United States is reduced by the amount of the tax credit. However, the tax credit granted cannot, as a proportion of the tax due, exceed the proportion of total taxable income which foreign-source income makes up.[78] In this situation, where a taxpayer pays taxes in a foreign jurisdiction, the United States treats a proportion of the tax due to the United States as a tax on foreign-source income, and grants a tax credit with respect to that income.[79]

101. In our view, the normative benchmark for determining whether the ETI measure involves the foregoing of revenue otherwise due, under Article 1.1(a)(1)(ii) of the *SCM Agreement*, is contained in the United States rules of taxation regarding the foreign-source income of United States' citizens or residents, which we have outlined in the preceding paragraph. Thus, we must compare the taxation of foreign-source income under these "other" rules of taxation, with the taxation of QFTI, which the United States also treats as foreign-source income of these same taxpayers.

102. In so doing, there appears to be a marked contrast between the "other rules" of taxation applicable to foreign-source income and the rules of taxation applicable to QFTI. For United States citizens and residents, the United States, in principle, taxes *all* foreign-source income, subject to

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[76] Sections 861-865 IRC and 26 CFR 1.861-1.865 provide rules to determine whether income of United States citizens and residents is from sources within or outside the United States.

[77] Section 901(a) IRC. Such creditable foreign taxes are those listed in Sections 901(b), 902 and 960 IRC, but these tax credits are subject to the limitation set forth in Section 904. See also the applicable Federal Regulations in 26 CFR 1.901-1.902, 1.904 and 1.960.

[78] Section 904(a) IRC. We understand this provision to mean that if foreign-source income makes up, for instance, 10 percent of the total taxable income, the amount of the tax credit cannot exceed 10 percent of the total tax due. The amount of the foreign-source income is determined by applying the source rules contained in Sections 861-865 IRC and 26 CFR 1.861-1.865.

[79] See J. Isenbergh, *International Taxation – U.S. Taxation of Foreign Persons and Foreign Income*, 2nd ed., (Aspen Law & Business, 1999), Vol. II, para. 30:4, p. 55:2, who states "[t]his limitation [in Section 904(a)] seeks to confine the credit to the U.S. tax attributable to foreign source income."

permissible deductions, although the United States grants tax credits for foreign taxes paid. However, under the ETI measure, QFTI is definitively excluded from United States taxation.

103. In addition, as we noted above, United States citizens and residents can *elect*, at their own discretion: *either* to have certain of their income treated as extraterritorial income under the ETI measure, with the result that a portion will be definitively excluded from taxation as QFTI; *or* these same taxpayers can elect to have the same income taxed under the "other" rules applicable to foreign-source income, with tax credits being recognized for, at least, a portion of foreign taxes paid. Where the taxpayer elects not to be taxed under the ETI measure, the United States taxes this income under the "other" rules of taxation applicable to foreign-source income. We see this as confirmation that, absent the ETI measure, the United States would tax the income under the "otherwise" applicable rules of taxation we have used as our benchmark.

104. Clearly, a taxpayer may be expected to elect to use the rules of taxation which result in the payment of the lowest amount of tax.[80] Thus, where a taxpayer *elects* to be taxed under the ETI measure, the amount of tax paid by the taxpayer will very likely be less than the tax which the taxpayer would have paid, on that income, under the rules "otherwise" applicable to foreign-source income, if the taxpayer did not elect to use the ETI measure. This, too, confirms that the United States will forego revenue under the ETI measure that would be "otherwise due".

105. In our view, the definitive exclusion from tax of QFTI, compared with the taxation of other foreign-source income, and coupled with the right of election for taxpayers to use the rules of taxation most favourable to them, means that, under the contested measure, the United States foregoes revenue on QFTI which is otherwise due.

106. For these reasons, we uphold the Panel's finding, in paragraphs 8.30 and 8.43 of the Panel Report, that through the measure at issue, the United States government foregoes revenue that is otherwise due within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*, and that the ETI measure, therefore, gives rise to a financial contribution under Article 1.1(a)(1) of that Agreement. In so holding, we observe that our reasons have a different focus from those given by the

[80]We mentioned earlier that, where a taxpayer elects to use the ETI measure, it must give up any tax credits it has obtained through taxation in a foreign State that is attributable to the income excluded from taxation. Accordingly, the measure will be beneficial to taxpayers where the amount of tax otherwise due on excluded QFTI is greater than the amount of tax credits which the taxpayer must give up in relation to the excluded QFTI. For instance, this calculus is likely to result in taxpayers electing to use the measure where: (a) the amount of income actually taxed in a foreign jurisdiction is less than the amount of excluded QFTI and (b) where the rate of taxation applied to income taxed in a foreign jurisdiction is lower than the United States rate of taxation that would "otherwise" be applied to the excluded QFTI.

Panel. In part, this is because, on appeal, the thrust of the United States' arguments has been directed towards the role of the measure in allocating income as either domestic- or foreign-source.

VI. Article 3.1(a) of the *SCM Agreement*: Export Contingency

107. Before the Panel, the European Communities drew a distinction between two *different* subsidies it alleged were granted under the ETI measure. The first subsidy which the European Communities identified was what it called the "*basic*" subsidy, which related to property produced "within the United States"; the second subsidy it identified was what it called the "*extended*" subsidy which related to property produced "outside the United States". The European Communities argued that both these subsidies are *de jure* contingent upon export performance.[81]

108. The Panel found that "the Act involves subsidies 'contingent … upon export performance' by reason of the requirement of 'use outside the United States' and is therefore inconsistent with Article 3.1(a) of the *SCM Agreement*."[82] This finding does not expressly draw any distinction between property produced "within" the United States and property produced "outside" the United States, nor does it adopt the distinction the European Communities drew between the so-called "basic" and "extended" subsidies. However, this finding must be read in the light of the reasoning which supports it. In the course of that reasoning, the Panel stated:

> … *in relation to US-produced goods*, the words of the statute itself make it clear that exporting is a necessary precondition to qualify for the subsidy. *In respect of US-produced goods*, the existence and amount of the subsidy depends upon the existence of income arising from the exportation of such goods. *In relation to US-produced goods*, the existence of such income is clearly conditional, or dependent upon, the exportation of such goods from the United States. We are therefore of the view that by necessary implication the scheme is *de jure* dependent or contingent upon export in relation to US-produced goods.[83] (emphasis added)

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[81] European Communities' first submission to the Panel, paras. 104-120; Panel Report, pp. A-21 – A-23. The European Communities also argued, in the alternative, that both the basic and the extended subsidies provided under the ETI Act are *de facto* export contingent. See European Communities' first submission to the Panel, paras. 131-145; Panel Report, pp. A-25 – A-28; European Communities' response to Question 2 posed by the Panel, para. 6-11; Panel Report, p. F-3.

[82] Panel Report, para. 8.75.

[83] Panel Report, para. 8.60.

109. This passage indicates that the Panel's finding under Article 3.1(a) of the *SCM Agreement* addressed only the alleged export contingency of the measure "in relation to" property produced "*within*" the United States and the Panel concluded that, in respect of this property, the grant of the subsidy is contingent upon export performance. (emphasis added) The Panel's finding did not also address the alleged export contingency of the measure in relation to property produced "outside" the United States. In other words, the Panel examined the European Communities' claim concerning the "basic" subsidy, but not the claim regarding the "extended" subsidy.[84]

110. The United States appeals the Panel's finding that the measure involves the grant of a subsidy "contingent … upon export performance". The United States contends that, under Article 3.1(a) of the *SCM Agreement*, export contingency is a *necessary* condition of grant if a subsidy is to be export contingent. It points out that the ETI measure is export-neutral as the tax exclusion is available with respect to property that is *not* produced in the United States and, therefore, not exported from the United States. Thus, it is argued, the tax exclusion can be obtained without exportation so that export performance is not a condition that must be satisfied in order to obtain this exclusion. The Panel, however, overlooked this fact and "artificially bifurcat[ed]" the ETI measure, examining it only as it relates to property produced in the United States.[85] The United States insists that no such distinction exists under the ETI measure.

111. We start with the text of Article 3.1(a) of the *SCM Agreement*, which provides that "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance" are prohibited. We have considered this provision in several previous appeals.[86] In *Canada – Aircraft*, we said that the key word in Article 3.1(a) is "contingent", which means "conditional" or "dependent for its existence on something else".[87] In other words, the grant of the subsidy must be conditional or dependent upon export performance. Footnote 4 of the *SCM Agreement*, attached to Article 3.1(a), describes the relationship of contingency by stating that the grant of a subsidy must be "tied to" export performance. Article 3.1(a) further provides that such export contingency may be the "sole []" condition governing the grant of a prohibited subsidy or it may be "one of several other conditions".

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[84]*Ibid*., para. 8.163. The European Communities filed a conditional appeal relating to the Panel's failure to examine the "extended" subsidy, which we will come to below. (*infra*, paras. 253-255)

[85]United States' appellant's submission, paras. 164 and 169.

[86]Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft* ("*Canada – Aircraft* "), WT/DS70/AB/R, adopted 20 August 1999, paras. 162-180; Appellate Body Report, *US – FSC*, *supra*, footnote 3, paras. 96-121; Appellate Body Report, *Canada – Autos*, *supra*, footnote 56, paras. 95-117; Appellate Body Report, *Canada – Aircraft (Article 21.5 – Brazil)*, *supra*, footnote 62, paras. 25-52.

[87]Appellate Body Report, *supra*, footnote 86, para. 166.

112. The Panel found that the measure involves *de jure* export contingency in relation to property produced in the United States and the United States appeals this finding. We recall that in *Canada – Autos*, we stated:

> … a subsidy is contingent "in law" upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure. … [F]or 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 fulfillment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.[88]

113. Under the ETI measure, the United States excludes from tax a portion of the income earned by United States citizens and residents through certain transactions involving, or related to, QFTP. We recall that Section 943(a)(1)(A) IRC defines QFTP, *inter alia*, as property "manufactured, produced, grown, or extracted *within or outside* the United States".[89] (emphasis added) The ETI measure, therefore, contemplates two different factual situations, one involving property produced within the United States and the other involving property produced outside the United States. The distinctiveness of these two situations is confirmed by the presence of two provisions in the IRC, each addressing one of these factual situations. Section 943(a)(2) IRC contains rules that apply only to property produced "outside the United States", while Section 943(c) IRC has source rules that address only the case of property produced "within the United States".

114. In respect of property produced within the United States, the taxpayer can obtain the subsidy only by satisfying the conditions in the measure relating to this property and, for this property, the measure provides only one set of conditions governing the grant of subsidy. The conditions for the grant of subsidy with respect to property produced *outside* the United States are distinct from those governing the grant of subsidy in respect of property produced *within* the United States.

[88] Appellate Body Report, *supra*, footnote 56, para. 100.

[89] Although Section 943(a)(1)(A) IRC applies to property "manufactured, produced, grown, or extracted within or outside the United States", we will refer to property "produced" within or outside the United States as a shorthand reference.

115. In our view, it is hence appropriate, indeed necessary, under Article 3.1(a) of the *SCM Agreement*, to examine separately the conditions pertaining to the grant of the subsidy in the two different situations addressed by the measure. We find it difficult to accept the United States' arguments that such examination involves an "artificial bifurcation" of the measure. The measure itself identifies the two situations which must be different since the very same property cannot be produced both within and outside the United States.

116. We turn to examine the conditions in the measure governing the grant of the subsidy for property produced within the United States. In its definition of QFTP, the measure provides that, in order to obtain the subsidy, this property must be "held primarily for sale, lease, or rental, in the ordinary course of trade or business for *direct use, consumption, or disposition outside* the United States …".[90] For property produced within the United States, this condition means that, for income to be eligible for the fiscal subsidy, the property must be exported. In other words, use outside the United States necessarily implies exportation of the property from the United States (the place of production) to the place of use.

117. At the oral hearing, we inquired of the United States whether, for property produced within the United States, such property must be exported from the United States in order to satisfy the condition of "direct use … outside the United States". The United States confirmed that such property must be exported to satisfy this condition.[91] For this property, then, the requirement of use outside the United States makes the grant of the tax benefit contingent upon export.

118. It may also be recalled that the measure at issue in the original proceedings in *US – FSC* contained an almost identical condition relating to "direct use … outside the United States" for property produced in the United States.[92] In that appeal, we upheld the panel's finding that the combination of the requirements to produce property in the United States and use it outside the United States gave rise to export contingency under Article 3.1(a) of the *SCM Agreement*. We see no reason, in this appeal, to reach a conclusion different from our conclusion in the original proceedings,

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[90]Section 943(a)(1)(B) IRC. (emphasis added)

[91]United States' response to questioning at the oral hearing.

[92]Under the FSC measure, qualifying property had to be produced in the United States *by a person other than an FSC*, and it had to be held primarily for sale, lease, or rental, in the ordinary course of trade or business *by, or to, an FSC* for direct use, consumption, or disposition outside the United States. (Section 927(a)(1)(A) and (B), now repealed by the ETI Act) Under Section 943(a)(1)(B), inserted into the IRC by Section 3 of the ETI Act, a United States citizen or resident producing property within the United States must hold this property "primarily for sale, lease, or rental, in the ordinary course of trade or business outside the United States." Thus, the only difference between the provisions at issue in the original proceedings and those at issue in these proceedings, relating to property produced in the United States, is that the FSC measure provided that the FSC could not produce the qualifying property, but that it had to be the seller or lessor, whereas the ETI measure does not state who must produce the qualifying property or who must sell it. This difference between the provisions has no bearing on the export contingency of the respective measures.

namely that there is export contingency, under Article 3.1(a), where the grant of a subsidy is conditioned upon a requirement that property produced in the United States be used outside the United States.

119. We recall that the ETI measure grants a tax exemption in two different sets of circumstances: (a) where property is produced *within* the United States and held for use *outside* the United States; and (b) where property is produced *outside* the United States and held for use outside the United States. Our conclusion that the ETI measure grants subsidies that are export contingent in the first set of circumstances is not affected by the fact that the subsidy can also be obtained in the second set of circumstances. The fact that the subsidies granted in the second set of circumstances *might* not be export contingent does not dissolve the export contingency arising in the first set of circumstances.[93] Conversely, the export contingency arising in these circumstances has no bearing on whether there is an export contingent subsidy in the second set of circumstances. Where a United States taxpayer is simultaneously producing property within and outside the United States, for direct use outside the United States, subsidies may be granted under the ETI measure in respect of both sets of property. The subsidy granted with respect to the property produced within the United States, and exported from there, is export contingent within the meaning of Article 3.1(a) of the *SCM Agreement*, irrespective of whether the subsidy given in respect of property produced outside the United States is also export contingent.

120. For these reasons, we uphold the Panel's finding, in paragraphs 8.75 and 9.1(a) of the Panel Report – which is limited to property "manufactured, produced, grown, or extracted" within the United States – that the measure at issue grants subsidies contingent in law upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*.[94] We do not opine upon the alleged export contingency of the subsidy in relation to property "manufactured, produced, grown, or extracted" outside the United States.[95]

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[93]We recall that the European Communities makes a conditional appeal of the Panel's exercise of judicial economy with respect to its claim concerning property produced outside the United States. We address this conditional appeal below. See *infra*, paras. 253-255.

[94]*Supra*, paras. 108-109.

[95]We note that the European Communities makes a conditional appeal concerning the Panel's exercise of judicial economy in relation to this issue. See *infra*, paras. 253-255.

VII. Footnote 59 to the *SCM Agreement*: Avoiding Double Taxation of Foreign-Source Income

121. The United States asserted, before the Panel, that, even if the Act involved export contingent subsidies, these subsidies would not be prohibited because of the fifth sentence of footnote 59 to the *SCM Agreement*, which is attached to item (e) of the Illustrative List of Export Subsidies in Annex I of that Agreement (the "Illustrative List").

122. The Panel began its inquiry by holding that the United States bore the burden of proving that the contested measure fell within the scope of the fifth sentence of footnote 59. The Panel recalled that the "party asserting the affirmative of a particular claim or defence bears the burden of proof with respect to that claim or defence," and that, in this case, the United States was asserting that the ETI Act was "justified" by footnote 59.[96]

123. In examining the United States' arguments under footnote 59, the Panel found that the term "foreign-source income" refers "to certain income susceptible to 'double taxation'."[97] The Panel observed that a measure need not avoid double taxation of foreign-source income with "precision", nor need it avoid double taxation "entirely" or "exclusively".[98] Nonetheless, the Panel said, "the relationship between the measure and its asserted purpose – i.e. 'to avoid the double taxation of foreign-source income …' – must be reasonably discernible."[99] The Panel examined the relationship between the measure and its asserted purpose by reviewing "the overall structure, design and operation of the Act".[100] The Panel found that the measure at issue is not taken "to avoid the double taxation of foreign-source income" within the meaning of the fifth sentence of footnote 59 to the *SCM Agreement*.[101]

124. The United States argues, on appeal, that the Panel erred in finding that the burden of proof was on the United States to demonstrate that the measure fell within footnote 59.[102] According to the United States, "the last sentence of footnote 59 is inextricably linked to … Article 3.1(a) [of the *SCM Agreement*] and it serves to define the scope of Article 3.1(a)."[103] Thus, it contends, the

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[96]Panel Report, para. 8.90 and footnote 188 thereto. (footnote omitted)

[97]*Ibid*., para. 8.93.

[98]*Ibid*., para. 8.95. (footnote omitted)

[99]*Ibid*.

[100]*Ibid*.

[101]Panel Report, paras. 8.107 and 9.1(a).

[102]United States' appellant's submission, para. 207.

[103]*Ibid*., para. 204.

European Communities bears the burden of proving that measure does *not* fall within footnote 59 to the *SCM Agreement*.

125. According to the United States, the fifth sentence of footnote 59 indicates that Members have "broad flexibility in fashioning double taxation relief".[104] It argues that foreign-source income "would appear to include income arising, at least in part, outside the borders or territory of the Member instituting a measure to avoid double taxation" as there is a "possibility of double taxation" of such income.[105] The United States points to the legislative history of the ETI Act to establish that the measure was taken to avoid double taxation within the meaning of footnote 59.[106] The United States maintains that measures to avoid double taxation, under footnote 59, need not be "comprehensive or all-encompassing."[107]

126. We address first the Panel's finding that the United States bears the burden of proving that the ETI measure falls within the scope of footnote 59. We have indeed stated that "the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence."[108] In applying this principle in *US – Wool Shirts and Blouses*, we said:

> Articles XX and XI:(2)(c)(i) are limited exceptions from obligations under certain other provisions of the GATT 1994, not positive rules establishing obligations in themselves. They are in the nature of affirmative defences. It is only reasonable that the burden of establishing such a defence should rest on the party asserting it.[109] (footnote omitted)

127. In *EC – Hormones*, we stressed that the usual rules on burden of proof could not be avoided simply by describing a particular provision as an "exception".[110] In that appeal, we explored the relationship between Articles 3.1 and 3.3 of the *Agreement on the Application of Sanitary and Phytosanitary Measures* (the "*SPS Agreement*"), as compared with the relationship between Articles I, III and XX of the GATT 1994. In the case of the GATT 1994 provisions, we observed that Article XX does not establish any "positive obligations" relevant to determining the proper scope of the obligations imposed under Articles I and III. Instead, Article XX sets out circumstances in which Members are

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[104] *Ibid*., para. 218.

[105] *Ibid*., paras. 187-188.

[106] *Ibid*., para. 194. See also Panel Report, footnote 197 to para. 8.95.

[107] United States' appellant's submission, para. 209.

[108] Appellate Body Report, *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India* ("*US – Wool Shirts and Blouses*"), WT/DS33/AB/R and Corr.1, adopted 23 May 1997, DSR 1997:I, 323, at 335.

[109] *Ibid*., at 337.

[110] Appellate Body Report, *supra*, footnote 40, para. 104.

entitled to "adopt or maintain" measures that are inconsistent with the obligations imposed under other provisions of the GATT 1994, such as Articles I and III.

128. Thus, in reviewing the Panel's finding on the burden of proof under the fifth sentence of footnote 59, we must determine whether that provision determines, in part, the proper scope of the obligations under Article 3.1(a) of the *SCM Agreement*, or whether it provides an exception for a provision that is otherwise an export contingent subsidy.

129. We recall that, in the original proceedings in this dispute, we said that the fifth sentence of footnote 59 "does not purport to establish an exception to the general definition of a 'subsidy' …"[111] Thus, a measure taken to avoid the double taxation of foreign-source income, falling within footnote 59, may be a "subsidy" under the *SCM Agreement*.

130. Article 3.1 of the *SCM Agreement* provides specific obligations with respect to two types of subsidy: subsidies contingent upon export performance and subsidies contingent upon the use of domestic over imported goods. Subsidies of these defined types are prohibited under Article 3 of the *SCM Agreement*. Item (e) of the Illustrative List identifies a particular measure which is deemed to be a prohibited export subsidy under Article 3.1(a).

131. The fifth sentence of footnote 59 provides that item (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." In the same way that we do not see the fifth sentence of footnote 59 as altering the scope of the definition of a "subsidy" in Article 1.1 of the *SCM Agreement*, we do not see it as altering either the scope of item (e) of the Illustrative List or the meaning to be given to the term "subsidies contingent … upon export performance" in Article 3.1(a) of the *SCM Agreement*. Thus, measures falling within the scope of this sentence of footnote 59 may continue to be export subsidies, much as they may continue to be subsidies under Article 1.1 of the *SCM Agreement*.

132. The import of the fifth sentence of footnote 59 is that Members are entitled to "take", or "adopt" measures to avoid double taxation of foreign-source income, notwithstanding that they may be, in principle, export subsidies within the meaning of Article 3.1(a). The fifth sentence of footnote 59, therefore, constitutes an exception to the legal regime applicable to export subsidies under Article 3.1(a) by explicitly providing that when a measure is taken to avoid the double taxation of foreign-source income, a Member is entitled to adopt it.

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[111] Appellate Body Report, *US – FSC*, *supra*, footnote 3, para. 93. (emphasis omitted)

133. Accordingly, as we indicated in *US – FSC*, the fifth sentence of footnote 59 constitutes an affirmative defence that justifies a prohibited export subsidy when the measure in question is taken "to avoid the double taxation of foreign-source income".[112] In such a situation, the burden of proving that a measure is justified by falling within the scope of the fifth sentence of footnote 59 rests upon the responding party.

134. We, therefore, uphold the Panel's finding, in paragraph 8.90 of the Panel Report, that, in this case, the burden of proof under the fifth sentence of footnote 59 falls on the United States.

135. We turn to the United States' appeal that the Panel erred in finding that the ETI measure is not one taken to avoid the double taxation of foreign-source income under footnote 59 to the *SCM Agreement*.

136. We recall that the fifth sentence of footnote 59 provides:

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

137. We note at the outset that "double taxation" occurs when the same income, in the hands of the same taxpayer, is liable to tax in different States. The fifth sentence of footnote 59 applies to a measure taken by a Member to avoid such double taxation of "foreign-source income". In examining the phrase "foreign-source income", we observe that, in ordinary usage, the word "source" can refer to the place where a thing originates, and that the words "source" and "origin" can be synonyms.[113] We consider, therefore, that the word "source", in the context of the fifth sentence of footnote 59, has a meaning akin to "origin" and refers to the place where the income is earned. This reading is supported by the combination of the words "foreign" and "source" as "foreign" also refers to the place where the income is earned. Used in this way, the word "foreign" indicates a source which is external to the Member adopting the measure at stake.[114] Footnote 59, therefore, applies to measures taken by a Member to avoid the double taxation of income earned by a taxpayer of that Member in a "foreign" State.

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[112] Appellate Body Report, *supra*, footnote 3, para. 101.

[113] *Shorter Oxford English Dictionary*, C. T. Onions (ed.) (Guild Publishing, 1983), Vol. II, p. 2057.

[114] *Ibid*., Vol. I, p. 788.

138. The fifth sentence of footnote 59 to the *SCM Agreement* permits a Member to take measures granting special fiscal treatment to "foreign-source income" in order to alleviate a "double taxation" burden on its taxpayer. Clearly, if the income benefitting from such special treatment could not be taxed twice, in two different States, there would be no double tax burden to alleviate, and hence no justification for permitting an exception to the prohibition on export subsidies. Thus, the term "foreign-source income" in footnote 59 refers to income which is susceptible of being taxed in two States. The Panel took a similar view when it stated that it understood "the term 'foreign-source income' … to refer to certain income susceptible to 'double taxation' ".[115]

139. It is, however, no easy matter to determine in every situation when income is susceptible of being taxed in two different States and, thus, when a Member may properly regard income as "foreign-source income". We have emphasized in previous appeals that Members have the sovereign authority to determine their own rules of taxation, provided that they respect their WTO obligations.[116] Thus, subject to this important proviso, each Member is free to determine the rules it will use to identify the source of income and the fiscal consequences – to tax or not to tax the income – flowing from the identification of source. We see nothing in footnote 59 to the *SCM Agreement* which is intended to alter this situation. We, therefore, agree with the Panel that footnote 59 does not oblige Members to adopt any particular legal standard to determine whether income is foreign-source for the purposes of their double taxation-avoidance measures.[117]

140. At the same time, however, footnote 59 does not give Members an unfettered discretion to avoid double taxation of "foreign-source income" through the grant of export subsidies. As the fifth sentence of footnote 59 to the *SCM Agreement* constitutes an exception to the prohibition on export subsidies, great care must be taken in defining its scope. If footnote 59 were interpreted to allow a Member to grant a fiscal preference for *any* income that a Member chooses to regard as foreign-source, that reading would seriously undermine the prohibition on export subsidies in the *SCM Agreement*. That would allow Members, relying on whatever source rules they adopt, to grant fiscal export subsidies for income that may not actually be susceptible of being taxed in two

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[115] Panel Report, para. 8.93.

[116] See Appellate Body Report, *Japan – Taxes on Alcoholic Beverages* ("*Japan – Alcoholic Beverages II*"), WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, DSR 1996:I, 97, at 110; Appellate Body Report, *Chile – Taxes on Alcoholic Beverages*, WT/DS87/AB/R, WT/DS110/AB/R, adopted 12 January 2000, paras. 59-60; and Appellate Body Report, *US – FSC*, *supra*, footnote 3, para. 90.

[117] Panel Report, para. 8.93.

jurisdictions. Accordingly, the term "foreign-source income", as used in footnote 59 cannot be interpreted by reference solely to the rules of the Member taking the measure to avoid double taxation of foreign-source income.

141. Although there is no universally agreed meaning for the term "foreign-source income" in international tax law, we observe that many States have adopted bilateral or multilateral treaties to address double taxation. The United States, for instance, has more than fifty bilateral tax treaties addressing double taxation.[118] Frequently, bilateral tax treaties have been based on multilaterally developed model tax conventions dealing with double taxation.[119] In addition, the respective member States of the Andean Community and of the Caribbean Community have adopted multilateral agreements, binding on the members of each community, that seek to avoid double taxation.[120]

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[118]Department of the Treasury, Internal Revenue Service, Publication 901 (Rev. April 2001), Cat. No. 46849F.

[119]Two commonly used model tax conventions are the Organisation for Economic Co-operation and Development ("O.E.C.D.") *Model Tax Convention on Income and Capital* ("*O.E.C.D. Model Tax Convention*") and the United Nations *Double Taxation Convention between Developed and Developing Countries* ("*U.N. Model Tax Convention*"), which contain similar provisions. The majority of bilateral treaties adopt the principles of these two model tax conventions, with many also adopting their detailed provisions (see B. J. Arnold & M. J. McIntyre, *International Tax Primer* (Kluwer Law International, 1995), p. 100 and A. H. Qureshi, *The Public International Law of Taxation* (Graham & Trotman, 1994), p. 371). According to the O.E.C.D., there are close to 350 treaties between O.E.C.D. Members and over 1500 treaties world-wide which are based on the *O.E.C.D. Model Tax Convention* (O.E.C.D. website, www.oecd.org; 2001). The member States of the Andean Community (Bolivia, Colombia, Ecuador, Peru and Venezuela) adopted a model tax agreement among themselves, which is to be used when member States conclude bilateral taxation treaties with third States (Decision 40 of 8 November 1971 of the Andean Group, Annex II, *Standard Agreement to Avoid Double Taxation between Member Countries and Other States Outside the Subregion* (*Convenio Tipo para evitar la doble tributación entre los Países Miembros y otros Estados ajenos a la Subregión*) ("*Andean Community Model Tax Agreement*").

[120]The member States of the Andean Community (Bolivia, Colombia, Ecuador, Peru and Venezuela) adopted an agreement among themselves to address double taxation (Decision 40 of 8 November 1971 of the Andean Group approving the *Agreement to Avoid Double Taxation between Member Countries* (*Convenio para evitar la doble tributación entre los Paises Miembros*) ("*Andean Community Agreement*"). (www.comunidadandina.org/normativa/dec/d040.htm and www.comunidadandina.org/ingles/treaties/dec/d040e.htm) This agreement entered into force on 1 January 1981.

11 member States of the Caribbean Community (Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, and Trinidad and Tobago) also adopted an agreement on double taxation among themselves on 6 July 1994 (*Agreement Among the Governments of the Member States of the Caribbean Community for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Profits or Gains and Capital Gains and for the Encouragement of Regional Trade and Investment*) ("*CARICOM Agreement*"). (www.caricom.org under "Information Services" and "Treaties and Protocols")

142. Although these instruments do not define "foreign-source income" uniformly, it appears to us that certain widely recognized principles of taxation emerge from them.[121] In seeking to give meaning to the term "foreign-source income" in footnote 59 to the *SCM Agreement*, which is a tax-related provision in an international trade treaty, we believe that it is appropriate for us to derive assistance from these widely recognized principles which many States generally apply in the field of taxation. In identifying these principles, we bear in mind that the measure at issue seeks to address foreign-source income of United States citizens and residents – that is, income earned by these taxpayers in "foreign" States where the taxpayers are not resident.

143. We recognize, of course, that the detailed rules on taxation of non-residents differ considerably from State-to-State, with some States applying rules which may be more likely to tax the income of non-residents than the rules applied by other States.[122] However, despite the differences, there seems to us to be a widely accepted common element to these rules. The common element is that a "foreign" State will tax a non-resident on income which is generated by activities of the non-resident that have some link with that State. Thus, whether a "foreign" State decides to tax non-residents on income generated by a permanent establishment or whether, absent such an establishment, it decides to tax a non-resident on income generated by the conduct of a trade or business on its territory, the "foreign" State taxes a non-resident only on income generated by

[121]We observe that, before the Panel, the United States provided examples of the source rules applied by Brazil, Canada, Chile, Malaysia, Panama, Saudi Arabia, Taiwan, the United Kingdom and the United States. The widely recognized principles of taxation appear to be reflected in these domestic rules of taxation. (United States' second submission to the Panel, para. 62; Panel Report, p. C-69; Exhibits US-24 – US-29 submitted by the United States to the Panel; United States' response to Question 12 posed by the Panel, paras. 27-29; Panel Report, pp. F-38 and F-39)

[122]For instance, some States will tax a non-resident only on business income generated by a *permanent establishment* on its territory. In that respect, we observe that the *O.E.C.D. Model Tax Convention* allows a State to impose tax on business profits generated by a non-resident through a "permanent establishment" situated on its territory. Article 5.1 of the Convention defines a "permanent establishment" as a "fixed place of business through which the business of an enterprise is wholly or partly carried on". This definition requires a relatively strong link with the "foreign" State before it may tax a non-resident. However, Article 5.5 of the Convention adds that a permanent establishment may exist where a person, other than the taxpayer, "habitually exercises … an authority to conclude contracts" for the taxpayer. The *O.E.C.D. Model Tax Convention* itself, therefore, admits of differing standards to determine whether business income was generated by activities linked to the territory of a "foreign" State.

However, we also observe that some States will tax a non-resident on the basis of activities of a less permanent character provided there is nonetheless a sufficient connection between the activities generating the income and the territory of the taxing State. The United States, for instance, taxes the business income of non-residents if the income is "effectively connected" with a trade or business conducted in the United States. (Sections 871(b) and 882(b) IRC) The United States cites examples of other States which it considers tax non-residents on income generated through a trade or business conducted in that State, without the creation of a permanent establishment (see *supra*, footnote 121).

activities linked to the territory of that State.[123] As a result of this link, the "foreign" State treats the income in question as domestic-source, under its source rules, and taxes it. Conversely, where the income of a non-resident does not have any links with a "foreign" State, it is widely accepted that the income will be subject to tax only in the taxpayer's State of residence, and that this income will not be subject to taxation by a "foreign" State.

144. Although the participants, and third participants, disagree on precisely whether or to what extent a "foreign" State will tax the income of a non-resident, none has suggested that a non-resident

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[123]We note that the *Andean Community Agreement*, the *CARICOM Agreement*, and the *Andean Community Model Tax Agreement and the O.E.C.D.* and *U.N. Model Tax Conventions* describe a variety of situations in which a "foreign" State is entitled to tax a non-resident on income generated through activities which are linked to that State. The nature of the links required depends on the nature of the income.

Articles 7 of the *Andean Community Agreement* and of the *Andean Community Model Tax Agreement* provide that business profits are taxable only in the State where these profits are "obtained" through business activities conducted in that State. Article 8 of the *CARICOM Agreement* states that business profits are taxable only in the State where the business activities generating these profits are "undertaken". Thus, a non-resident will be taxed on business profits generated through activities undertaken in a "foreign" State. Articles 7 of the *O.E.C.D.* and *U.N. Model Tax Conventions* provide that "business" income of a non-resident, generated through a "permanent establishment", may be taxed in the State where the permanent establishment is located (see *supra*, footnote 122).

Articles 5 and 12 of the *Andean Community Agreement* and the *Andean Community Model Tax Agreement*, Articles 6 and 7.2(i) of the *CARICOM Agreement*, and Articles 6 and 13 of the *O.E.C.D.* and *U.N. Model Tax Conventions* state that income, or capital gains, derived by a non-resident from immovable property, or from its alienation, are taxable in the "foreign" State where the property is situated.

Articles 8 of the *O.E.C.D.* and *U.N. Model Tax Conventions* provide that income generated from the "operation of ships or aircraft in international traffic" may be taxed in a "foreign" State if the "place of effective management" of the non-resident enterprise is situated in that State. Article 8 of the *Andean Community Agreement* and Article 9.1 of the *CARICOM Agreement* allow only the State of residence of the enterprise to tax such "international" income. However, Article 9.2 of the *CARICOM Agreement* provides that where the transport activities take place exclusively within the territory of one of the member States, that State shall tax the income, irrespective of the place of residence of the enterprise. Article 8 of the *Andean Community Model Tax Agreement* is similar to Article 8 of the *Andean Community Agreement,* while the alternative Article 8 of the *Andean Community Model Tax Agreement,* allows a State to tax transport activities that take place in that State, irrespective of the place of residence of the enterprise.

Articles 13 of the *Andean Community Agreement* and of the *Andean Community Model Tax Agreement*, and Articles 15 of the *CARICOM Agreement* and of the *O.E.C.D.* and *U.N. Model Tax Conventions*, indicate that the employment income of a non-resident may be taxed in a "foreign" State if the services are rendered or if the employment is exercised in that State.

According to Article 17 of the *CARICOM Agreement*, and Articles 16 of the *O.E.C.D.* and *U.N. Model Tax Conventions*, the fees of a non-resident director may be taxed in the "foreign" State if the corporation of which the person is a director is resident in that State. Under Article 14 of the *Andean Community Agreement* and of the *Andean Community Model Tax Agreement*, professional services provided by an enterprise may be taxed in a "foreign" State if the services are performed there.

Under Articles 16 of the *Andean Community Agreement* and of the *Andean Community Model Tax Agreement*, Article 18 of the *CARICOM Agreement*, and Articles 17 of the *O.E.C.D.* and *U.N. Model Tax Conventions*, the income of an entertainer derived from "activities" exercised in a "foreign" State may be taxed in that State.

Thus, in the case of each type of income addressed by these agreements and conventions, a "foreign" State may tax a non-resident only on income which is generated by activities which are linked to or connected with the territory of that State.

will be taxed in a "foreign" State on income generated by activities that are not, in any way, linked to that "foreign" State. Indeed, the United States argues that QFTI is foreign-source income because this portion of extraterritorial income has "*sufficient foreign contacts* … [such] that the transaction may be subject to tax in [a] foreign nation."[124] (emphasis added) According to the United States, these "foreign contacts" are established, under the measure, through the performance of the activities described in the foreign economic processes requirement under Section 942(b) IRC.[125] Thus, the United States accepts that "foreign-source income" in footnote 59 is income generated by economic activities that have "sufficient contacts" with a "foreign" State.

145. Accordingly, in our view, "foreign-source income", in footnote 59 to the *SCM Agreement*, refers to income generated by activities of a non-resident taxpayer in a "foreign" State which have such links with that State so that the income could properly be subject to tax in that State.[126]

146. In view of the divergence in the detailed rules applied by States when taxing non-residents, there will be many situations where some States tax the income of a non-resident, while other States would consider that there was an inadequate link to justify the imposition of tax on non-residents. Thus, from the perspective of the State of residence, there will not be certainty as to when the income of its taxpayers will be subject to tax in a "foreign" State. Despite this uncertainty, one of the widely recognized methods of avoiding double taxation is the tax exemption method.[127] Under this method, States may exempt income from taxation to avoid double taxation, irrespective of whether or not

[124] United States' additional written memorandum, p. 2.

[125] *Ibid*.

[126] We note that Isenbergh states that "the concept of source is not infinitely malleable. If only for practical reasons, some *connection with a country is required* to justify treating income as being from sources within that country." (emphasis added) Isenbergh also states that "commercial or industrial countries regard income as deriving its source from *specific economic activity conducted within them*, whereas many developing countries … focus on whose pocket income is paid from." (emphasis added) (J. Isenbergh, *supra*, footnote 79, Vol. I, para. 5.1, p. 5:2)

[127] See, for instance, Articles 23A of the *O.E.C.D.* and *U.N. Model Tax Conventions*. Among bilateral tax treaties, see, for instance, Article 22(1)(a) of the *Agreement between the Federal Republic of Germany and the Islamic Republic of Pakistan for Avoidance of Double Taxation in the Area of Taxes on Income* (*Abkommen zwischen der Bundesrepublik Deutschland und der Islamischen Republik Pakistan zur Vermeidung der Doppelbesteuerung auf dem Gebiet der Steuern vom Einkommen*), 14 July 1994, Bundesteuerblatt 1995 I p. 617, Bundesgesetzblatt 1995 II p. 836; Article 22(2)(a) of the *Double Taxation Agreement between Mauritius and Madagascar* (*Convention entre le Gouvernement de la République de Maurice et le Gouvernement de la République de Madagascar tendant à éviter les doubles impositions et la prévention de l'évasion fiscale en matière d'impôts sur le revenu*), 30 August 1994; and Article 24(b)(1) of the *Double Taxation Agreement between the Republic of France and the United Kingdom* (*Convention entre la France et le Royaume-Uni de Grande-Bretagne et d'Irlande du Nord tendant à éviter les doubles impositions et à prévenir l'évasion fiscale en matière d'impôts sur les revenus*), 22 May 1968, *Journal Officiel de la République française*, 24 November 1969, p. 11476, as amended. See also A. H. Qureshi, *supra*, footnote 119, p. 370; B. J. Arnold & M. J. McIntyre, *supra*, footnote 119, pp. 40-43; J. Schuch, "The Methods for the Elimination of Double Taxation in a Multilateral Tax Treaty", in M. Lang *et al*. (eds.), *Multilateral Tax Treaties, New Developments in International Tax Law* (Kluwer Law International and Lindeverlagwien, 1998), pp. 129-152; and M. Pires, *International Juridical Double Taxation of Income* (Kluwer Law and Taxation, 1989), pp. 173-184.

another State taxes the exempt income. The avoidance of double taxation is not an exact science. Indeed, the income exempted from taxation in the State of residence of the taxpayer might not be subject to a corresponding, or any, tax in a "foreign" State. Yet, this does not necessarily mean that the measure is not taken to avoid double taxation of foreign-source income. Thus, we agree with the Panel, and the United States, that measures falling under footnote 59 are not required to be perfectly tailored to the actual double tax burden.[128]

147. However, the fact that measures falling under footnote 59 to the *SCM Agreement* may grant a tax exemption even for income that is not taxed in another jurisdiction does not mean that such tax exemptions may be granted, under the fifth sentence of footnote 59, for *any* income. Footnote 59 prescribes that the income benefitting from a double taxation-avoidance measure must be "foreign-source" and, as we have said, that means that the income must have links with a "foreign" State such that it could properly be subjected to tax in that State, as well as in the Member taking the double taxation-avoidance measure.

148. We also recognize that Members are not obliged by the covered agreements to provide relief from double taxation. Footnote 59 to the *SCM Agreement* simply preserves the prerogative of Members to grant such relief, at their discretion, for "foreign-source income". Accordingly, we do not believe that measures falling under footnote 59 must grant relief from *all* double tax burdens. Rather, Members retain the sovereign authority to determine for themselves whether, and to what extent, they will grant such relief.

149. We turn once more to the ETI measure and recall that footnote 59 to the *SCM Agreement* applies to measures "tak[en] … to avoid the double taxation of foreign-source income …". Like the Panel, we will scrutinize the design, structure and architecture of the contested measure to determine whether it falls within footnote 59.

150. We recall that the United States points to the legislative history of the measure. According to certain passages from that legislative history, "the exclusion of … extraterritorial income is a means of avoiding double taxation".[129] The legislative history also states that the measure was adopted "to comply with decisions of a World Trade Organization dispute panel and Appellate Body."[130] We

[128]Panel Report, para. 8.95; United States' appellant's submission, paras. 216-220.

[129]United States' appellant's submission, para. 194, quoting the United States' *Senate Report on the FSC Repeal and Extraterritorial Income Exclusion Act* ("Senate Report"), S. Rep. No. 106-416 (2000), Exhibit US-2 submitted by the United States to the Panel, pp. 2 and 6; United States' *House of Representatives Report on the FSC and Repeal and Extraterritorial Income Exclusion Act* ("House Report"), H.R. Rep. No. 106-845 (2000), Exhibit US-3 submitted by the United States to the Panel, pp. 10 and 13.

[130]Panel Report, footnote 197 to para. 8.95 quoting House Report, p. 19.

take particular note of these statements, though we do not believe that it would be appropriate for us to end our inquiry here.

151. It is clear to us that the measure addresses situations where United States citizens and residents have engaged in certain economic activities in a "foreign" State. We note that a taxpayer will be treated as having foreign trading gross receipts, which give rise to exempt QFTI, only if the transaction generating these receipts satisfied the "foreign economic process requirement" in Section 942(b) IRC.[131]

152. Under this requirement, certain aspects of the transaction must take place outside the United States. First, the taxpayer must have "participated outside the United States" in one of the following activities: the "solicitation", "negotiation" or "making" of the contract, other than participation in advertising. Second, at least 50 percent of certain of the transaction costs must be attributable "to activities performed outside the United States." The relevant costs are those pertaining to the following five categories of activity: "advertising and sales promotion"; "the processing of customer orders and the arranging for delivery"; "transportation outside the United States in connection with delivery to the customer"; "the determination and transmittal of a final invoice or statement of account or the receipt of payment"; and, "the assumption of credit risk".[132]

153. The foreign economic process requirement focuses on activities of the taxpayer in respect of making and executing the sale or lease of the qualifying property. While we agree with the European Communities that the measure addresses only a limited range of economic activities, we also agree with the United States that these activities occur in a "foreign" State, as they must take place outside the United States. It is, therefore, clear to us that the foreign economic process requirement establishes a link between some part of the qualifying transactions covered by the ETI measure and a "foreign" State.

154. However, the fact that a transaction involves some foreign element, such as the "foreign economic process", does not necessarily mean that *all* of the income generated by such a transaction will be "foreign-source income" within the meaning of footnote 59 to the *SCM Agreement*. The sale or lease of property may give rise to taxable income attributable to a variety of activities, of which

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[131]See *infra*, paras. 175-177, where we address the exception to this requirement in Section 942(c)(1) IRC.

[132]Sections 942(b)(2)(A)(ii) and 942(b)(3) IRC. As an alternative, the foreign economic process requirement may be satisfied where the costs attributable to activities performed outside the United States account for at least 85 percent of the costs in two of the five categories mentioned in paragraph 152. See Section 942(b)(2)(B) IRC.

only some may occur in a "foreign" State. Thus, a sale or lease transaction may give rise to income attributable to activities such as research and development, manufacturing, advertising, selling, transport, and administration. In our view, under footnote 59 to the *SCM Agreement*, the "foreign-source income" arising in such a transaction is only that portion of the total income which is generated by and properly attributable to activities that do occur in a "foreign" State.[133] Conversely, the portion of the total income generated by and properly attributable to activities that occur within the State of residence is domestic-source income in that State. Thus, where sales or lease income *combines* domestic- and foreign-source income, *not all* of the income is foreign-source, just as *not all* of the income is domestic-source.

155. Under Section 942(a)(1) IRC, "foreign trading gross receipts" are the *entirety* of the receipts earned by the taxpayer in transactions covered by the measure. "Extraterritorial income" is defined in Section 114(e) IRC as the gross income attributable to foreign trading gross receipts of the taxpayer. "Foreign trade income" is defined in Section 941(b)(1) IRC as the (net) taxable income attributable to foreign trading gross receipts of the taxpayer. Under the ETI measure, as we read the statutory provisions, *all* of the receipts from a qualifying transaction involving qualifying property are treated as foreign trading gross receipts; *all* of the gross income earned in such a transaction is treated as extraterritorial income; and *all* of the (net) taxable income earned in such transaction is treated as foreign trade income.

156. We said earlier that the *exempt* income under the measure is only QFTI and that the amount of QFTI is calculated, at the choice of the taxpayer, using one of three different formulae set forth in Section 941(a)(1) IRC. Under one of these formulae, the amount of QFTI is equal to 15 percent of the (net) foreign trade income of the taxpayer[134] (the "15 percent rule"), while under a second, QFTI is equal to 1.2 percent of foreign trading gross receipts (the "1.2 percent rule").[135] Thus, under these two formulae, QFTI is a *fixed percentage* of either the net amount or the gross amount of *all* of the income earned by the taxpayer in any qualifying transaction. Under these formulae, QFTI, therefore,

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[133] We note that Isenbergh states that, in the case of sale of goods by a producer, the income generated by the sales transaction is attributable to "easily distinguishable activities" which are "often combined", namely "production and sale" activities. Isenbergh indicates that in an international sales transaction, these production and sales activities may take place "in different countries". These activities, therefore, generate income that has different sources which are "compounded" unless the income from the different sources is separated. Isenbergh states that "ideally" the different "elements of the transaction" would be "disengaged" using arm's length pricing rules. The manufacturer would be treated as if it had sold the goods to an independent distributor at arm's length prices, who in turn resold the goods. This would "dissect" the transaction on the basis of the place where the different activities occurred. (J. Isenbergh, *supra*, footnote 79, Vol. I, para. 10.9, p. 10:16)

[134] Section 941(a)(1)(C) IRC.

[135] Section 941(a)(1)(B) IRC. We note that, under Section 941(a)(1)(A) IRC, QFTI may be 30 percent of the "foreign sales and leasing income" of the taxpayer. We will examine this formula below. See *infra*, paras. 172-178.

includes a percentage of the income earned by the taxpayer from the activities that, cumulatively, generated the totality of the income. In other words, in calculating QFTI under these formulae, the measure does not purport to distinguish, except on an "rule of thumb" basis, between domestic- and foreign-source income according to whether activities generating the income occurred in the United States or in a "foreign State".[136] Instead, QFTI is a fixed percentage of an amount that bundles together both domestic- and foreign-source income.

157. This may be illustrated by way of examples which are based on an example of the operation of the measure given in the United States' House Report.[137] The first example involves two separate sales transactions. We assume that a United States corporation manufactures property in the United States and sells it to an unrelated distributor in the United States, without satisfying the foreign economic process requirement. We assume that the sales price was $80, generating $30 of profit for the manufacturer. At the oral hearing, the United States confirmed that, in such a transaction, the manufacturer will have no extraterritorial income and no QFTI. All of the $30 profit will be gross income under Section 61(a) IRC. We next assume that the same distributor sells this same property to a foreign buyer, for use outside the United States, in a transaction satisfying the foreign economic process requirement. The sales price is $100, generating $20 of profit. At the oral hearing, the United States confirmed that the distributor will have $20 of extraterritorial income and, assuming this is all taxable income, the QFTI will equal $3 using the 15 percent rule in Section 941(a)(1)C) IRC.

158. In this first example, the manufacturer made $30 of profit and the distributor $20. Of this total of $50 of profit, only the distributor's $20 of profit is extraterritorial income. The exempt QFTI is a portion of distributor's sales and distribution profits, and does not include any profits made by the manufacturer. The United States explained that the 15 percent rule is intended to allocate the sales and distribution income earned in a transaction, in this example by the distributor, between the domestic portion (85%), and the foreign portion attributable to the activities involved in completing the foreign economic process (15%).[138] Thus, the $3 of QFTI is the amount the United States treats as exempt foreign-source income in this example, with the remaining $47 treated as United States domestic-source income.

[136] At the oral hearing, the United States referred to the formulae for calculating the amount of QFTI as "rules of thumb".

[137] House Report, p. 20. The figures used in these examples are also based on the example given in the United States' House Report.

[138] United States' response to questioning at the oral hearing.

159. Our second example is taken directly from the House Report itself, and uses the figures given in that Report. It involves precisely the same transactions as our first example, with the same sales prices and profits for the manufacturer and distributor. However, in this case the manufacturer and distributor are related parties. By virtue of Section 942(b)(4) IRC, the manufacturer is deemed to have satisfied the foreign economic process requirement in its transaction with the related distributor because the distributor satisfied this requirement in the subsequent transaction with the foreign buyer. In other words, because the manufacturer and distributor are related, the measure deems the foreign economic process requirement to have been met in the sales transaction between the related parties, when, in fact, it was not met. At the oral hearing, the United States confirmed what is stated in the House Report, namely that as a result of the "deeming" provision in Section 942(b)(4) IRC, the manufacturer's $30 of profit is treated as extraterritorial income and, assuming this is all taxable income, the manufacturer's QFTI will equal $4.50 using the 15 percent rule in Section 941(a)(1)(C) IRC. The distributor will also still have $3 of QFTI. Thus, the related parties have a total of $7.50 of exempt QFTI, which the United States regards as foreign-source income.[139] The remaining $42.50 of profit is treated as domestic-source income. We will comment on this example below.

160. The third example involves only one transaction: the direct sale, by a United States corporation, of property which that corporation manufactured in the United States, to an unrelated foreign buyer for use outside the United States. In this example, we assume that the transaction satisfies the foreign economic process requirement. We assume also that the sales price was $100, generating $50 of profit for the manufacturer. Thus, like the last two examples, the total profit from all activities is $50. However, unlike the last two examples, the entire $50 profit is earned by the manufacturer. At the oral hearing, the United States confirmed that, in this example, the manufacturer will have $50 of extraterritorial income and, again assuming that this is all taxable income, it will have $7.50 of QFTI using the 15 percent rule. The United States argues that the $7.50 represents foreign-source income of the manufacturer, while the remaining $42.50 is taxed in the United States as domestic-source income.

161. The differences in tax treatment among these three examples are revealing. In each example, precisely the same total amount of profit ($50) is earned from precisely the same activities (manufacture, sales and distribution). Moreover, the nature and extent of the foreign-based activities are identical in each example. Yet, in these examples, the allocation between domestic- and foreign-source income that arises from the application of the ETI measure is very different. Indeed, in the second and third examples, the amount of income treated as exempt foreign-source income is more than twice the amount of such income in the first example.

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[139] The United States confirmed our understanding at the oral hearing.

162. The reason for the noteworthy difference in the exempt income between the first and third example is, as we said earlier, that QFTI is calculated as a fixed percentage of *all* of the income earned by the taxpayer in any qualifying transaction from the cumulation of activities which generated the income.[140] In the first example, QFTI was 15 percent of the entire $20 of income earned by the distributor from the cumulation of its sales and distribution activities; QFTI did not, however, include any of the $30 of profits earned by the manufacturer, in a separate transaction, from its activities. By contrast, in the third example, because the sale was made directly by a manufacturer, QFTI was 15 percent of the entire $50 of income earned by it from the cumulation of all of its activities, including manufacturing, sales and distribution. Thus, in the third example, QFTI bundles together, as exempt foreign-source income, 15 percent of the manufacturing income from the transaction, as well as 15 percent of the sales and distribution income.

163. The difference in tax treatment between the first and second examples is explained by Section 942(b)(4) IRC, which provides that the transaction between the related manufacturer and distributor is deemed to satisfy the foreign economic process requirement because this requirement is satisfied in the *subsequent sale* by the distributor *to the unrelated foreign buyer*. Thus, in the absence of Section 942(b)(4) IRC, the domestic manufacturing income of the related parties would not be included in the calculation of QFTI. Yet, through the deeming provision, the measure allows the related parties to bundle together, in the calculation of QFTI, *all* of the profits earned by them, including profits earned in a purely domestic transaction between the related parties *inter se*. Thus, as in the third example, QFTI includes, in the second example, as exempt foreign-source income, 15 percent of the manufacturing income, as well as 15 percent of the sales and distribution income.

164. We note that our examples, like the one in the House Report, calculate QFTI using the 15 percent rule. However, if the taxpayer elected to calculate QFTI using the 1.2 percent rule, similar anomalies in the allocation of income as either domestic- or foreign-source would arise. Under this formula also, QFTI would be a portion of the combined domestic- and foreign-source income earned through the cumulation of activities that generated the foreign trading gross receipts of which 1.2 percent is QFTI.[141]

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[140] See *supra*, para. 25, for a description of the formulae used to calculate the amount of QFTI.

[141] Where the taxpayer elects to use the 1.2 percent rule to calculate the tax exemption with respect to any transaction, Section 941(a)(3) IRC confines the exemption to the income earned in that single transaction. Any income earned in any other transaction, relating to the same property, cannot benefit from an exemption, even in the case of a second transaction between related parties. This provision, therefore, effectively excludes the application of the deeming rule for related parties in Section 942(b)(4) IRC, which allows income from more than one transaction to be included in the calculation of QFTI. See *supra*, paras. 159 and 163.

165. We have said that, under footnote 59 to the *SCM Agreement*, "foreign-source income" is income which is generated through activities linked with a "foreign" State. Although the ETI measure ensures that transactions giving rise to exempt QFTI have some link with a "foreign" State, through compliance with the foreign economic process requirement, two of the measure's allocation rules (the 15 percent and 1.2 percent rules) do not distinguish, on a proper basis, between income generated by activities that occur in the United States and income from activities that occur elsewhere. Rather, under these two rules, QFTI is a fixed portion of all of the income earned by the taxpayer in relevant transactions, including income generated by activities that occur in the United States, such as manufacturing income in our examples. As we have said, income generated by activities that do not have a link with a "foreign" State is not properly regarded as "foreign-source income" within the meaning of footnote 59, but as domestic-source income.

166. Accordingly, in our view, in the calculation of QFTI using the 1.2 and 15 percent rules set forth in Section 941(a)(1)(B) and (C) IRC[142], the ETI measure fails to distinguish between income which can give rise to foreign-source income – that is, sales and distribution income attributable to the foreign economic processes – and income which cannot, such as income attributable to United States' manufacturing activities. As a result, under these two formulae, the ETI measure improperly combines domestic-source income and foreign-source income in the calculation of QFTI. We, therefore, consider that, when taxpayers elect to use either of these two formulae, the ETI measure results systematically in a misallocation of domestic- and foreign-source income.

167. Furthermore, as we saw in the second example, through Section 942(b)(4) IRC, related parties are able to "sweep into" the calculation of QFTI income from purely domestic transactions, involving in that example domestic-source manufacturing income.[143] In the absence of this provision, the separate transactions between the manufacturer and related distributor, and between the distributor and unrelated foreign buyer, would have operated as a means of separating out some domestic- and foreign-source income in these separate transactions. In other words, the domestic-source income in the first transaction would not be included in the calculation of QFTI. However, the result of the deeming provision in Section 942(b)(4) IRC is to misallocate domestic-source income from the first transaction as foreign-source income.[144]

[142] See *supra*, paras. 25 and 156.

[143] See *supra*, para. 159.

[144] We acknowledge that, for certain purposes, related parties may be treated as a single economy entity. Yet, the application of the deeming rule here adds another situation where the ETI measure misallocates domestic- and foreign-source income.

168. Finally, with respect to the two formulae we have just examined – namely, the 1.2 percent rule or 15 percent rule – we note that the last sentence of this provision states that the amount determined under the 1.2 percent rule shall in no case exceed 200 percent of the amount determined under the 15 percent rule. This last sentence of Section 941(a)(1) suggests to us that there could be situations where the QFTI claimed by a taxpayer under the 1.2 percent rule could be as much as 200 percent of the QFTI computed for the same transactions under the 15 percent rule. This reinforces our view that the approach embodied in the ETI measure can lead to very different allocations of income between domestic-and foreign-source in respect of precisely the same transaction. This implies to us that the different formulae for calculating QFTI result in a misallocation of income as between the domestic-and foreign-source and, through the election which the taxpayer can make between these formulae, allows the taxpayer to obtain the maximum benefit from the misallocation.

169. The third and final formula for calculating QFTI addresses "foreign sales and leasing income" ("FSLI") and is set forth in Section 941(c)(1) IRC. This provision states that QFTI may be 30 percent of the taxpayer's FSLI. The definition of FSLI contains some noteworthy differences from the allocation rules under the two formulae we have just examined. Whereas the first two formulae base the calculation of QFTI on *combined* domestic- and foreign-source income, in contrast, the definition of FSLI, under Section 941(c)(1)(A) IRC, does not. Under this provision, FSLI is limited to the "foreign trade income properly allocable to activities" that are "performed … *outside* the United States" in satisfaction of the foreign economic process requirement described in Sections 942(b)(2)(A)(i) and 942(b)(3) IRC.[145]

170. Thus, under this third formula, FSLI is a portion of foreign trade income.[146] We recall that, under Section 941(b) IRC, foreign trade income bundles together both domestic- and foreign-source income. However, in contrast, FSLI is only that portion of foreign trade income "properly allocable" to foreign sales and distribution activities. We note that, although the IRC does not define the words "properly allocable", the Senate and House Reports indicate that those words limit FSLI to foreign trade income "*associated with sales* activities" described in the foreign economic process requirement.[147] We envisage that the application of such a rule requires the taxpayer to establish that, in fact, the "alloca[tion]" made is, indeed, "proper". Interpreted in this way, FSLI is *not* the *entirety* of the taxpayers' sales and leasing income, but is only the portion "properly allocable" or attributable

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[145]This method of determining FSLI does not apply to income derived from the "lease or rental" of QFTP. We examine below the calculation of FSLI in transactions involving the "lease or rental" of QFTP. See *infra*, paras. 170-174.

[146] We note that, under Section 941(c)(3)(B) IRC, only "*directly* allocable expenses" are to be "taken into account in computing foreign trade income" for purposes of FSLI. (emphasis added)

[147]Senate Report, p. 10; House Report, p. 24. (emphasis added)

to foreign activities. By requiring such a process of separating domestic- and foreign-source income, on the basis of the locus of the activities generating the income, Section 941(a)(1)(A) IRC includes in the calculation of FSLI only income which may properly be regarded as "foreign-source income" under footnote 59 of the *SCM Agreement*. In other words, Section 941(c)(1)(A) IRC separates out, or unbundles, the domestic- and foreign-source income that are combined in foreign trade income.

171. We note, however, that rules on "proper alloca[tion]" in Section 941(c)(1)(A) IRC do *not* apply to income derived from the lease or rental of QFTP. In the case of income derived from the "lease or rental" of QFTP, FSLI is simply the "foreign trade income" derived from these transactions.[148] We recall that foreign trade income bundles together domestic- and foreign-source income[149], in other words, the process of separating domestic- and foreign-source income that we consider is contemplated by the words "properly allocable" does *not* apply to FSLI which is lease or rental income.

172. However, the provisions relating to FSLI include "special rules for leased property" in Section 941(c)(2) IRC for the calculation of foreign trade income. These special rules apply in two situations. First, where qualifying property is leased by the manufacturer and, second, where qualifying property which has been leased is sold by the manufacturer. In these two situations, FSLI is determined as if the manufacturer had acquired the property from a third party at an arm's length price. The Senate and House Reports explain that:

> This limitation is intended to *prevent* foreign sales and leasing income from including *profit associated with manufacturing activities*.[150] (emphasis added)

173. We agree that, under the "special rules for leased property", the use of the arm's length rule effects a separation of manufacturing income from all other income.[151] The amount of FSLI is *all* of the income, *less* manufacturing income, earned through the lease transaction, or through the sale of leased property. FSLI, therefore, combines or bundles together the *remaining* income, irrespective of the locus of the activities that generated this income. The remaining FSLI could combine income generated by domestic activities and income generated by foreign activities. As a result the

[148]Section 941(c)(1)(B) IRC.

[149]See *supra*, paras. 155 and 166.

[150]Senate Report, p. 11; House Report, p. 24.

[151]We note that Isenbergh considers that the use of arm's length pricing is an appropriate method for separating manufacturing income from sales income. (J. Isenbergh, *supra*, footnote 79, Vol. I, para. 10.9, p. 10:16) See also *supra*, footnote 133.

calculation of FSLI for leased property could result in a misallocation of domestic-source income as foreign-source income.

174. To our minds, the inclusion of certain restrictions in calculating FSLI – the "properly allocable" rule and the exclusion of manufacturing income – makes all the more striking the omission of any such restrictions where QFTI is calculated using the other two formulae, that is, the 1.2 percent and 15 percent rules. We find it particularly incongruous that one part of the ETI measure expressly requires a "proper alloca[tion]" of foreign-source income, on the basis of activities "performed … outside the United States", while the remainder of the measure does not. We also find it noteworthy that, in one part of the ETI measure, a restriction is included specifically "to prevent" an exemption being granted to "profit associated with manufacturing activities" – which activities will often take place within the United States – while under the 1.2 percent and 15 percent rules no such limitation is provided to exclude domestic-source manufacturing income.

175. We turn now to two other aspects of the ETI measure which we consider similarly result in domestic-source income being treated as exempt foreign-source income. First, for taxpayers with declared foreign trading gross receipts of up to $5,000,000, Section 942(c)(1) IRC dispenses entirely with the foreign economic process requirement. Thus, a portion of the taxpayers' income is treated as exempt foreign-source income even though it has not been established – and need not be established – that the taxpayer undertook any activities outside the United States. However, in the absence of an established link between the income of such taxpayers and their activities in a "foreign" State, we do not believe that there is "foreign-source income" within the meaning of footnote 59 of the *SCM Agreement*.

176. The United States argued, at the oral hearing, that, in the case of "small" taxpayers with foreign trading gross receipts of only up to $5,000,000, the burden under the foreign economic process requirement is too great to justify imposing this requirement.[152] At the oral hearing, the United States also asserted that, where the exception in Section 942(c)(1) IRC applies, there is in any event a link with a foreign State because, in these cases, the qualifying property in the transaction must be used outside the United States.[153] In our view, however, sales income cannot be regarded as "foreign-source income", under footnote 59, for the sole reason that the property, subject-matter of the sale, is exported to another State, for use there. The mere fact that the buyer uses property outside the United States does not mean that the seller undertook activities in a "foreign" State generating income

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[152]We note that a taxpayer with no more than $5,000,000 of declared foreign trading gross receipts may have other gross receipts which are not declared as foreign trading gross receipts.

[153]Clearly, where the transaction involves the production of QFTP outside the United States, there would be other foreign links than the use outside the United States. We deal here with the United States' argument as it relates to property produced within the United States.

there. Such an interpretation of footnote 59 would, in effect, allow Members to grant a tax exemption in favour of export-related income on the ground that the exportation by itself of the property renders the income "foreign-source". In our view, this reading would allow Members easily to evade the prohibition on export subsidies in Article 3.1(a) of the *SCM Agreement* and render this prohibition meaningless.

177. Accordingly, where and to the extent that the "$5,000,000"exception in Section 942(c)(1) IRC applies, the measure grants a tax exemption in favour of income which is not demonstrated to be "foreign-source income" within the meaning of footnote 59 to the *SCM Agreement*. Rather, this income remains domestic-source.

178. Second, the measure treats domestic-source income as exempt foreign-source income in connection with the performance of services "related and subsidiary" to the sale or lease of qualifying property under Section 942(a)(1)(C) IRC. Under this provision, the performance of certain services in connection with qualifying property, for example repair or maintenance services, can generate foreign trading gross receipts and, hence, exempt QFTI.

179. The IRC does not state expressly that these subsidiary and related service activities need to be performed outside the United States. We note that the rules contained in the Code of Federal Regulations, which applied to the FSC legislation, continue to apply to the provisions of the measure regarding foreign trading gross receipts.[154] According to these regulations, subsidiary and related services "may be performed *within* or without the United States."[155] (emphasis added)

180. The measure, in conjunction with these regulations, therefore, exempts QFTI derived by a United States citizen or resident from the performance of services *within* the United States. The activities which generate the services income may occur entirely in the United States. In our view, such income has no link with any "foreign" State which could lead to that State taxing the income and therefore, is not "foreign-source income" within the meaning of footnote 59 to the *SCM Agreement*. Rather it is domestic-source income.

181. There is one final aspect of the measure to be highlighted. The measure provides rules that exempt a portion of income as QFTI so as to avoid, the United States argues, the double taxation of foreign-source income. The measure does not, however, displace the rules the United States otherwise applies to avoid the double taxation of foreign-source income. These other rules involve the grant of tax credits with respect to foreign-source income on which the taxpayer has paid tax in a

[154] Senate Report, p. 19; House Report, p. 33.

[155] 26 CFR 1.924(a)–1T–(d).

"foreign" State.[156] Both the ETI measure and these rules continue to be available, and taxpayers with foreign trading gross receipts under the ETI measure have a *choice*, on a transaction-by-transaction basis, to opt either for an exemption of a portion of their income as QFTI or to have the income taxed under the other rules with tax credits granted to offset the taxes due in the United States.[157] Moreover, if a taxpayer elects to have income from a transaction taxed under the ETI measure, the taxpayer also has a choice as to the formula to be used to calculate the amount of QFTI.

182. As we said earlier, taxpayers will obviously opt to use the rules which result in the most favourable tax treatment for them. In making its choices, the taxpayer will naturally decide whether the tax which is due on exempt QFTI is greater than the tax credits which it could claim if it did not elect to take a tax exemption under the ETI measure.[158]

183. Under the ETI measure, the taxpayer can obtain a tax exemption even for income that is domestic-source income. The taxpayer will not have foreign tax credits with respect to this domestic-source income. In these circumstances, with no tax credits to surrender, the taxpayer would very likely opt for an exemption under the ETI measure of income that includes domestic-source income. The measure operates, in these circumstances, as a means to provide export subsidies for income earned from domestic activities. Correspondingly, the greater the amount of genuine "foreign-source income" included in QFTI, the more likely it is that the taxpayer will have tax credits to give up, and the less likely it becomes that the ETI measure will be used by the taxpayer.

184. In conclusion, our examination discloses that the measure at issue is an extremely complex instrument. We set out to review whether the measure was "tak[en] … to avoid the double taxation of foreign-source income" within the meaning of footnote 59 to the *SCM Agreement*. The ETI measure, viewed as a whole, does not permit us to conclude that this measure exempts *only* "foreign-source income". Rather, in some situations, the ETI measure exempts QFTI which is foreign-source income[159]; in other situations, the ETI measure exempts QFTI which is not foreign-source[160]; and, in

[156] See *supra*, para. 100.

[157] We recall that, under Section 114(d) IRC, a taxpayer gives up tax credits attributable to income excluded from taxation under the ETI measure.

[158] See *supra*, para. 104 and footnote 80 thereto.

[159] See *supra*, para. 170, examining the rule that, where QFTI is calculated as 30 percent of FSLI, FSLI is the income "properly allocable" to certain foreign activities, other than in the case of "lease or rental" income.

[160] See *supra*, paras. 175-177, examining the exemption granted to certain taxpayers without satisfaction of the foreign economic process requirement and, paras. 178-180, examining the exemption granted for service-related income where the services are performed in the United States.

yet other situations, the measure exempts QFTI which is a combination of both domestic- and foreign-source income.[161]

185. Certainly, if the ETI measure were confined to those aspects which grant a tax exemption for "foreign-source income", it would fall within footnote 59. However, the ETI measure is not so confined. Rather, in several important respects, two of the three basic allocation rules of the ETI measure, the (1.2 and 15 percent rules) provide an exemption for domestic-source income.[162] We have said that avoiding double taxation is not an exact science and we recognize that Members must have a degree of flexibility in tackling double taxation. However, in our view, the flexibility under footnote 59 to the *SCM Agreement* does not properly extend to allowing Members to adopt allocation rules that systematically result in a tax exemption for income that has no link with a "foreign" State and that would not be regarded as foreign-source under any of the widely accepted principles of taxation we have reviewed.

186. For these reasons, even though parts of the ETI measure may be regarded as granting a tax exemption for foreign-source income, we find that the United States has not met its burden of proving that the ETI measure, viewed as a whole, falls within the justification available under the fifth sentence of footnote 59 of the *SCM Agreement*. Accordingly, we uphold the Panel's finding in paragraphs 8.107 and 9.1(a) of the Panel Report.

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[161]See *supra*, paras. 156-168, examining the rules whereby QFTI may be calculated either as 1.2 percent of total foreign trading gross receipts or as 15 percent of total foreign trading income.

[162]In addition, under the third formula for FSLI, there are circumstances where the ETI measure could grant a tax exemption for lease or rental income which includes domestic-source income. See *supra*, para. 173.

VIII. Article 10.1 of the *Agreement on Agriculture*: Export Subsidies

187. The United States appeals the Panel's finding that:

> … the United States has acted inconsistently with its obligations under Article 10.1 of the *Agreement on Agriculture* by applying the export subsidies, with respect to both scheduled and unscheduled agricultural products, in a manner that, at the very least, threatens to circumvent its export subsidy commitments under Article 3.3 of the *Agreement on Agriculture*.[163]

188. The Panel reached this conclusion because it considered that its reasoning under the *SCM Agreement* was "also applicable as regards whether the Act gives rise to subsidies contingent upon export performance within the meaning of Article 1(e) of the *Agreement on Agriculture* for the purposes of Article 10.1 of the *Agreement on Agriculture*." [164]

189. The United States argues that the ETI measure does not involve export subsidies under Article 1(e) of the *Agreement on Agriculture* because the measure is not a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*.[165] For this reason alone, the United States contends that the Panel erred in finding that the United States had acted inconsistently with its obligations under Articles 10.1 and 8 of the *Agreement on Agriculture*.

190. Before addressing the ETI measure we consider it useful to recall our findings regarding the FSC measure in our Report in *US – FSC*. In that Report, we held that, under the *Agreement on Agriculture*, just as in cases under Article 1.1(a)(1)(ii) of the *SCM Agreement*, a subsidy may arise where a government foregoes revenues that are otherwise due.[166] In that Report, the reasons which led us to hold, under the *SCM Agreement*, that the FSC measure involved the foregoing of revenue otherwise due, also led us to the same conclusion under the *Agreement on Agriculture*.[167]

191. In its appeal in the original proceedings, the United States did not contest that, if the FSC measure involved a "benefit" under Article 1.1(b) of the *SCM Agreement*, it also involved a benefit under the *Agreement on Agriculture*. We reached the conclusion that the FSC measure "confer[red]

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[163] Panel Report, para. 8.122.

[164] Panel Report, para. 8.116.

[165] United States' appellant's submission, paras. 247-248.

[166] Appellate Body Report, *US – FSC*, *supra*, footnote 3, para. 138.

[167] *Ibid*., para. 139.

upon the recipient the obvious benefit of reduced tax liability and, therefore, reduced tax payments". Accordingly, we found that the measure involved a subsidy under the *Agreement on Agriculture*.[168]

192. We held, in *US – FSC*, that there was no reason to read the requirement of "contingent upon export performance" differently in the *SCM Agreement* and in the *Agreement on Agriculture*. Therefore, for the reasons that led us to conclude, under Article 3.1(a) of the *SCM Agreement*, that this subsidy was contingent upon export performance, we reached the same conclusion under the *Agreement on Agriculture*.[169]

193. In consequence, we held that the FSC measure involved "subsidies contingent upon export performance" under Article 1(e) of the *Agreement on Agriculture*. As these subsidies had not been found to be listed in Article 9.1 of the *Agreement on Agriculture*, we examined whether they were inconsistent with Article 10.1 of that Agreement, as the European Communities claimed. We held that the subsidies were inconsistent with this provision.

194. In this appeal, the United States contends that the measure is not an export subsidy under Article 1(e) of the *Agreement on Agriculture* because, it argues, the measure is not an export subsidy under Article 3.1(a) of the *SCM Agreement*. We have rejected the United States' appeal regarding the proper characterization of the measure under Article 3.1(a) of the *SCM Agreement*. The Panel held, and we have upheld, that the measure involves the foregoing of revenues that are otherwise due under Article 1.1(a)(ii) of the *SCM Agreement*. As we indicated in *US – FSC*, where a government foregoes revenues that are otherwise due in relation to agricultural products, a subsidy may arise under the *Agreement on Agriculture*. The fiscal treatment of agricultural products, under the measure, is not materially different from the fiscal treatment of products falling within the scope of the *SCM Agreement*. Accordingly, we see no reason to reach any conclusion under the *Agreement on Agriculture* that differs from our conclusion under the *SCM Agreement*. The ETI measure also reduces the liability of United States citizens and residents to pay tax on income earned from qualifying transactions involving agricultural products.

195. In addition, for the reasons we have given in Part VI of this Report with respect to Article 3.1(a) of the *SCM Agreement*, the measure makes the grant of subsidies "contingent … upon export performance" where qualifying property is produced within the United States. We can see no reason to conclude otherwise under Article 1(e) of the *Agreement on Agriculture*, and none has been suggested to us. We, therefore, find that the measure also involves subsidies contingent upon export performance under Article 1(e) of the *Agreement on Agriculture*.

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[168] Appellate Body Report, *US – FSC*, *supra*, footnote 3, para. 140.

[169] *Ibid*., paras. 141-142.

196. For these reasons, we uphold the Panel's finding that the measure involves export subsidies under Article 1(e) of the *Agreement on Agriculture* with respect to qualifying property produced within the United States. We also uphold the Panel's finding, in paragraphs 8.122 and 9.1(c), that the United States acted inconsistently with Articles 10.1 and 8 of the *Agreement on Agriculture*.[170]

IX. Article III:4 of the GATT 1994

197. Before the Panel, the European Communities challenged the consistency with Article III:4 of the GATT 1994 of Section 943(a)(1)(C) IRC, which establishes, as one of the conditions of eligibility for the tax benefits under the ETI measure, that not more than 50 percent of the fair market value of qualifying property be attributable to articles produced or direct labour performed *outside* the United States (the "foreign articles/labour limitation" or "fair market value rule").[171]

198. The Panel found that:

> … by reason of the foreign articles/labour limitation, the Act accords less favourable treatment within the meaning of Article III:4 of the *GATT 1994* to imported products than to like products of US origin …[172]

199. This finding was based on the following three findings by the Panel: (i) that the imported and domestic products at issue are "like products"[173]; (ii) that the measure is a "law, regulation, or requirement affecting their internal sale, offering for sale, purchase, transportation, distribution, or use"[174]; and (iii) that, by conferring an advantage upon the use of domestic products but not upon the use of imported products, the measure accords less favourable treatment to imported products in relation to like products of United States origin.[175]

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[170]We note that the United States has not appealed any other aspect of the Panel's finding under Article 10.1 of the *Agreement on Agriculture*. In particular, the United States has not appealed the Panel's finding that it was appropriate to examine the European Communities' primary claim under Article 10.1 of the *Agreement on Agriculture*, without first examining its alternative claim under Article 9.1 of that Agreement. (Panel Report, para. 8.112 and footnote 219 thereto) Nor has the United States appealed the Panel's finding that the measure is "applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments" within the meaning of Article 10.1. (Panel Report, paras. 8.117-8.120) We note that the United States did not contest either of these issues before the Panel. (Panel Report, para. 8.112 and footnote 219 thereto; Panel Report, para. 8.121; and United States' first submission to the Panel, paras. 220-221; Panel Report, p. A-100)

[171]See *supra*, para. 21. See also *infra*, para. 201, for the text of Section 943(a)(1)(C) IRC of the fair market value rule.

[172]Panel Report, para. 8.158.

[173]*Ibid*., para. 8.135.

[174]*Ibid*., para. 8.149.

[175]*Ibid*., para. 8.158.

200. In its appeal under Article III:4 of the GATT 1994, the United States does not challenge the Panel's finding on "like products". Rather, the United States confines its appeal to the Panel's findings: that the measure is a "law, regulation, or requirement *affecting* their internal sale, offering for sale, purchase, transportation, distribution, or use"; and that the measure provides "less favourable treatment" to imported products as compared with like products of United States origin. (emphasis added)

201. We note that the issues arising under Article III:4 of the GATT 1994 relate to the definition of "QFTP" in the measure, in particular the following requirement, which is contained in Section 943(a)(1)(C) IRC:

> (C) not more than 50 per cent of the fair market value of [Qualifying Foreign Trade Property may be] attributable to -
>
> > (i) articles manufactured, produced, grown, or extracted outside the United States, and
> >
> > (ii) direct costs for labour … performed outside the United States.[176]

202. The European Communities' claim under Article III:4 of the GATT 1994, and the Panel's examination of the ETI Act, concern Section 943(a)(1)(C) solely as it relates to the production of qualifying property *within* the United States. We recall that, in examining export contingency under Article 3.1(a) of the *SCM Agreement*, we considered the ETI measure solely in relation to the conditions governing the grant of the subsidy for qualifying property produced *within* the United States. We do not, therefore, see that the Panel committed any error of law in adopting the same approach in its examination of the claim under Article III:4 of the GATT 1994.

203. Article III:4 of the GATT 1994 reads:

> The products of the territory of any Member imported into the territory of any other Member 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.

204. Article III:4 is one of a series of provisions in Article III which set forth obligations regarding "*National Treatment on Internal Taxation and Regulation*". In previous appeals, we have stated that:

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[176] We refer to this provision as the "fair market value rule"; the Panel termed it the "foreign articles/labour limitation".

> The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. More specifically, the purpose of Article III "is to ensure that internal measures 'not be applied to imported and domestic products so as to afford protection to domestic production'". Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products. … Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products.[177] (footnotes omitted)

205. We have also stated that, although this "general principle" is not explicitly invoked in Article III:4, nevertheless, it "informs" that provision.[178] In interpreting Article III:4 we are, therefore, guided by this principle.

206. With these general considerations in mind, we turn to the two issues raised by the United States in its appeal under Article III:4 of the GATT 1994.

A. *Law, Regulation or Requirement Affecting the Internal Use of Imported and Like Domestic Products*

207. The United States contests the Panel's finding that the measure "affects" the internal use of like imported products, and argues that there is no "necessary relationship" between the fair market value rule and the internal use of imported products. The United States emphasizes that the fair market value rule is a "measure of general application that is not directed against imports".[179] In such a situation, the United States argues, the word "affecting" in Article III:4 must be given a narrow scope. However, the United States does not contest the Panel's finding that the fair market value rule is a "law, regulation or requirement" within the meaning of Article III:4 of the GATT 1994.

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[177] Appellate Body Report, *Japan – Alcoholic Beverages II*, *supra*, footnote 116, at 109-110, quoting from Panel Report, *United States – Section 337 of the Tariff Act of 1930*, adopted 7 November 1989, BISD 36S/345, para. 5.10. We cited this statement in Appellate Body Report, *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products* ("*EC – Asbestos*"), WT/DS135/AB/R, adopted 5 April 2001, para. 97, a dispute that also involved Article III:4 of the GATT 1994.

[178] Appellate Body Report, *EC – Asbestos*, *supra*, footnote 177, para. 98.

[179] United States' appellant's submission, paras. 254-256.

208. We observe that the clause in which the word "affecting" appears – "in respect of all laws, regulations and requirements *affecting* their internal sale, offering for sale, purchase, transportation, distribution or use" – serves to define the scope of application of Article III:4. (emphasis added) Within this phrase, the word "affecting" operates as a link between identified types of government action ("laws, regulations and requirements") and specific transactions, activities and uses relating to products in the marketplace ("internal sale, offering for sale, purchase, transportation, distribution or use"). It is, therefore, not *any* "laws, regulations and requirements" which are covered by Article III:4, but only those which "*affect*" the specific transactions, activities and uses mentioned in that provision. Thus, the word "affecting" assists in defining the types of measure that must conform to the obligation not to accord "less favourable treatment" to like imported products, which is set out in Article III:4.

209. The word "affecting" serves a similar function in Article I:1 of the *General Agreement on Trade in Services* (the "GATS"), where it also defines the types of measure that are subject to the disciplines set forth elsewhere in the GATS but does not, in itself, impose any obligation.[180] In *EC – Bananas III*, we considered the meaning of the word "affecting" in that provision of GATS. We stated:

> [t]he ordinary meaning of the word "affecting" implies a measure that has "an effect on", which indicates a *broad scope of application*. This interpretation is further reinforced by the conclusions of previous panels that the term "affecting" in the context of Article III of the GATT is wider in scope than such terms as "regulating" or "governing".[181] (emphasis added, footnote omitted)

210. In view of the similar function of the identical word, "affecting", in Article III:4 of the GATT 1994, we also interpret this word, in this provision, as having a "broad scope of application".

211. Turning to the fair market value rule, we recall that, under the ETI measure, a taxpayer producing property in the United States will be eligible to obtain a tax exemption in respect of income derived from an export-sale of such property on the condition that, *inter alia*, not more than 50 percent of the fair market value of the product is attributable to articles produced outside the United States or to direct costs for labour performed outside the United States. The United States regards the fair market value of property as the sales price of the property in the marketplace. Fair market value is attributable to three different elements: (i) inputs used to produce the property;

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[180] Article I:1 of the GATS provides that "[t]his Agreement applies to measures by Members *affecting* trade in services." (emphasis added)

[181] Appellate Body Report, *supra*, footnote 47, para. 220. We made the same statement regarding the word "affecting" in Article I:1 of the GATS in our Report in *Canada – Autos, supra*, footnote 56, para. 150.

(ii) direct labour used to produce the property, and (iii) "non-tangible elements, including intellectual property rights, goodwill, capital, marketing, distribution, and other services".[182]

212. Any taxpayer that seeks to obtain a tax exemption under the ETI measure must ensure that, in the manufacture of qualifying property, it does not "use" imported input products, whose value comprises more than 50 percent of the fair market value of the end-product. The fair market value rule, thus, places an express maximum limit on the extent to which the value of qualifying property can be attributable to imported input products. A manufacturer's use of imported input products always counts against the 50 percent ceiling in the fair market value rule, while in contrast, the same manufacturer's use of like domestic input products has no such negative implication. Manufacturers wishing to obtain the ETI tax exemption are not restricted, in any way, on the use they make of domestic inputs. The fair market value rule, therefore, influences the manufacturer's choice between like imported and domestic input products if it wishes to obtain the tax exemption under the ETI measure.

213. Accordingly, we agree with the Panel's finding, in paragraph 8.149 of its Report, that the fair market value rule "affects" the "internal … use" of imported products, within the meaning of Article III:4 of the GATT 1994, as compared with like domestic products.

B. *"Less Favourable Treatment"*

214. We now come to the second part of the United States' appeal of this issue, namely, its argument that the Panel erred in finding that the fair market value rule accords less favourable treatment to like imported products. The United States asserts that it is possible for a manufacturer to satisfy the fair market value rule without using as inputs *any* goods produced in the United States, and that the Panel could not, therefore, have found that the fair market value rule involves *de jure* discrimination against imports.

215. The examination of whether a measure involves "less favourable treatment" of imported products within the meaning of Article III:4 of the GATT 1994 must be grounded in close scrutiny of the "fundamental thrust and effect of the measure itself".[183] This examination cannot rest on simple assertion, but must be founded on a careful analysis of the contested measure and of its implications

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[182]See United States' first submission to the Panel, para. 201; Panel Report, pp. A-95 – A-96. The United States confirmed our understanding of the fair market value rule in its response to questioning at the oral hearing.

[183]Appellate Body Report, *Korea – Various Measures on Beef, supra*, footnote 44, para. 142.

in the marketplace. At the same time, however, the examination need not be based on the *actual effects* of the contested measure in the marketplace.[184]

216. If a United States citizen or resident fulfills the prescribed conditions of grant, it obtains a clearly significant financial benefit in the form of a tax exemption.[185] The availability of such a tax exemption depends upon the taxpayer organizing its business affairs in such a way as to comply with the prescribed conditions of grant.

217. One of these conditions is the fair market value rule which places, as we have said, an express maximum limit on the extent to which the value of qualifying property can be attributable to imported input products. No such limit exists for like domestic input products. The fair market value rule, therefore, draws a formal distinction, on its face, between the treatment of like domestic and imported input products.[186] This formal difference also has substantive importance because, on its face, the fair market value rule constrains the use of like imported input products.

218. In situations where the use of imported input products in the manufacture of qualifying property may breach the 50 percent limit and thereby render a manufacturer ineligible to obtain a tax exemption, the manufacturer will avoid the use of like imported input products if it wishes to obtain a tax exemption. As the 50 percent limit is approached, the manufacturer will be increasingly sensitive to the value of the imported input products it can use and to the contribution these products will make to the fair market value of the property being manufactured. Before making purchasing decisions, the manufacturer will weigh the choice between domestic and imported input product, in the light of the anticipated value of the end-product, to ensure that the purchases of imported products do not adversely affect the availability of the tax exemption. These same considerations will never apply if the manufacturer opts to purchase domestic input products. Thus, for purposes of satisfying the fair market value rule and ensuring the availability of the tax benefit, a real and substantive advantage attaches to the use of domestic input products, and a corresponding disadvantage to the use of like imported products.

219. The difference in resulting treatment between like domestic and imported products becomes very clear where the manufacturing process is product input-intensive and the value of input products

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[184] Appellate Body Report, *Japan – Alcoholic Beverages II, supra*, footnote 116, at 110.

[185] We recall that the tax exemption may be: 1.2 percent of foreign trading gross receipts; 15 percent of foreign trade income; or 30 percent of foreign sales and leasing income. See *supra*, para. 25.

[186] See s*upra*, para. 201, for the text of the fair market value rule. See also Panel Report, para. 8.133.

typically constitutes more than 50 percent of the fair market value of the qualifying property.[187] In these situations, the measure in effect precludes United States manufacturers who desire the tax benefit, from making a free choice between like domestic and imported input-products on the basis of purely commercial considerations.

220. In sum, if the manufacturer wishes to obtain the beneficial tax exemption under the ETI measure, the fair market value rule provides a considerable impetus, and, in some circumstances, in effect, a requirement, for manufacturers to use domestic input products, rather than like imported ones. As such, the fair market value rule treats imported products less favourably than like domestic products.

221. In our view, the above conclusion is not nullified by the fact that the fair market value rule will not give rise to less favourable treatment for like imported products in each and every case. There may well be, as the United States maintains, property which does not require extensive material and labour inputs such that the fair market value rule would not, in those cases, bear upon the input choices manufacturers make. Even so, the fact remains that in an indefinite number of other cases, the fair market value rule operates, by its terms, as a significant constraint upon the use of imported input products. We are not entitled to disregard that fact.

222. For the above reasons, we uphold the Panel's finding, in paragraphs 8.154 and 9.1(d) of its Report that, by virtue of the fair market value rule, the measure accords less favourable treatment within the meaning of Article III:4 of the GATT 1994 to imported products than to like products of United States origin.

X. Article 4.7 of the *SCM Agreement*: Withdrawal of FSC Subsidies

223. The United States appeals the Panel's finding that:

> … the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies inconsistent with Article 3.1(a) of the *SCM Agreement* and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 *SCM Agreement*.[188]

224. The United States notes that the ETI Act repeals the FSC provisions and provides that no corporation can elect to be treated as an FSC after 30 September 2000. The ETI Act also contains

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[187]We note that the European Communities provided the Panel with a list of circumstances, for illustrative purposes, where such a requirement to use like domestic products may arise. (Annex to the European Communities' second submission to the Panel; Panel Report, pp. C-46 – C-52)

[188]Panel Report, para. 8.170.

certain transitional rules that, in the view of the United States, ensure taxpayers a degree of certainty in their tax planning and that are essential to the orderly passage from one set of tax rules to another. The United States submits that, in requiring a Member to change its tax rules, WTO rules cannot be intended to require such a Member to deny its taxpayers the right to an orderly transition. Thus, the United States reasons, the Panel's finding that the United States has acted inconsistently with Article 4.7 of the *SCM Agreement* should be reversed.

225. We recall that, in our Report in *US – FSC*, we upheld the panel's finding "that the FSC measure constitutes a prohibited export subsidy under Article 3.1(a) of the *SCM Agreement*".[189] In its report, the panel recommended, pursuant to Article 4.7 of the *SCM Agreement*, that the United States withdraw the FSC subsidies found to be prohibited export subsidies under Article 3.1(a) of the *SCM Agreement* by 1 October 2000".[190] On 12 October 2000, the DSB acceded to the United States' request "that the DSB modify the time-period in this dispute so as to expire on 1 November 2000".[191]

226. Article 4.7 of the *SCM Agreement* reads:

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

227. In examining this provision in *Brazil – Aircraft (Article 21.5 – Canada)*, we said:

> Turning to the ordinary meaning of "withdraw", we observe first that this word has been defined as "remove" or "take away", and as "to take away what has been enjoyed; to take from." This definition suggests that "withdrawal" of a subsidy, under Article 4.7 of the *SCM Agreement*, refers to the "removal" or "taking away" of that subsidy.[192] (footnotes omitted)

228. Under the ETI Act, no corporation may elect to be treated as an FSC after 30 September 2000.[193] However, for FSCs in existence as of that date, the repeal of the original FSC measure "shall not apply" to any transaction which occurs before 1 January 2002.[194] Moreover, even after that date, existing FSCs can continue to use the original FSC measure for transactions pursuant

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[189] Appellate Body Report, *supra*, footnote 3, para. 177(a).

[190] Original Panel Report, *supra*, footnote 4, para. 8.8.

[191] WT/DS108/11, 2 October 2000. See also WT/DSB/M/90, paras. 6-7.

[192] Appellate Body Report, *supra*, footnote 86, para. 45.

[193] Section 5(b)(1) of the ETI Act.

[194] Section 5(c)(1)(A) of the ETI Act.

to a binding contract between the FSC and any unrelated person that was in effect on and after 30 September 2000.[195] Thus, by the United States' own acknowledgement, the original FSC measure continues to apply, unmodified, to existing FSCs in respect of a defined set of transactions.[196] The success of the United States' appeal depends on the success of its argument that prohibited FSC subsidies can continue to be granted to protect the contractual interests of private parties and to ensure an orderly transition to the regime of the new measure. In short, on the basis of these arguments, the United States seeks to have the time-period for the full withdrawal of the prohibited FSC subsidies extended, in some circumstances, indefinitely.

229. Article 4.7 of the *SCM Agreement* requires prohibited subsidies to be withdrawn "without delay", and provides that a time-period for such withdrawal shall be specified by the panel. We can see no basis in Article 4.7 of the *SCM Agreement* for extending the time-period prescribed for withdrawal of prohibited subsidies for the reasons cited by the United States. In that respect, we recall that, in *Brazil – Aircraft (Article 21.5 – Canada),* Brazil made a similar argument to the one made by the United States in these proceedings. Brazil argued that, after the expiration of the time-period for withdrawal of the prohibited export subsidies, it should be permitted to continue to grant certain of these subsidies because it had assumed contractual obligations, under municipal law, to do so.[197] We rejected this argument, and observed that:

> … to continue to make payments under an export subsidy measure found to be prohibited is not consistent with the obligation to "withdraw" prohibited export subsidies, in the sense of "removing" or "taking away".[198]

230. Thus, as we indicated in that appeal, a Member's obligation under Article 4.7 of the *SCM Agreement* to withdraw prohibited subsidies "without delay" is unaffected by contractual obligations that the Member itself may have assumed under municipal law. Likewise, a Member's obligation to withdraw prohibited export subsidies, under Article 4.7 of the *SCM Agreement,* cannot be affected by contractual obligations which private parties may have assumed *inter se* in reliance on laws conferring prohibited export subsidies. Accordingly, we see no legal basis for extending the time-period for the United States to withdraw fully the prohibited FSC subsidies.

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[195]See Section 5(c)(1)(B)(ii) of the ETI Act.

[196]Panel Report, para. 8.169.

[197]Appellate Body Report, *Brazil – Aircraft (Article 21.5 – Canada)*, *supra*, footnote 86, para. 46.

[198]*Ibid*., para. 45.

231. Accordingly, we uphold the Panel's finding, in paragraphs 8.170 and 9.1(e) of its Report, that the United States has not fully withdrawn the FSC subsidies found to be prohibited export subsidies under Article 3.1(a) of the *SCM Agreement* and has therefore failed to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 of the *SCM Agreement*.

XI. Article 10.3 of the DSU

232. In its first written submission to the Panel, the European Communities requested:

> … the Panel to make a preliminary ruling to the effect that third parties are entitled to receive all written submissions of the parties submitted prior to the meeting of the Panel and to make this preliminary ruling and communicate it to the parties and the third parties as soon as possible after receipt of the US first written submission and before the date for the presentation of the second written submissions.[199] (footnote omitted)

233. The United States requested the Panel to reject the European Communities' request and to find, on the basis of reasoning employed by previous panels proceeding under Article 21.5 of the DSU, "that the third parties in this proceeding do not have a right to the parties' rebuttal submissions."[200]

234. On 21 February 2001, the Panel issued a decision to the parties refusing the request of the European Communities and stating that:

> … we do not consider that Article 10.3 *DSU* requires that third parties receive all pre-meeting submissions of the parties (including rebuttal submissions) in the context of an accelerated proceeding under Article 21.5 *DSU* that involves only one meeting of the parties and third parties with the panel.[201]

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[199] Panel Report, para. 6.1; European Communities' first submission to the Panel, paras. 247-258 and 260; Panel Report, pp. A-44 – A-45.

[200] Panel Report, para. 6.2. (footnote omitted)

[201] *Ibid*., para. 6.3, subpara. 2.

235. The European Communities appeals this interpretive preliminary ruling by the Panel. In the view of the European Communities, Rule 9 of the working procedures adopted by the Panel in this case (the "Working Procedures") conflicts with Article 10.3 of the DSU and does not respect the rights afforded to third parties under the DSU. According to the European Communities, although panels have a certain discretion to establish their own working procedures, they may not derogate from binding provisions of the DSU, including the requirement in Article 10.3 of the DSU that "[t]hird parties *shall receive* the submissions of the parties to the dispute to the *first meeting of the panel*." (emphasis added) In the view of the European Communities, this requirement means that third parties are entitled to receive *all* written submissions made *prior to* the *first* meeting of the panel – even if, as in many proceedings under Article 21.5 of the DSU, there is only one meeting with the panel.

236. We review briefly the factual background against which this appeal is made. The Working Procedures provide for two written submissions by each party to be made to the Panel, followed by a single meeting of the Panel. The Panel communicated its proposed Working Procedures to the parties on 20 December 2000, and requested that the parties comment on them at the organizational meeting of the Panel to be held the following day. The proposed Rule 9 provided, in relevant part, that:

> Third parties *shall receive* copies of the parties' *first written submissions*. Any party may decide to provide the third parties with a copy of its rebuttal or other submissions. (emphasis added)

237. Neither of the parties commented on the proposed Rule 9 at the organizational meeting.[202] The Working Procedures adopted by the Panel – including the above-quoted portion of Rule 9 – were communicated to the parties on 22 December 2000, and to the third parties on 4 January 2001.

238. In its first written submission to the Panel, submitted on 17 January 2001, the European Communities requested the Panel to amend Rule 9 of the Working Procedures to provide that third parties shall receive copies of *all* the submissions filed by the parties prior to the single meeting of

[202]Panel Report, para. 6.3, subpara. 11.

the Panel.[203] The United States opposed the request in its first written submission, submitted to the Panel on 7 February 2001. On 21 February 2001, the Panel issued its decision denying the request of the European Communities.

239. We also note that in proceedings under Article 21.5, which are subject to considerably shorter time-frames than apply under Article 12.8 of the DSU [204], panels have adopted the practice of holding a single meeting with the parties, rather than two meetings. At the same time, Article 21.5 panels uniformly have maintained the practice of requiring parties to file two written submissions.

240. We begin our examination of the European Communities' appeal with Article 12.1 of the DSU, which states that panels "shall" follow the working procedure set out in Appendix 3 to the DSU "unless the panel decides otherwise after consulting the parties to the dispute". We observe, first, that the DSU and, in particular, paragraphs 5, 6 and 7 of Appendix 3 to the DSU, "contemplate two distinguishable stages in a proceeding before a panel."[205] The "first stage" comprises the first written submissions by the parties and the first meeting of the panel, while the "second stage" consists of the second written submissions – or "rebuttal" submissions – and the second meeting with the panel.[206] However, no provision of the DSU explicitly requires panels to hold two meetings with the parties, or to oblige the parties to submit two written submissions.

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[203] By way of background, we note that the European Communities has, as a third party in four unrelated proceedings under Article 21.5 of the DSU, requested an Article 21.5 panel to amend a rule in its working procedures similar to the contested portion of Rule 9 of the Working Procedures. Two of those panels denied the request by the European Communities. (Panel Report, *Australia – Measures Affecting Importation of Salmon – Recourse to Article 21.5 of the DSU by Canada*, WT/DS18/RW, adopted 20 March 2000, paras. 7.5 – 7.6; and Panel Report, *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather – Recourse to Article 21.5 of the DSU by the United States*, WT/DS126/RW and Corr.1, adopted 11 February 2000, paras. 3.9-3.10) According to the United States, a similar decision refusing the request of the European Communities was taken by the panel in a third case, although such decision was not published as the parties ultimately reached a mutually acceptable solution. (Panel Report, *United States – Anti-Dumping Duty on Dynamic Random Access Memory Semiconductors (DRAMS) of One Megabit or Above from Korea – Recourse to Article 21.5 of the DSU by Korea*, WT/DS99/RW, 7 November 2000; Decision of the panel concerning the EC request for access to the parties' rebuttal submissions, 27 June 2000, reproduced in part in the United States' first submission to the Panel, para. 236; Panel Report, p. A-103) One panel agreed to modify its working procedures to provide that the third parties in those proceedings were entitled to receive all written submissions submitted by the parties prior to the single substantive meeting of the panel. (Panel Report, *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products – Recourse to Article 21.5 of the DSU by New Zealand and the United States* ("*Canada – Dairy (Article 21.5 – New Zealand and US)*"), WT/DS103/RW, WT/DS113/RW, adopted 18 December 2001, as reversed by the Appellate Body Report, WT/DS103/AB/RW, WT/DS113/AB/RW, paras. 2.32-2.35) This is the first occasion on which this issue has been raised on appeal.

[204] Article 21.5 of the DSU contemplates that panels will complete their work within 90 days, whereas Articles 12.6 and 12.8 of the DSU contemplate that panels will circulate their reports within six months.

[205] Appellate Body Report, *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*, WT/DS56/AB/R and Corr.1, adopted 22 April 1998, DSR 1998:III, 1003, para. 79.

[206] *Ibid*.

241. We have already observed that:

> [a]lthough panels enjoy some discretion in establishing their own working procedures, this discretion does not extend to modifying the substantive provisions of the DSU. … Nothing in the DSU gives a panel the authority either to disregard or to modify other explicit provisions of the DSU.[207]

242. In this appeal, we must determine whether, in refusing to require that the third parties be given access to the second, "rebuttal", submissions filed prior to the sole substantive meeting with the Panel, the Panel acted inconsistently with any provision of the DSU.

243. In respect of the provisions of the DSU governing third party rights, we have already observed that, as the DSU currently stands, the rights of third parties in panel proceedings are limited to the rights granted under Article 10 and Appendix 3 to the DSU.[208] Beyond those minimum guarantees, panels enjoy a discretion to grant additional participatory rights to third parties in particular cases, as long as such "enhanced" rights are consistent with the provisions of the DSU and the principles of due process.[209] However, panels have no discretion to circumscribe the rights guaranteed to third parties by the provisions of the DSU.

244. In this appeal, the European Communities alleges that the Working Procedures adopted by the Panel are inconsistent with the rights afforded to third parties pursuant to Article 10.3 of the DSU, which provides:

> Third parties *shall receive* the submissions of the parties to the dispute to the *first meeting* of the panel. (emphasis added)

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[207]Appellate Body Report, *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, adopted 16 January 1998, DSR 1998:I, 9, para. 92.

[208]Appellate Body Report, *United States – Anti-Dumping Act of 1916* ("*US – 1916 Act*"), WT/DS136/AB/R, WT/DS162/AB/R, adopted 26 September 2000, para. 145.

[209]Appellate Body Report, *US – 1916 Act*, *supra*, footnote 208, para. 150. See also Appellate Body Report, *EC-Hormones, supra*, footnote 40, para. 154.

245. Article 10.3 of the DSU is couched in mandatory language. By its terms, third parties "shall" receive "the submissions of the parties to the *first* meeting of the panels". (emphasis added) Article 10.3 does *not* say that third parties shall receive "the *first* submissions" of the parties, but rather that they shall receive "*the* submissions" of the parties. (emphasis added) The number of submissions that third parties are entitled to receive is *not* stated. Rather, Article 10.3 defines the submissions that third parties are entitled to receive by reference to a specific step in the proceedings – the first meeting of the panel.[210] It follows, in our view, that, under this provision, third parties must be given all of the submissions that have been made by the parties to the panel up to the first meeting of the panel, irrespective of the number of such submissions which are made, including any rebuttal submissions filed in advance of the first meeting.[211]

246. The Panel, however, reasoned that the use of the word "first" in Article 10.3 "presupposes a context where there is more than one meeting of a Panel."[212] The Panel concluded, from this "presupposition", that in proceedings involving a *single* panel meeting, Article 10.3 "must be understood as limiting third party rights in these proceedings to access to the *first* written submissions *only*, and as not including access to the written rebuttals."[213]

247. In our view, the interpretation of Article 10.3 of the DSU must start from the express wording of the provision. We have noted that the text of Article 10.3 does not limit the number of submissions which third parties may receive prior to the "first meeting". We do not see any reason to "presuppose" that such a limitation applies in cases where the "first meeting" with the Panel proves to be the only meeting. The DSU allows panels the flexibility, in determining their procedures, to request more than one submission in advance of the first meeting, and the DSU also allows for the possibility that panels may, ultimately, hold only one meeting. The text of Article 10.3 applies the same rule in each case – third parties are entitled to receive the submissions to the first meeting.

248. We read the reference to the "first meeting" as reflecting the flexibility that exists in panel proceedings under the DSU. Thus, in any proceedings, even if only one meeting with the parties is initially scheduled, it cannot be excluded that a second will not be held later. Panels have the discretion to request such an additional meeting with the parties, and the parties can also request such

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[210]We note, in this regard, that paragraph 6 of Appendix 3 to the DSU also links the participatory rights of third parties to this step in the proceeding. It states that third parties "*shall be invited in writing to present their views during a session of the first substantive meeting of the panel*". (emphasis added)

[211]We note, in that respect, that the DSU does not place any limits on the number of submissions which panels can request of the parties in advance of the first meeting.

[212]Panel Report, para. 6.3, subpara. 5.

[213]*Ibid*., para. 6.3, subpara. 9. (emphasis added)

a meeting with the panel at the stage of interim review.[214] The wording of Article 10.3 provides for this flexibility by referring generically to the "first meeting", which may be one of a series of meetings or may be the only meeting.

249. Our interpretation of Article 10.3 is also consistent with the context of that provision. Article 10.1 directs panels "fully" to take into account the interests of Members other than the parties to the dispute, and Article 10.2 requires panels to grant to third parties "an opportunity to be heard". Article 10.3 ensures that, up to a defined stage in the panel proceedings, third parties can participate fully in the proceedings, on the basis of the same written submissions as the parties themselves. Article 10.3 thereby seeks to guarantee that the third parties can participate at a session of the first meeting with the panel in a full and meaningful fashion that would not be possible if the third parties were denied written submissions made to the panel before that meeting. Moreover, panels themselves will thereby benefit more from the contributions made by third parties and will, therefore, be better able "fully" to take into account the interests of Members, as directed by Article 10.1 of the DSU.

250. In this regard, we observe that we agree with the panel in *Canada – Dairy (Article 21.5 – New Zealand and US)*, which reasoned that:

> Third parties can only [participate in an informed and, hence, meaningful, manner] if they have received all the information exchanged between the parties before that session. Otherwise, third parties might find themselves in a situation where their oral statements at the meeting become partially or totally irrelevant or moot in the light of second submissions by the parties to which third parties did not have access. Without access to all the submissions by the parties to the dispute to the first meeting of the panel, uninformed third party submissions could unduly delay panel proceedings and … prevent the Panel from receiving "the benefit of a useful contribution by third parties which could help the Panel to make the objective assessment that it is required to make under Article 11 of the DSU.[215] (footnote omitted)

251. For these reasons, we believe that Article 10.3 requires that third parties be provided with all of the submissions made by the parties up to the time of the first panel meeting in which the third parties participate – whether that meeting is the first of two panel meetings, or the first and only panel meeting. Read in this way, Article 10.3 has the same meaning, and can be applied in the same way, regardless of the number of panel meetings that are held in a particular case.

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[214] Paragraph 12 of Appendix 3 to the DSU recognizes that the standard timetable for panels may be adjusted to allow for "additional meetings with the parties", including a possible meeting at the stage of interim review.

[215] Panel Report, *supra*, footnote 203, para. 2.34.

252. We, therefore, find that, in its decision refusing the European Communities' request to modify Rule 9 of the Panel's Working Procedures, the Panel erred in its interpretation of Article 10.3 of the DSU.

XII. Conditional Appeals

253. The European Communities makes four conditional appeals requesting us to consider claims in respect of which the Panel exercised judicial economy.[216] It declares that these appeals are made only "in case [the Appellate Body] should reverse those of the Panel's findings that led the Panel to exercise judicial economy."[217] The European Communities states explicitly that it is *not* challenging the Panel's exercise of judicial economy *as such*, and that it considers that "the Panel has effectively ruled on all elements of the subsidy scheme under review and has, accordingly, already given sufficiently precise guidance … ".[218]

254. The United States observes that "the conditions that would trigger the Appellate Body's consideration of any of these claims is not clear".[219]

255. In this Report, we have upheld all of the Panel's findings under appeal. Therefore, in any event, none of the conditions on which the European Communities' appeal is predicated arise, and there is no need for us to examine any of the conditional appeals.

XIII. Findings and Conclusions

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

(a) upholds the Panel's finding, in paragraphs 8.30 and 8.43 of the Panel Report, that the ETI measure involves the foregoing of revenue which is "otherwise due" and thus gives rise to a "financial contribution" within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*;

(b) upholds the Panel's finding, in paragraphs 8.75 and 9.1(a) of the Panel Report, that the ETI measure includes subsidies "contingent … upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement*;

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[216] Panel Report, paras. 8.108, 8.162-8.163 and 8.171.
[217] European Communities' other appellant's submission, para. 31.
[218] *Ibid*., para. 30.
[219] United States' appellee's submission, para. 13.

(c) upholds the Panel's finding, in paragraphs 8.107 and 9.1(a) of the Panel Report, that the ETI measure, viewed as a whole, does not fall within the scope of footnote 59 of the *SCM Agreement* as a measure taken to avoid the double taxation of foreign-source income;

(d) upholds the Panel's finding, in paragraphs 8.122 and 9.1(c) of the Panel Report, that the ETI measure involves export subsidies inconsistent with the United States' obligations under Articles 3.3, 8 and 10.1 of the *Agreement on Agriculture*;

(e) upholds the Panel's finding, in paragraphs 8.158 and 9.1(d) of the Panel Report, that the ETI measure is inconsistent with the United States' obligations under Article III:4 of the GATT 1994 because it accords less favourable treatment to imported products as compared with like products of United States origin;

(f) upholds the Panel's finding, in paragraphs 8.170 and 9.1(e) of the Panel Report, that the United States has not fully withdrawn the subsidies found, in the original proceedings, to be prohibited export subsidies under Article 3.1(a) of the *SCM Agreement*, and that the United States has, therefore, failed fully to implement the recommendations and rulings of the DSB made pursuant to Article 4.7 of the *SCM Agreement*; and

(g) finds that the Panel erred in its interpretation of Article 10.3 of the DSU in declining, in its decision of 21 February 2001, reproduced in paragraph 6.3 of the Panel Report, to rule that all the written submissions of the parties filed prior to the only meeting of the Panel must be provided to the third parties.

257. The Appellate Body *recommends* that the DSB request the United States to bring the ETI measure, found in this Report, and in the Panel Report as modified by this Report, to be inconsistent with its obligations under Article 3.1(a) of the *SCM Agreement*, under Articles 3.3, 8 and 10.1 of the *Agreement on Agriculture*, and under Article III:4 of the GATT 1994, into conformity with its obligations under those Agreements, and that the DSB request the United States to implement fully the recommendations and rulings of the DSB in *US – FSC*, made pursuant to Article 4.7 of the *SCM Agreement*.

Signed in the original at Geneva this 21st day of December 2001 by:

Florentino P. Feliciano
Presiding Member

A.V. Ganesan
Member

Yasuhei Taniguchi
Member