1 ANNEX II

1.1 Text of Annex II

ANNEX II

GUIDELINES ON CONSUMPTION OF INPUTS IN THE PRODUCTION PROCESS[1]

I

1. Indirect tax rebate schemes can allow for exemption, remission or deferral of prior-stage cumulative indirect taxes levied on inputs that are consumed in the production of the exported product (making normal allowance for waste). Similarly, drawback schemes can allow for the remission or drawback of import charges levied on inputs that are consumed in the production of the exported product (making normal allowance for waste).

2. The Illustrative List of Export Subsidies in Annex I of this Agreement makes reference to the term "inputs that are consumed in the production of the exported product" in paragraphs (h) and (i). Pursuant to paragraph (h), indirect tax rebate schemes can constitute an export subsidy to the extent that they result in exemption, remission or deferral of prior-stage cumulative indirect taxes in excess of the amount of such taxes actually levied on inputs that are consumed in the production of the exported product. Pursuant to paragraph (i), drawback schemes can constitute an export subsidy to the extent that they result in a remission or drawback of import charges in excess of those actually levied on inputs that are consumed in the production of the exported product. Both paragraphs stipulate that normal allowance for waste must be made in findings regarding consumption of inputs in the production of the exported product. Paragraph (i) also provides for substitution, where appropriate.

II

In examining whether inputs are consumed in the production of the exported product, as part of a countervailing duty investigation pursuant to this Agreement, investigating authorities should proceed on the following basis:

1. Where it is alleged that an indirect tax rebate scheme, or a drawback scheme, conveys a subsidy by reason of over-rebate or excess drawback of indirect taxes or import charges on inputs consumed in the production of the exported product, the investigating authorities should first determine whether the government of the exporting Member has in place and applies a system or procedure to confirm which inputs are consumed in the production of the exported product and in what amounts. Where such a system or procedure is determined to be applied, the investigating authorities should then examine the system or procedure to see whether it is reasonable, effective for the purpose intended, and based on generally accepted commercial practices in the country of export. The investigating authorities may deem it necessary to carry out, in accordance with paragraph 6 of Article 12, certain practical tests in order to verify information or to satisfy themselves that the system or procedure is being effectively applied.

[1] Inputs consumed in the production process are inputs physically incorporated, energy, fuels and oil used in the production process and catalysts which are consumed in the course of their use to obtain the exported product.

2. Where there is no such system or procedure, where it is not reasonable, or where it is instituted and considered reasonable but is found not to be applied or not to be applied effectively, a further examination by the exporting Member based on the actual inputs involved would need to be carried out in the context of determining whether an excess payment occurred. If the investigating authorities deemed it necessary, a further examination would be carried out in accordance with paragraph 1.

3. Investigating authorities should treat inputs as physically incorporated if such inputs are used in the production process and are physically present in the product exported. The Members note that an input need not be present in the final product in the same form in which it entered the production process.

4. In determining the amount of a particular input that is consumed in the production of the exported product, a "normal allowance for waste" should be taken into account, and such waste should be treated as consumed in the production of the exported product. The term "waste" refers to that portion of a given input which does not serve an independent function in the production process, is not consumed in the production of the exported product (for reasons such as inefficiencies) and is not recovered, used or sold by the same manufacturer.

5. The investigating authority's determination of whether the claimed allowance for waste is "normal" should take into account the production process, the average experience of the industry in the country of export, and other technical factors, as appropriate. The investigating authority should bear in mind that an important question is whether the authorities in the exporting Member have reasonably calculated the amount of waste, when such an amount is intended to be included in the tax or duty rebate or remission.

1.2 General

1. In explaining the relevance of Annex II to the SCM Agreement outside the context of countervailing duty investigations, the Panel in *India – Export Related Measures* pointed out that:

> "Next, footnote 1 must also be read 'in accordance with' Annex II to the SCM Agreement. Annex II sets forth 'Guidelines on Consumption of Inputs in the Production Process'. As Annex II itself recalls, both items (h) and (i) in Annex I refer to 'inputs that are consumed in the production of the exported product', and the Guidelines in Annex II relate to the examination, for that purpose, of 'whether inputs are consumed in the production of the exported product'.
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> Part II of these Guidelines is expressly directed at this examination 'as part of a countervailing duty investigation'. This, however, does not make Annex II irrelevant outside the context of countervailing duty investigations. While some of the provisions in this Annex (such as those envisaging that the investigating authority carry out 'certain practical tests') are not directly applicable outside the context of countervailing duty investigations, Annex II helps inform the understanding of footnote 1 also beyond the context of countervailing duty investigations."[2]

2. Further, the Panel in *India – Export Related Measures* rejected India's argument that "any contention regarding whether or in what quantity inputs are 'consumed' … in a duty drawback … scheme is to be examined by an investigating authority". According to the Panel:

> "It is true that Part II of Annex II is expressly addressed to 'investigating authorities' 'as part of a countervailing duty investigation'. This provision could apply, therefore, in the context of a countervailing duty investigation conducted pursuant to Part V of the SCM Agreement. However, this does not mean that a complainant is obliged to carry out a countervailing duty investigation before it can challenge a measure that might fall under Annex II. While footnote 35 of the SCM Agreement makes it clear

[2] Panel Report, *India – Export Related Measures*, paras. 7.181-7.182.

> that the provisions of Part II and III 'may' be invoked in parallel with the provisions of Part V, there is no suggestion that Parts II and V *must* always be invoked in parallel."[3]

1.3 Meaning of 'silence' in Annex II(II)2

3. The Appellate Body in *EU – PET (Pakistan)* noted that the European Union's contention was that Annex II(II)(2) does not prescribe what happens in the event that an exporting Member does not carry out the "further examination" prescribed in the first sentence of this provision or where such examination is unsatisfactory. The European Union referred to this "absence of prescription as a 'silence', the consequence of which is that the remission of import duties no longer qualifies as a duty drawback scheme and the entire amount of duties refunded or not collected upon exportation can be countervailed by the investigation authority."[4] However, the Appellate Body noted that the perceived "silence" referred to by the European Union is not one that pertains to the definition of the subsidy, and in particular to what constitutes the financial contribution element of the subsidy. It emphasized that Annex II(II)(2) is unambiguous in stating that drawback schemes can constitute an export subsidy to the extent that they result in a remission or drawback of import charges in excess of those actually levied on inputs that are consumed in the production of the exported product. The Appellate Body added that it did not consider what the European Union considered "silence" to be without cure in the SCM Agreement. Finally, the Appellate Body clarified that "the perceived 'silence' relates to a procedural step in the context of an investigating authority's inquiry into whether the *excess* remission or drawback occurred".[5] In the Appellate Body's view:

> "[T]he guidelines in Annexes II and III emphasize that the focus of the investigating authority's inquiry is to determine whether there has been a drawback of the import charges 'in excess' of those originally levied on the inputs consumed in the production of the exported product. Thus, we agree with the Panel that any perceived 'silence' connected to the procedural step in Annex II(II)(2) 'does not mean that other portions of Annex II cease to speak, and [the Panel] recall[ed] that the entirety of Annex II(II)(2) only operates in the presence of an allegation that a 'drawback scheme [] conveys a subsidy by reason of over-rebate or excess drawback'.
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> In this vein, we emphasize that this perceived 'silence' referred to by the European Union is not one that pertains to the definition of the subsidy, and in particular to what constitutes the financial contribution element of the subsidy. In that respect, Annex II(I)(2) is unambiguous in stating that 'drawback schemes can constitute an export subsidy to the extent that they result in a remission or drawback of import charges *in excess* of those actually levied on inputs that are consumed in the production of the exported product.' This echoes the limitation of the financial contribution to the excess amount of the remission, articulated in footnote 1 and Annex I(i) to the SCM Agreement, and the *Ad* Note to Article XVI of the GATT 1994. Instead, the perceived 'silence' referred to by the European Union relates only to a procedural step in the context of an investigating authority's inquiry into whether the *excess* remission or drawback occurred.
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> Moreover, we do not consider what the European Union perceives as 'silence' to be without cure in the SCM Agreement. According to the European Union, this perceived 'silence' relates to a situation where an investigating authority determines that there is no verification system in place in the exporting Member, or a verification system is in place but it is not fit for purpose, or it has not been applied effectively by the exporting Member, and where the subsequent 'further examination' that needs to be carried out by the exporting Member, at the behest of the investigating authority, is not undertaken or is unsatisfactory. In our view, this situation finds accommodation in Article 12.7 of the SCM Agreement, which envisages instances 'in which any interested Member or interested party refuses access to, or otherwise does not provide, *necessary information* within a reasonable period'. In the context of duty drawback schemes, the 'necessary information' relates to the consumption of inputs in the production process, and this information is aimed at determining whether the duty

[3] Panel Report, *India – Export Related Measures*, para. 7.215.
[4] Appellate Body Report, *EU – PET (Pakistan)*, para. 5.120.
[5] Appellate Body Report, *EU – PET (Pakistan)*, para. 5.131.

> drawback scheme under investigation conveys a subsidy by reason of excess drawback on import charges on inputs."[6]

1.4 Footnote 61 to Annex II

4. In *India – Export Related Measures*, the parties disagreed on whether capital goods, whose importation was exempt from customs duties under India's EOU/EHTP/BTP Schemes, were inputs consumed in the production of an exported product, in light of footnote 1, read together with Annex I(i) and Annex II of the SCM Agreement. The Panel pointed out that capital goods are, by their very nature, "not 'physically incorporated' in the goods or services they are used to produce, as envisaged in footnote 61, nor are they 'physically present', even in a different form, in the final product, as envisaged in Annex II(II)(3). Capital goods also do not fall under any of the other listed categories in footnote 61, because they are not energy, fuels, oil, or catalysts."[7] On this basis, the Panel reached the preliminary conclusion that capital goods were not "inputs consumed in the production of the exported product", for purposes of Annex I(i).

5. In addition, the Panel rejected India's argument that capital goods are inputs within the meaning of Annex I(i) because they contribute to the cost of the final exported product. According to the Panel, "[c]ontributing to a product's cost is not the same as being 'consumed' in the production of that product. Indeed, under the definition provided by footnote 61, whether goods are 'consumed' does not depend on whether they contribute to the cost of the final product."[8] The Panel also disagreed with India's view that the existence of depreciation rates for capital goods is evidence that these goods are physically incorporated in the production process of exported products.[9]

6. With regards to footnote 61, the Panel further stated that this sets forth an exhaustive definition of "inputs consumed in the production process", and not merely an illustrative list. Accordingly, the Panel rejected India's proposition that capital goods should be included in the definition of inputs consumed in the production process, even though they are not listed in footnote 61.[10]

7. To support its position regarding capital goods, India also relied on Members' work on Implementation Related Issues and Concerns as evidence of a political will to include capital goods among inputs consumed in the production process. In particular, India referred to the General Council Decision on Implementation-Related Issues and Concerns of 15 December 2000, and the report thereon of the Chairman of the SCM Committee of 3 August 2001 (WT/L/384) and the Chairman's Report on the Implementation-Related Issues referred to the SCM Committee in the 15 December 2000 Decision of the General Council (G/SCM/34). Regarding these documents, the Panel pointed out that:

> "Members decided, in 2000, that the Committee on Subsidies and Countervailing Measures (SCM Committee) would 'examine as an important part of its work the issue[] … of the definition of 'inputs consumed in the production process', taking into account the particular needs of developing-country Members'. In the report that India itself relies upon, the chairperson of the SCM Committee noted the divergent views of Members on the matter, and observed that '[s]ome Members ha[d] noted that footnote 61 was specifically negotiated to exclude capital goods and therefore could not lend itself to interpretation as including such goods'. The Panel does not view this as showing that footnote 61 includes capital goods."[11]

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Current as of: December 2024

[6] Appellate Body Report, *EU – PET (Pakistan)*, paras. 5.126–5.128.
[7] Panel Report, *India – Export Related Measures*, para. 7.202.
[8] Panel Report, *India – Export Related Measures*, para. 7.207.
[9] Panel Report, *India – Export Related Measures*, para. 7.209.
[10] Panel Report, *India – Export Related Measures*, para. 7.211.
[11] Panel Report, *India – Export Related Measures*, para. 7.246.