

## WTO PANEL REPORT IN UNITED STATES – TAX TREATMENT OF ‘FOREIGN SALES CORPORATIONS’

SIMON KOZLINA\*

### I INTRODUCTION

The creation of the World Trade Organization (‘WTO’) by the *Marrakesh Agreement Establishing the World Trade Organization*<sup>1</sup> in 1994 was another attempt in both international economic law and public international law to create a truly effective international organisation. While having fewer Members than the United Nations, the WTO possesses fantastic enforcement mechanisms that substantially improve its ability to encourage compliance by nation states with international law obligations, a point Australian business has increasingly stressed to the Australian government.

Against this background, the on-going disagreement between the European Communities (‘EC’) and the United States (‘US’) in *United States – Tax Treatment of ‘Foreign Sales Corporations’* provides an interesting example of the developing law of the WTO – both its procedures and jurisprudence. It illuminates the methods and operation of this important rule-based international organisation.

While the dispute may not yet have reached a definitive conclusion, the recent WTO panel decision provides an opportune moment to comment on the question of the tax treatment of Foreign Sales Corporations (‘FSC’) as an example of WTO procedure.

### II BACKGROUND TO THE CURRENT DISPUTE

The FSC scheme was part of the US Internal Revenue Code which exempted from US income tax certain sales and leases through foreign corporations of products substantially produced in the US (‘foreign trade income’). While a similar dispute arose in the Domestic International Sales Corporation (‘DISC’)

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\* B Soc Sc (Hons), LLB (UNSW), Grad Dip Leg Prac (UTS); Casual Lecturer, Faculty of Law, University of New South Wales. The author wishes to thank Nicola Kozlina, Tim Perry and the external reviewer for their comments and suggestions.

1 Opened for signature 15 April 1994, 33 ILM 1125 (entered into force 1 January 1995).

debates of the 1970s,<sup>2</sup> the most recent problems emerged in November 1998 when the EC requested a WTO consultation on whether the US FSC scheme was an export subsidy<sup>3</sup> and therefore breached US WTO obligations.<sup>4</sup> In its request for a consultation, the EC alleged several problems with the FSC scheme:

- (1) that it was a subsidy under art XVI of the *General Agreement on Tariffs and Trade* ('GATT');<sup>5</sup>
- (2) that it was also a subsidy under art 3.1(a) and (b) of the *Agreement on Subsidies and Countervailing Measures* ('SCM');<sup>6</sup> and,
- (3) in an addendum to their original request,<sup>7</sup> that it was contrary to arts 8-10 of the *Agreement on Agriculture* ('AA').<sup>8</sup>

### III THE DISPUTE RESOLUTION PROCESS

#### A Consultations

Under art 4 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* ('DSU')<sup>9</sup> a Member of the WTO can request a consultation between itself and another Member about the operation of any of

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2 In 1971 the European Communities complained to the General Agreement on Tariffs and Trade ('GATT') Council about the export subsidies provided by the US through its DISC scheme. In reply, the US complained about similar schemes in France, Belgium and the Netherlands. Four identical panels reported in 1976, in decisions known as the *Tax Legislation Cases*, and found that all of the schemes had export subsidy characteristics (*Tax Legislation – United States Tax Legislation (DISC)*, 12 November 1976, GATT Panel Rep L/4422, BISD 23S/98; *Tax Legislation – Income Tax Practice Maintained By France*, 12 November 1976, GATT Panel Rep L/4423, BISD 23S/114; *Tax Legislation – Income Tax Practice Maintained By Belgium*, 12 November 1976, GATT Panel Rep L/4424, BISD 23S/127; *Tax Legislation – Income Tax Practice Maintained By The Netherlands*, 12 November 1976, GATT Panel Rep L/4425, BISD 23S/137). Because of disagreements between the parties, the reports were not adopted by the GATT Council until 1981. However, the GATT Council still disagreed on several key aspects, essentially allowing the European tax schemes to operate and requiring a clearer territory-based system in the US (*Tax Legislation Cases*, 7-8 December 1981, GATT Council Rep BISD 28S/114).

3 Although the definition of 'export subsidy' for the purpose of the WTO is provided by several agreements (see below p 523), a useful definition of the term 'subsidy' is 'a financial grant made by the state for the purpose of encouraging a particular activity in the field of trade, commerce, or business': *Reckitt and Colman v FCT* (1974) 23 FLR 58, 67.

4 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 28 November 1997, EC Request for Consultations, WTO Doc WT/DS108/1 (97-5232).

5 *General Agreement on Tariffs and Trade*, Annex 1A to the *Marrakesh Agreement establishing the World Trade Organisation*, opened for signature 15 April 1994, 33 ILM 1125 (entered into force 1 January 1995).

6 *Agreement on Subsidies and Countervailing Measures*, Annex 1A to the *Marrakesh Agreement establishing the World Trade Organisation*, opened for signature 15 April 1994, 33 ILM 1125 (entered into force 1 January 1995).

7 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 12 March 1998, EC Request for Consultations, WTO Doc WT/DS108/1/Add.1 (98-0995).

8 *Agreement on Agriculture*, Annex 1A to the *Marrakesh Agreement establishing the World Trade Organisation*, opened for signature 15 April 1994, 33 ILM 1125 (entered into force 1 January 1995).

9 *Understanding on Rules and Procedures Governing the Settlement of Disputes*, Annex 2 to the *Marrakesh Agreement establishing the World Trade Organisation*, opened for signature 15 April 1994, 33 ILM 1125 (entered into force 1 January 1995).

the agreements administered by the WTO.<sup>10</sup> Consultations are confidential and are held between Members. Apart from allowing Members to resolve disputes, the significance of the consultation process is that it allows Members to request that a panel make findings on the dispute. Usually Members can request a panel 60 days after the request for a consultation, although this period can be shortened if consultations are never commenced or where the Members give their consent.<sup>11</sup> The *SCM* reduces the required time period to 30 days in relevant disputes.<sup>12</sup>

In the FSC dispute, the EC and the US met three times for consultations in late 1997 and early 1998. The parties failed to resolve the dispute and the EC requested the appointment of a panel in July 1998.<sup>13</sup>

## B The Panel and the Dispute Settlement Body

The Dispute Settlement Body ('DSB') established a panel in September 1998.<sup>14</sup> The role of the panel is to make findings so as to assist the DSB in issuing recommendations and rulings on the dispute.

The DSB is the WTO's central institution for ensuring the effective operation of the many international trading agreements that comprise the WTO's area of responsibility. Its main roles include the appointment of panels, the adoption of reports by such panels and the Appellate Body, the surveillance of DSB rulings and recommendations and, most significantly, the exercise of its power to authorise the suspension of concessions and obligations under WTO agreements.<sup>15</sup> All Members of the WTO may participate in the DSB and, significantly, the DSB makes decisions by consensus.<sup>16</sup> It is the DSB that must decide whether to adopt or reject a panel report and its recommendations, although a report will be adopted unless rejected by consensus.<sup>17</sup>

The panel has both a fact-finding and a decision-making role under art 11 of the *DSU*. Consisting of three panellists, the panel makes an objective assessment of the dispute and the application of the relevant agreements. It reports to the DSB particular rulings and recommendations necessary to settle the dispute.<sup>18</sup>

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10 For example, the *GATT* 1994 and the *SCM*.

11 *DSU* arts 4.3, 4.6, 4.7-4.8. It is relevant to note the parallel and intertwining mechanisms of good offices (neutral party review), conciliation and mediation established by art 5 of the *DSU*, which also allows a request for a panel. Interestingly, action under art 5 can precede or form part of the consultation, and can continue even after the matter has gone to a panel.

12 *SCM* art 4.4.

13 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 9 July 1998, EC Request for Establishment of Panel, WTO Doc WT/DS108/2 (98-2734).

14 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 11 November 1998, Constitution of Panel Established at EC Request, WTO Doc WT/DS108/3 (98-4440).

15 *DSU* art 2.1.

16 *DSU* art 2.4. While 'consensus' in this context means the decision of the DSB must be unanimous, it has been characterised as a 'negative consensus', since fn 1 to the *DSU* deems consensus to occur unless a Member who is present formally objects to a proposed decision.

17 *DSU* art 16.4.

18 *DSU* arts 8, 11.

In a form very similar to the standard case management timetable now well known to legal practitioners in New South Wales,<sup>19</sup> the *DSU* establishes a strict timeline for the operation of the panel and for submissions by parties.<sup>20</sup> The panel's method of decision-making is to seek written submissions from the parties, responses to submissions, answers to questions posed by the panel and other parties, and finally oral submissions. Written and oral submissions can also be made by third parties who have a substantial interest in the dispute.<sup>21</sup>

In the FSC dispute, written and oral submissions were received over a period of five months from November 1998 through to March 1999, with meetings between the panel and parties being held in February and March 1999. Third party submissions were received from Barbados, Canada and Japan, with the latter two strongly supporting the EC position.

In October 1999, well outside the nine month mandated timetable, the FSC panel circulated its report to the DSB and all WTO Members. It found the FSC provisions to be inconsistent with both the *SCM* and *AA*. Significantly, the panel found that the FSC scheme was an export subsidy because it provided a financial benefit to US corporations that was dependent upon export performance.<sup>22</sup> The panel's recommendations to the DSB were clear – it should request that the FSC scheme be withdrawn, and that it be withdrawn by 1 October 2000.<sup>23</sup>

### C The Appellate Body

Appeals from panel reports are to the Appellate Body, a permanent and separate body which consists of seven persons, although only three sit on any one case.<sup>24</sup> Appeals are limited by the *DSU* with respect to both time and content: appeals must be lodged before the DSB adopts a report (usually 60 days after the report is circulated); and may only be on issues of law covered by the panel's report and the legal interpretations of the relevant conduct considered by the panel. Also, while third parties with a substantial interest in the matter can make submissions to the Appellate Body, only parties to the dispute may appeal.<sup>25</sup>

Within weeks of the distribution of the panel's report, the US invoked the appeal procedures contained in art 16 of the *DSU*. It withdrew that appeal and

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19 See, eg, *District Court of New South Wales Practice Note No 33 1995* (NSW); see also *Supreme Court of New South Wales Practice Note No 120 2001* (NSW).

20 *SCM* app 3 'Working Procedures', para 12.

21 *DSU* art 10.

22 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 8 October 1999, Panel Rep, WTO Doc WT/DS108/R (99-4118) (adopted 20 March 2000) as modified by *United States – Tax Treatment of 'Foreign Sales Corporations'*, 24 February 2000, Appellate Body Rep, WTO Doc WT/DS108/AB/R (00-0675) paras 7.100, 7.108, 7.122, 7.175-7.176.

23 *Ibid* paras 8.3, 8.8.

24 As a permanent and separate body, the Appellate Body is similar to the Courts of Appeal in most Australian States, in which a select and dedicated set of judges sit on appeal cases. This is in contrast to a 'Full Bench' appellate court in which several judges are selected on ad hoc basis to hear a case on appeal.

25 *DSU* arts 17.1, 17.4, 17.6, 17.8, 17.13.

then re-submitted it in exactly the same terms several weeks later.<sup>26</sup> The basis for the US appeal was the claim that the panel had erred in law because it had failed to properly consider the surrounding circumstances and history of the FSC dispute. In particular, the US claimed that the panel had failed to properly interpret the *SCM* in the context of the earlier DISC dispute and its resolution in the *Tax Legislation Cases* and the GATT Council.<sup>27</sup>

Article 17.5 of the *DSU* sets a standard period of 60 days from a notification of appeal to the circulation of the Appellate Body's report, with an upper limit of 90 days if the Appellate Body submits reasons to the DSB explaining why 60 days will be insufficient. In the FSC dispute, the Appellate Body did in fact seek such an extension 'due to the time required for completion and translation of the report'.<sup>28</sup>

In late February 2000, the Appellate Body circulated its report, upholding the panel's decision on the FSC's contraventions of the *SCM*.<sup>29</sup> The report reversed the panel's finding on the scheme's contravention of the AA, but relied on an alternative claim to find that the FSC was a subsidy under the AA nonetheless.<sup>30</sup>

#### D Surveillance of Implementation

Following the adoption by the DSB of the Appellate Body report and the modified panel report,<sup>31</sup> the parties to the FSC dispute agreed on procedures under arts 21 and 22 of the *DSU* and art 4 of the *SCM* to ensure that the DSB's recommendations were implemented.

Article 21, on the surveillance of the implementation of recommendations and rulings, forms part of the WTO's 'enforcement machinery'. It requires Members

26 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 28 October 1999, Notification of US Appeal under *DSU* art 16 para 4, WTO Doc WT/DS108/5 (9904742); *United States – Tax Treatment of 'Foreign Sales Corporations'*, 3 November 1999, Withdrawal of US Appeal under *SCM* app 3 r 30(1), WTO Doc WT/DS108/6 (99-4817); *United States – Tax Treatment of 'Foreign Sales Corporations'*, 26 November 1999, Notification of US Appeal under *DSU* art 16 para 4, WTO Doc WT/DS108/7 (99-5183).

27 See above n 2. Here there were three additional points of appeal. Firstly, the US referred to the panel's recommendations on the AA, arguing that the panel's interpretation of the terms 'provide' and 'costs of marketing' were erroneous. Secondly, the US argued that the panel should have dismissed the EC claims, as the EC's request for consultation was incomplete (the EC failed to attach a statement of available evidence to the request of consultation as required by art 4.2 of the *SCM*). Thirdly, the US claimed that the panel should have rejected the EC claim as the EC had failed to use appropriate forums to resolve a dispute on transfer pricing, as noted by fn 59 of the *SCM* (see below n 44).

28 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 24 January 2000, Appellate Body Communication, WTO Doc WT/DS108/8 (00-0306).

29 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 24 February 2000, Appellate Body Rep, WTO Doc WT/108/AB/R (00-0675) (adopted 20 March 2000) paras 121, 177.

30 *Ibid* paras 154, 177. On the two procedural points, firstly, the Appellate Body found that the US could not now complain of the incomplete request for consultation – in language very similar to an estoppel argument, the Appellate Body referred to the requirement in art 10.3 of the *DSU* that parties act in good faith to resolve the dispute and that strict adherence to procedural requirements, if not promptly raised, merely contributes to 'the development of litigation techniques' (para 166). Secondly, the tax forum question did not arise, as neither the panel nor the Appellate Body had addressed the issue of transfer (administrative) pricing rules (para 171).

31 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 24 March 2000, Appellate Body Rep, Panel Rep, DSB Action, WTO Doc WT/DS108/10 (00-1218).

to explain to the DSB how they intend to comply with its recommendations and rulings. It also establishes a right for parties to request a panel to determine disagreements on whether measures taken by parties comply with DSB recommendations and rulings.

Article 22 complements the WTO's enforcement powers in art 21 and provides for compensation and for the suspension of concessions owed to Members by other Members. Significantly, if a party fails to implement DSB recommendations, then other parties can seek DSB authorisation not to extend concessions under WTO agreements to the contravening party. If there are disagreements between the parties about the suspension of concessions, an arbitration is then imposed.

It is important to understand the relationship between the *DSU* and the *SCM*. While the *DSU* establishes the 'procedural' rights of parties to disputes generally, the *SCM* (which sets out the 'substantive law' on what constitutes a prohibited subsidy) also establishes the remedies that are available to a Member where another Member provides a prohibited subsidy.<sup>32</sup> There is a substantial degree of overlap between the *SCM* remedies and the *DSU*, since the *SCM* uses the *DSU* process of consultations, panel reports and Appellate Body reports, although with much shorter time periods. Significantly, the *SCM* also creates the opportunity for countermeasures to be authorised by the DSB if recommendations are not implemented by parties.<sup>33</sup> The *SCM* extends the powers of an arbitration under art 22 of the *DSU* so as to include an assessment of the appropriateness of countermeasures. The overlap between the two agreements, in which the general framework of the *DSU* is reinforced and extended, highlights the importance of maintaining consistent rule-based procedures for resolving disputes. It also reflects the pragmatic nature of international negotiations in the drafting of agreements where procedural rights agreed to in one context may then be extended in another, as seen in the addition of countermeasure powers under the *SCM*.

### 1 *The US-EC Agreement on Implementation*

The agreement reached on 29 September 2000 between the parties in the FSC dispute, and later circulated to the DSB,<sup>34</sup> included detailed statements about when arbitrations, a panel and appeals were to occur. In particular, the parties agreed on how compliance would be ensured. Firstly, there were to be consultations between the parties (para 1); secondly, a compliance panel under art 21.5 of the *DSU* could be appointed by the EC if consultations ended (para 2); and thirdly, the EC could request permission to apply countermeasures and suspend concessions if, after the deadline, either consultations ended (para 8) or no steps had been taken by the US to implement the DSB recommendations (para 9). It was also agreed that should countermeasures be requested by the EC,

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32 *SCM* art 4.

33 *SCM* art 4.10.

34 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 5 October 2000, EC-US Understanding Regarding Procedures under *DSU* arts 21, 22 and *SCM* art 4, WTO Doc WT/108/12 (00-4067).

the US would take the matter to arbitration before the DSB could consider the request (para 10). However, if a panel were requested, then any arbitration would be suspended (para 11). The agreement also stated that the US would replace the FSC scheme in the current session of Congress.

## 2 *The Agreement in Operation*

The 29 September agreement was implemented through a series of peculiar procedural twists. With the deadline for implementation approaching on 1 October 2000 (a Sunday) and the possibility of countermeasures becoming apparent, the parties agreed on 29 September 2000 (a Friday) on a compromise for the implementation process. The same day (ie, the last working day before the deadline), the US requested an extension ('modification') of the deadline from 1 October 2000 to 1 November 2000.<sup>35</sup> The EC did not object to the 'modification' and on 12 October the DSB allowed the extension. It is interesting to note that, while the request for an extension was received by the Chair of the DSB on 29 September 2000 (Friday), the implementation procedure agreement was only forwarded to the DSB on 2 October 2000 (the following Monday) – a very well placed weekend. Consider what may have occurred had the EC objected to the agreement or the extension, or even if the DSB had not granted the extension. The machinations of that weekend highlight the great efforts Members will exert to maintain the timetable established by the *DSU*, perhaps motivated by the spectre of countermeasures should compliance fail to be achieved. It emphasises the importance of clear rules and tangible consequences should international obligations not be adhered to. However, as subsequent events showed, those concerns do not guarantee timely performance.

The new deadline for implementation of 1 November 2000 passed without the US – now in the middle of a presidential election campaign – altering the FSC. On 17 November 2000, the EC informed the DSB that in accordance with para 9 of the 29 September agreement, it now requested authorisation to suspend concessions and take countermeasures to the value of US\$4.04 billion, by way of a 100 per cent duty on a range of US imports. On the same day, the US Ambassador to the WTO informed a meeting of the DSB that, two days earlier, President Clinton had signed into law the *FSC Repeal and Extraterritorial Income Exclusion Act of 2000* ('*FSC Repeal Act*').<sup>36</sup> Hours later, the EC replied by alleging the new Act substantially replicated the non-compliant FSC scheme and requested consultations pursuant to the *DSU*, *SCM* and other agreements.<sup>37</sup>

35 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 2 October 2000, Request for Modification of Compliance Time-Period, WTO Doc WT/DS108/11 (00-4029).

36 HR 4986, Public Law 106-519, 114 Stat 2423 (2000).

37 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 21 November 2000, EC Recourse to *DSU* art 21.5 Request for Consultation, WTO Doc WT/DS108/14 (00-4957). It is interesting to note that the EC pointedly attached to this request for consultation a particularly long and detailed Statement of Available Evidence. Also, it seems implicitly understood in the request for consultation that the earlier countermeasures authorisation request would be suspended (perhaps because para 9 – 'where there exist no measures taken to comply...' – no longer applies). The consultation request appears to be in accordance with para 1 of the 29 September agreement and may have been made with an eye to using para 8 as a means of triggering a further request for countermeasure authorisation.

Over a week later, on 27 November 2000, the US formally objected to the threatened countermeasures and suspension of concessions and referred the dispute to arbitration, pursuant to art 22.6 of the *DSU*,<sup>38</sup> effectively blocking the EC countermeasures. Next, pursuant to the earlier EC request for consultation, the parties consulted on 4 December 2000, but failed to settle the dispute. However, following the end of consultations, on 7 December 2000 the EC requested that the DSB establish a panel on the implementation of the DSB's recommendations,<sup>39</sup> a tactic which halted the US recourse to arbitration on the appropriateness of the EC countermeasures and replaced it with a panel on the sufficiency of the US removal of the FSC scheme.

Thus, on 20 December 2000 a panel was established by the DSB under art 21.5 of the *DSU*.<sup>40</sup> In accordance with the 29 September agreement, the Arbitrators were informed that their work was now suspended and that a panel would take over the matter.<sup>41</sup> There was a certain element of unreality in this process – the members of the panel were the same people as the members of the arbitration, and were in fact the same panel members who originally heard the dispute over a year earlier. It reveals an interesting context to the rule-based operation of the WTO's attempts at dispute resolution. Despite the strict and ordered division of powers, roles and responsibilities in the DSB established by the *DSU* and other agreements, a small group of individuals can wield significant influence through the adoption of different legal personas. In a situation that has parallels with the role of a judge as fact finder and law giver in a trial without a jury, and the role of parliamentary ministers in the Westminster version of a separation of powers, it emphasises that the relevance and application of legal principles ultimately rests on the individuals who enforce it, regardless of their changing titles.

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38 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 27 November 2000, US Request for Arbitration under *DSU* art 22.6, WTO Doc WT/DS108/15 (00-5121). This action complies with para 10 of the 29 September agreement. The arbitration was established by the DSB on 28 November 2000: *United States – Tax Treatment of 'Foreign Sales Corporations'*, 13 December 2000, US Recourse to *DSU* art 22.6 and *SCM* art 4.11, Agreement Constitution of the Arbitrator Note by the Secretariat, WTO Doc WT/DS108/17 (00-5399).

39 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 8 December 2000, EC Recourse to *DSU* art 21.5, Request for Establishment of Panel, WTO Doc WT/DS108/16 (00-5380). It is interesting to note that the EC support their request for a panel on a plethora of grounds – *DSU* art 6 (general power to establish panels); *DSU* art 21.5 (panel for surveillance of implementation); *SCM* art 4 (panel for remedies); *AA* art 19 (application of *DSU* to *AA*); *GATT* 1994 art XXIII (dispute resolution); and the 29 September agreement. Conceivably, para 2 of the 29 September agreement would have sufficed.

40 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 5 January 2001, EC Recourse to *DSU* art 21.5, Constitution of the Panel Note by the Secretariat, WTO Doc WT/DS108/19 (01-0038).

41 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 21 December 2000, US Recourse to *DSU* art 22.6 and *SCM* art 4.11, Communication from the Panel, WTO Doc WT/DS108/18 (00-5635).



## IV THE REPORT OF THE ARTICLE 21.5 PANEL

The art 21.5 panel in the FSC dispute circulated its report to the DSB on 20 August 2001. It is yet to be adopted.<sup>42</sup> In that report the panel found that the new US Act remained in contravention of US WTO obligations.

### A Issues

The main issue before the panel was whether the *FSC Repeal Act* continued to provide for a prohibited subsidy and thus contravened art 3 of the *SCM*. The EC alleged the Act was properly characterised as an export subsidy for two reasons: firstly, to be excluded from US income tax, the Act required products to be sold outside the US; and secondly, no more than 50 per cent of the product's 'fair market price' could be added in parts or labour from outside the US. In reply, the US argued, amongst other things, that the new Act was designed to reduce double taxation, a legitimate ground under footnote 59 of the *SCM*.

#### 1 *The SCM Agreement*

Article 3 of the *SCM* is predicated on art 1.1 of the *SCM*, which defines what constitutes a subsidy. In the context of government subsidies and taxation, it states:

1.1 ... [A] subsidy shall be deemed to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a Member, i.e. where: ...

(ii) government revenue that is otherwise due is foregone or not collected.<sup>43</sup>

Article 3 prohibits two forms of subsidy: those based on exports (art. 3.1(a)) and those that encourage the use of local goods over imported goods (art.3.1(b)). Examples of export subsidies are listed in an Annex to the *SCM*, of which (e) is the relevant illustration:

(e) the full or partial exemption, remission or deferral specifically related to exports of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.<sup>44</sup>

42 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 20 August 2001, EC Recourse to DSU art 21.5, Panel Rep, WTO Doc WT/DS108/RW (01-3979).

43 *SCM* art 1.2 narrows the application of the definition to subsidies that are 'specific', a concept itself defined by art 2 of the *SCM*, although art 2.3 reduces its significance by deeming all subsidies caught by art 3 as specific.

44 Para (e) is further explained by fn 59 to the *SCM*, which is significant for an understanding of the US case:

## 2 Additional Claims

In addition to the claims based on the *SCM* outlined above, the EC also made claims based on the *AA* and art III:4 of the *GATT* 1994.

The *AA*, which regulates and limits the use of subsidies in agriculture, still restricts subsidies that might circumvent Members' commitments to reduce subsidies on agricultural goods. The *AA* identifies two categories of agricultural goods, the distinction being between unscheduled goods, for which subsidies must be reduced in strict accordance with the *AA*, and scheduled goods, for which a Member expressly agrees to reduce subsidies in accordance with a declared, albeit slower, timetable.<sup>45</sup>

The EC argued that if the new US Act provided for a prohibited subsidy under the *SCM*, it was also a contravention of the *AA*.

Article III:4 of the *GATT* 1994 restricts a Member's ability to provide less favourable treatment to imports over domestically produced goods.<sup>46</sup> Previous panel decisions identified several key issues which are to be considered in interpreting art III:4. The panel should: compare imports and domestic products that are 'like goods'; identify whether the relevant statute is a law or regulation affecting the internal use of goods; and determine whether less favourable treatment exists.<sup>47</sup>

## B *SCM* Reasoning

The panel identified three critical points in the EC's argument on the application of the *SCM*: firstly, what was the definition of 'revenue that is

The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the price which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practice which may contravene this principle and which results in a significant saving of direct taxes in export transaction. In such circumstances the Members shall normally attempt to resolve their difference using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under *GATT* 1994, including the right of consultation created in the preceding sentence. 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 of the enterprises of another Member.

45 *AA* art 8 states: 'Each Member undertakes not to provide export subsidies other than in conformity with this Agreement and with the commitments as specified in that Member's schedule'. *AA* art 10.1 states, in part: 'Export subsidies ... shall not be applied in a manner which results in ... circumvention of export subsidy agreements'.

46 *GATT* 1994 art III:4 states, in part:

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 ...

47 *Canada – Certain Measures Affecting the Automotive Industry*, 11 February 2000, Panel Rep, WTO Docs WT/DS139/R, WT/DS142/R (adopted 19 June 2000) as modified by *Canada – Certain Measures Affecting the Automotive Industry*, 31 May 2000, Appellate Body Rep, WTO Docs WT/DS139/AB/R, WT/DS142/AB/R.

otherwise due'; secondly, was a benefit conferred by the US Act; and thirdly, was the benefit 'contingent on export performance'. The panel's approach was complicated by the need to make a decision in light of the Appellate Body's earlier report on the FSC dispute. While the panel was considering legislation different from that considered by the Appellate Body, the Appellate Body's interpretation of the *SCM* remained pertinent.

A closer examination of the panel's findings reveals that it found that the new US Act 'carved out' areas of taxable income to be excluded from income tax assessment. Rather than state that certain types of 'foreign source income' were not part of gross income, and therefore not US tax revenue, the panel found the 'stringently restrictive qualitative conditions and quantitative requirements' of the Act excluded income that, apart from the Act, would be included in tax revenue. This meant that the US was foregoing revenue and therefore the Act provided a subsidy according to art 1 of the *SCM*.<sup>48</sup>

Having quickly found that a taxpayer not paying tax is better off than one that does,<sup>49</sup> the panel considered that the Act was export contingent because the wording of the Act required export in order to qualify for the tax exclusion.<sup>50</sup> Also, the purported expansion by the US of the category of those eligible for the scheme did not operate to reduce or remove the specific requirement that goods be exported.

## 1 *Comment on SCM Reasoning*

The panel appeared particularly driven by the 'perilous systemic implications' for the *SCM* of a finding that the US scheme was acceptable. It repeatedly expressed concern about reducing the significance of the *SCM* to 'redundancy and inutility' or rendering it 'operationally ineffective', even to 'eviscerate' the agreement. However, the panel also stressed that the US, like any other country, was free to adopt whatever tax scheme it desired – a territorial, world-wide or mixed scheme.

It seemed important to the panel, and to the earlier Appellate Body, that the WTO did not *force* Members to adopt either a territorial or world-wide tax system. Rather, the panel stressed that once any such a system was adopted, it had to be implemented in compliance with WTO obligations. One US justification for the scheme was that it approximated the advantages of a territorial-based tax system (that taxes activity with some connection to the taxing country, like many European systems and the Australian tax system) within a world-wide tax system (that taxes entities for activities conducted throughout the world and is the formal basis of the US system). The US argument suggested that it would be difficult to create a WTO-compliant, world-wide system if the panel were to interpret the *SCM* broadly. Fatal to the US

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48 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 20 August 2001, EC Recourse to *DSU* art 21.5, Panel Rep, WTO Doc WT/DS108/RW (01-3979) paras 8.3-8.43; see especially paras 8.25-6, 8.43.

49 *Ibid* paras 8.44-8.48; see especially para 8.46.

50 *Ibid* paras 8.49-8.75; see especially para 8.60.

claim was the fact that the territorial aspects of its world-wide system were export contingent. If the Act were territorial without being export-based (eg, a US company importing to the US goods manufactured in Japan) or export-based without being territorial (eg, a US company exporting a good substantially made in Japan to Australia), then it may have been WTO compliant. It was the method of implementation that contravened the *SCM*, not the system of taxation itself.

### C Double Tax Reasoning

The panel roundly rejected the US claim that the Act was designed to reduce double taxation. In doing so, it cited the highly selective qualitative and quantitative distinctions in the Act for identifying excluded income, and noted that it excluded income rarely taxed in other countries, that it did not include income typically taxed in other countries, and that the US did not direct the Act to the very extensive list of bilateral agreements on double taxation to which the US was already a party.<sup>51</sup>

### D AA Reasoning

On the application of the AA, the panel applied similar logic and reasoning to that used in the original dispute to find that the new US Act contravened US obligations for scheduled goods, by providing an effectively unlimited subsidy on agricultural products, and for unscheduled goods, by providing no means to reduce the unlimited subsidy over time in accordance with the requirements of the AA.<sup>52</sup>

### E GATT Reasoning

The panel found that the US Act contravened the *GATT* 1994. Relying on past decisions, the panel found that it did not need to identify particular classes of 'like products' or even actual products, as it was sufficient to know that the Act was both general in its application (and therefore applied to many products which conceivably would compete with imports) and that it had the potential to affect imports. The panel stated that there was an important distinction between form and content and that the form of the US Act (conditioning access to income tax relief) and the content (requiring a maximum overseas labour or component contribution) both illustrated the way in which the US Act breached the *GATT* 1994. Finally, even though it may have been possible for US companies to comply with the Act using only overseas components – by attributing more than 50 per cent of the fair market value of the good to other factors, such as intellectual property or goodwill – the Act still provided an incentive to use domestic components instead of overseas components.<sup>53</sup>

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51 Ibid paras 8.98-8.8.108; see especially para 8.106.

52 Ibid paras 8.111-8.8.122; see especially paras 8.119-8.120.

53 Ibid paras 8.123-8.159; see especially paras 8.133, 8.145-6, 8.148, 8.156-7.

## F Further Actions

The panel's report concluded by confirming two points: firstly, that the new US Act was in contravention of several WTO obligations; and secondly, that the US had actually failed to remove in its entirety the original FSC subsidies, since the transitional provisions in the new US Act allowed subsidies to continue indefinitely for long term contracts entered into before 30 September 2000 between FSCs and independent third parties.

These two points form the gist of the panel's recommendation to the DSB and will allow the EC to request, again, the suspension of concessions and the imposition of countermeasures. The DSB is yet to adopt the panel report; however, on 15 October 2001 the US filed its Notice of Appeal with the Appellate Body, effectively challenging all of the findings of the art 21.5 panel.<sup>54</sup> The Appellate Body should report on the appeal early in 2002.

## V FURTHER COMMENTS

### A Jurisprudence

Considering the panel is not situated in a formal hierarchy of precedent, it is of interest to note how the panel in the FSC dispute has used Appellate Body decisions to support and justify its own conclusions. Apart from the Appellate Body decision in this dispute, the panel referred to numerous previous reports of the Appellate Body. Many of these were used to support interpretations of substantive rights conferred by the *SCM. Brazil*<sup>55</sup> was used to support the panel's argument for its general approach to the *SCM*, that the panel cannot limit the meaning of the agreement so much as to reduce to it to 'redundancy and inutility'. *Canada*<sup>56</sup> was used repeatedly by the panel to support the particular interpretation of the *SCM* it adopted – both in identifying the object and purpose of the *SCM*, and in identifying the meaning of 'benefit' in art 1.1. The panel also used *Korea*<sup>57</sup> and *European Communities*<sup>58</sup> to answer the related *GATT* 1994 art III:4 issue. Similarly, the panel used Appellate Body reports to support procedural arguments. *United States*<sup>59</sup> places the burden of proof on parties alleging a defence and allows panels not to respond to all legal arguments put to

54 *United States – Tax Treatment of 'Foreign Sales Corporations'*, 15 October 2001, EC Recourse to DSU art 21.5, US Notification of Appeal under DSU art 16 para 4, WTO Doc WT/DS108/21 (01-5050).

55 *Brazil – Export Financing Programme for Aircraft*, 9 May 2000, Appellate Body Rep, WTO Doc WT/DS46/AB/R (adopted 20 August 1999).

56 *Canada – Measures Affecting the Export of Civilian Aircraft*, 2 August 1999, Appellate Body Rep, WTO Doc WT/DS70/AB/R (adopted 20 August 1999).

57 *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, 11 December 2000, Appellate Body Rep, WTO Docs WT/DS161/AB/R, WT/DS169/AB/R (adopted 10 January 2001).

58 *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products*, 12 March 2001, Appellate Body Rep, WTO Doc WT/DS135/AB/R (adopted 6 April 2001).

59 *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India*, 25 April 1997, Appellate Body Rep, WTO Doc WT/DS33/AB/R (adopted 23 May 1997).

them, while *Australia*<sup>60</sup> requires sufficient findings by a panel to allow the DSB to make precise recommendations, with which Members can comply.

The growing body of WTO case law now contains important sources of law in its own right, in addition to the formal requirements of the various WTO treaties. In addition to two early decisions incorporating environmental concerns and the protection of social values,<sup>61</sup> these cases illustrate a reliance on Appellate Body decisions, not merely the wording of agreements, to support arguments. In the subtle shift from reference to treaties towards reference to reports, independent authority is being created and reinforced.

Although Appellate Body decisions may not be binding on other disputes, a developing practice of self-referential support and justification develops an expectation that panel reports will be justified in like terms. The persuasiveness of a report will be reduced if it fails to draw upon this source. Considering that Appellate Body decisions must still be adopted, or not rejected, by the DSB, the Appellate Body's consistency with its own developing authority supports its persuasive force on the DSB. Critically, it is the use of 'case-law' to justify argument that is one of the exemplars of legal reasoning, and in the practice of WTO panels and the Appellate Body, the use of law, legal method and legal reasoning are seen as a means of legitimating or justifying decisions. As noted by Rambod Behoodi, in the absence of 'physical enforcement', persuasion is necessary.<sup>62</sup> The legal form represents a present and accepted form of logical persuasion, ideally suited to the quasi-legal context of the 'issues of law' which determine the Appellate Body's competency.

## B Role of the WTO

At this point in the FSC dispute, the most important concerns are whether the US scheme really is a subsidy and whether or not the WTO panel and EC countermeasures will force a change in US policy. Underlying this is a deeper question: can the WTO be effective in implementing the fabled 'level playing field' of economic trade theory?

Regarding the subsidy, there is a strong emphasis on legal interpretation by the panel of both the US law and the relevant treaties. The panel repeatedly allowed itself to consider *de jure* the operation of the US Act and its effect for the purpose of the treaties. Nonetheless, the panel's task was to rationalise a conclusion which is obvious but difficult to explain. Ultimately, the panel based its conclusions on common sense, rather than legal principle. In its reference to

60 *Australia – Measures Affecting Importation of Salmon*, 20 October 1998, Appellate Body Rep, WTO Doc WT/DS18/AB/R (adopted 6 November 1998).

61 *United States – Standards for Reformulated and Conventional Gasoline*, 16 January 1996, Panel Rep, WTO Doc WT/DS2/R; *EC – Measures Concerning Meat and Meat Products (Hormones)*, 16 January 1998, Appellate Body Rep, WTO Docs WT/DS28/AB/R, WT/DS48/AB/R. As noted by Paolo Mengozzi, 'The WTO Law: an analysis of its first practice', in Paolo Mengozzi (ed), *International Trade Law on the 50<sup>th</sup> Anniversary of the Multilateral Trading System* (1999) 20.

62 Rambod Behoodi, 'Legal Reasoning and the Appellate Body of the WTO', in Paolo Mengozzi (ed), *International Trade Law on the 50<sup>th</sup> Anniversary of the Multilateral Trading System* (1999) 322, 324.

'qualitative conditions and quantitative requirements', there is a perceptible exasperation in explaining the patent yet inexplicable. In its frequent reference to Appellate Body decisions, the panel sought to wrap its reasoning in a cloak of legal authority. Perhaps the commonsense approach is most clearly seen in its denial of the double taxation claim by the US, in which the panel concluded by suggesting that no reasonable legislator would create such a law to minimise double taxation. The panel's conclusion was correct; however, a different form of analysis may have been more compelling.

It is conceivable that the US will refuse to amend its legislation again. It is also conceivable that a 'trade war' will break out with the imposition of EC countermeasures. However the assumptions or policy decisions underlying the WTO shows that formalised and legalistic avenues for dispute resolution will result in most matters being settled long before they get heated or intractable. Also, in the shift from the *GATT* to the WTO, there is the strong notion of 'legal order' with clear standards, principles, procedures and methods of enforcement, in preference to a system of power.

The outstanding feature of the WTO treaty system is that it relies on nation-state actors in order to function, but imposes burdens on individuals – the individual producers, import-exporters and consumers who will bear the cost of EC countermeasures. It is perhaps this dual play that is a harbinger of the WTO's ultimate success. By shifting the focus of the international system out of the unreal interactions of sovereign states and into the real world of customers and sellers, investors and workers, the WTO allows tangible political pressures to emerge. In the context of the FSC, it is significant to recognise that such pressure has already compelled the US Congress to alter important domestic legislation once. That fact alone reveals a degree of success in the 25 year struggle over export subsidies between the EC and the US. Its ability to compel a further change will decisively determine its overall effectiveness.