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CHALLENGING FISCAL SUBSIDIES UNDER WTO LAW: THE EXAMPLE OF THE US FOREIGN SALES CORPORATION

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Since the creation of The EC Tax Journal, several contributors have examined the effect of the European Community's internal state aid rules on national tax measures which distort competition.[1] The purpose of the present article is to examine the counterpart situation - the effect of World Trade Organisation ("WTO") subsidy rules on the tax measures of any WTO Member. In the first section, this article will examine the WTO anti-subsidy rules as they apply in the fiscal context. The second section of this article will examine how certain of these rules were applied, to the European Community's advantage, in the recent *US Foreign Sales Corporation Case*. In the last part of this article some conclusions will be drawn as to the relevance of WTO subsidies law to EC and international tax practice.

1.1 The GATT 1994 Agreement on Subsidies and Countervailing Measures

The WTO rules on subsidies are contained in the GATT 1994 Agreement on Subsidies and Countervailing Measures ("the SCM Agreement"), one of the many agreements signed in Marrakesh on 15th April 1994 as a result of the Uruguay Round of multilateral trade negotiations. The SCM Agreement defines a subsidy and establishes the conditions in which a subsidy is (a) "prohibited", (b)

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1 Marc Dassesse, *Tax Deductibility of Insurance Premiums: A case of State Aid for Insurance Companies?* ECTJ 1/1 [1995/96] 15; Carlos Benítez, *The Canary Special Zone ("ZEC")*, ECTJ 1/3 [1995/96] 187; Alex Easson, *Tax Competition and Investment Incentives*, ECTJ 2/2 [1997] 63; Carlos Benítez and Diego del Cuadro, *State Aid and Taxation in Spain*, ECTJ 3/1 [1998] 17.

"actionable" or (c) "non-actionable". The SCM Agreement establishes a procedure for consultation and settlement of disputes among WTO member countries arising out of prohibited or actionable subsidies. The SCM Agreement also lays down the conditions in which a WTO member country may impose countervailing measures on imports of products that benefit from subsidies other than non-actionable subsidies. It is important to emphasise the distinction here between (1) the rules on prohibited and actionable subsidies, which are treaty rules governing relations between sovereign states, and (2) the rules on countervailing measures which are translated by national legislation into rules of administrative law conferring rights and obligations on individuals. Both aspects are properly part of EC law. The first governs the European Community's trading relations with third countries, while the second has been transposed into EC "domestic" law by Council Regulation (EC) No 202/97 of 6th October 1997 (hereinafter referred to as "the Basic Regulation").[2]

1.2 The WTO Definition of a Subsidy in the Fiscal Context

The SCM Agreement defines a subsidy as a financial contribution by government which confers a benefit.[3] The SCM Agreement provides five generic examples of subsidies, of which the following is of interest in the fiscal context:

> " where ... government revenue that is otherwise due, is foregone or otherwise not collected (for example, fiscal incentives such as tax credits) ..."[4]

This simple principle is applicable to both direct and indirect taxes.[5] Direct taxes are defined as "tax on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property." Indirect taxes are defined as "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes

2 Council Regulation on protection against subsidised imports from countries not members of the European Community, OJ L288, 21.10.97, p.1; for ECSC matters see Commission Decision No 1889/98/ECSC, OJ L245, 4.9.98, p.3, which differs from the EC regulation only in institutional matters arising out of the different roles of the Commission and Council.

3 Article 1.1. See also Basic Regulation, Article 2.

4 Article 1.1, paragraph (a)(ii). See also Basic Regulation, Article 2(1)(a)(ii).

5 SCM Agreement, Annex I (e) to (i).

and import charges." Import charges are defined as "tariffs, duties and other fiscal charges ... that are levied on imports" other than those already enumerated.[6]

1.3 Prohibited Subsidies under the SCM Agreement

There are two categories of prohibited subsidy under the SCM Agreement, export subsidies and domestic input subsidies. The latter are defined as subsidies "contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."[7] It would appear that domestic input subsidies have always been of lesser concern than export subsidies. For example, Article XVI of the GATT 1947 and the Tokyo Round Anti-subsidy Code of 1979 hardly mention domestic input subsides, but deal in some detail with export subsidies.

An export subsidy is one which is contingent in law or in fact, whether solely or as one of several other conditions, upon export performance.[8] A subsidy which is not legally contingent on export performance, but which is in fact tied to actual or anticipated exportation or export earnings, will constitute an export subsidy. However, the SCM Agreement limits the scope of this "factual contingency" test by providing that the mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy.[9] Annex I to the SCM Agreement provides an illustrative, i.e. non-exhaustive, list of export subsidies. Five of the twelve examples in the illustrative list relate to taxation. The first two of these examples, (e) and (f), relate to direct taxation, while the next three, (g), (h) and (i), relate to indirect taxation:

(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.[10]

(f) The allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption, in the calculation of the base on which direct taxes are charged.

6 SCM Agreement, Annex I, footnote 52.

7 SCM Agreement, Article 3.1(b); see also Basic Regulation, Article 3(4)(b).

8 SCM Agreement, Article 3.1(a); see also Basic Regulation, Article 3(4)(a).

9 SCM Agreement, Article 3.1(b), footnote 4. See also Basic Regulation, Article 3(4)(a). For a perhaps questionable illustration of the factual contingency test see *Australian subsidies to producers and exporters of automotive leather* - Panel Report WT/DS126/R.

10 This item is followed by an important footnote 59 which is discusssed in section 2.2 below.

(g) The exemption or remission, in respect of the production and distribution of exported products, or indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.

(h) The exemption, remission or deferral of prior-stage cumulative indirect taxes on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like prior-stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided however, that prior stage cumulative indirect taxes may be exempted, remitted or deferred on exported products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the prior-stage cumulative indirect taxes are levied on inputs that are consumed in the production of the exported product (making normal allowance for waste).[11]

(i) The remission or drawback of import charges in excess of those levied on imported inputs that are consumed in the production of the exported products (making normal allowance for waste); provided, however, that in particular cases a firm may use a quantity of home market inputs equal to, and having the same quality and characteristics as, the imported inputs as a substitute for them in order to benefit from this provision if the import and the corresponding export operations both occur within a reasonable time period, not to exceed two years.[12]

It is not difficult to see why, in the first two examples, (e) and (f), relating to direct taxation that government revenue is foregone or not collected when goods are exported. Such revenue is "otherwise due" in the sense that it is due when goods are not exported. There is therefore a fiscal subsidy contingent on export performance. The principle is easy to grasp in the abstract, but it gave rise to considerable debate in the *US Foreign Sales Corporation Case* discussed below.

It is not so readily apparent why government revenue is foregone or not collected in the three examples relating to indirect taxation. None of these were at issue in the *US Foreign Sales Corporation Case*, but they are commonly met in anti-subsidy cases. Item (g) recognises that indirect taxes are a tax on consumption and therefore need not be levied on products which are exported. It is therefore

11 The remainder of the text explains that this item is to be interpreted in accordance with the guidelines on consumption of inputs set out in Annex II to the SCM Agreement.

12 The remainder of the text explains that it is to be interpreted in accordance with the guidelines on consumption of inputs contained in Annex II to the SCM Agreement and the guidelines on the determination of substitution drawback systems as export subsidies contained in Annex III to the same Agreement.

permissible to reimburse "upstream" indirect taxes in respect of exported products without giving rise to a subsidy. There will only be a subsidy to the extent, if any, that the amount of indirect taxes reimbursed exceeds the amount levied on the same goods when destined for domestic consumption. It can be seen that this item (g) deals, in particular, with the problem of excessive remission of value-added taxes in respect of exported goods.[13]

Item (h) deals with a situation similar to that in item (g) except that the "upstream" or "prior-stage" indirect taxes are cumulative. The same principle applies. The upstream taxes actually borne by the product during manufacture may be reimbursed. It is, however, more difficult to measure the upstream tax when one is dealing with cumulative tax systems as opposed to neutral value-added tax systems. Item (h) therefore provides two alternative measures. The first measure is obtained by reference to the amount of tax borne by the product when sold for domestic consumption. Alternatively, the measure of the tax borne by the exported product can be determined as the sum of the prior-stage taxes borne by all the inputs actually consumed in the manufacture of the product.

Item (i) is similar to item (h) except that it deals with remission of import charges rather than remission of indirect taxes. The principle applicable here is the same as that applicable to inward processing. Import duties need not be imposed on inputs which are incorporated into a product which is subsequently exported. Any remission of import charges in excess of the amount borne by imported inputs would, of course, constitute a subsidy. Item (i) differs from item (h) in that it recognises the possibility of substituting home produced inputs for the imported inputs. In other words, a producer may import 100 tonnes of inputs and use them to make widgets for sale on the domestic market, and use 100 tonnes of similar inputs produced locally and use them to make widgets for export, provided the two-year time limit is respected and provided also that certain conditions as to verification and control laid down in Annex III to the SCM Agreement are respected.

1.4 WTO Remedies Against Prohibited Subsidies

The basic principle of the SCM Agreement is that WTO member countries should not grant or maintain export or domestic input subsidies, i.e. prohibited subsidies.[14] Where a member country has reason to believe that a prohibited subsidy is being granted or maintained by another member country, it may request

13 See footnote 60 to item (h) in the Illustrative List in Annex I to the SCM Agreement.

14 SCM Agreement, Article 3.2.

consultations with such other member.[15] The request for consultation must contain a statement of available evidence with regard to the existence and nature of the subsidy in question,[16] a requirement which was the subject of the *US Foreign Sales Corporation Case* discussed later. The purpose of such consultations is to clarify the facts and seek to arrive at a mutually agreed solution.[17] The deadline for completion of such consultations is 30 days, on the expiry of which any party to the consultations may refer the matter to the WTO Dispute Settlement Body for the establishment of a Panel.[18] The Panel is required to submit a final report within 90 days of the date of its composition and setting of its terms of reference.[19] If the Panel finds that there is a prohibited subsidy it must recommend that the subsidy be withdrawn and set a time limit for withdrawal. The Panel's report is then submitted to the WTO Dispute Settlement Body for adoption.[20] The Dispute Settlement Body must adopt the report within 30 days unless either it decides "by consensus" not to adopt the report, or one of the parties notifies its intention to appeal. The WTO Appellate Body has jurisdiction to overrule the Panel and substitute its own ruling on questions of WTO law, but it does not have jurisdiction to make a new assessment of the facts. The Appellate Body has 30 days in which to report, although this period can be extended to a maximum of 60 days. Once the Appellate Body has issued its report, the Dispute Settlement Body has 20 days in which to adopt the Appellate Body's report or decide "by consensus" not to adopt the report. Once adopted, the member country concerned must comply with the Dispute Settlement Body's recommendation within the time-limit laid down. In the case of non-compliance within the deadline, the complaining member country may apply to the Dispute Settlement Body for authorisation to adopt countermeasures. The question whether the countermeasures authorised are disproportionate may be submitted to arbitration in accordance with Article 22(6) of the WTO Dispute Settlement Understanding.[21] It can be seen, from the foregoing brief discussion, that the dispute settlement procedure under the SCM Agreement provides a remedy which is at least as strong as and certainly a lot quicker than the remedy provided by EC law when, at the suit of the Commission

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15 SCM Agreement, Article 4.1.

16 SCM Agreement, Article 4.2.

17 SCM Agreement, Article 4.3.

18 SCM Agreement, Article 4.4.

19 SCM Agreement, Article 4.6.

20 Set up by the WTO Dispute Settlement Understanding. The dispute settlement procedure under the SCM Agreement is a variant on the general procedure set up by the Understanding.

21 SCM Agreement, Article 4.11.

pursuant to Article 88(2) EC, the Court of Justice rules that an EU Member State has wrongfully failed to comply with a Commission decision that aid be abolished or altered within a prescribed deadline.

1.5 Actionable Subsidies Under the SCM Agreement

Subsidies other than non-actionable subsidies are "actionable" and can be challenged in a procedure similar to that already described for prohibited subsidies[22] provided:

- the subsidy is specific;[23]

- the subsidy causes adverse effects to the interests of other member countries;[24] and

- the request for consultations includes a statement of the available evidence with regard to the existence of the subsidy (and the fact that it is specific) and the adverse effects caused to the interests of other member countries.[25]

The specificity test in the SCM Agreement is the counterpart of the test in Article 88(1) EC according to which state aid comprises measures which favour certain undertakings or the production of certain goods. A subsidy, whether in direct or indirect taxation or otherwise, will be specific if it can be granted only to an enterprise or group of enterprises, i.e. it is not generally available. Where there are objective criteria governing the eligibility for, and the amount of the subsidy, the specificity criterion is not satisfied provided that eligibility is automatic and the criteria and conditions are adhered to strictly. Thus, even where there are objective criteria laid down in an official document, a subsidy may still be specific if *de facto* it is only granted to, or is granted in disproportionately large amounts, to certain enterprises. For the avoidance of doubt, the SCM Agreement provides that the setting or change of generally applicable tax rates by all levels of government entitled to do so shall not be specific.[26] This is similar to the rule of EC state aid law, according to which fiscal measures of economic policy that apply to all economic operators on the basis of objective criteria do not constitute aid.

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22 See SCM Agreement, Article 7. Some of the deadlines are different.

23 SCM Agreement, Article 2.

24 SCM Agreement, Article 5.

25 SCM Agreement, Article 7.2.

26 SCM Agreement, Article 2.2.

The adverse effects test is the counterpart of the rule in Article 88(1) EC according to which state aid is incompatible with the common market to the extent that it distorts or threatens to distort competition and affects trade between Member States. Adverse effects here means one of three things, none of which has anything to do with taxation:

1. injury to the domestic industry of another Member of the kind that would warrant the opening of a countervailing investigation pursuant to Part V of the SCM Agreement. This means[27] (i) material injury to the Community industry; (ii) threat of material injury to the Community industry; or material retardation of the establishment of such an industry and is assessed by applying the detailed provisions of Articles 15 and 16 of the SCM Agreement;[28]

2. nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994 in particular the benefits or concessions bound under Article II of GATT 1994; or

3. serious prejudice to the interests of another Member. Serious prejudice is defined in Article 6 of the SCM Agreement and means broadly cases where the total *ad valorem* subsidisation of a product exceeds 5%, or the subsidies are to cover operating losses sustained by an industry other than non-recurrent measures to provide time to develop long-term solutions and to avoid acute social problems in a particular enterprise.

It can be seen from the foregoing that there is a material difference between prohibited subsidies and actionable subsidies. A subsidy other than a prohibited subsidy or a non-actionable subsidy will only be actionable if it is proved that the subsidy is specific and that it causes adverse effects to the interests of other member countries. Prohibited subsidies, on the other hand, are deemed to be specific and to produce adverse effects.[29]

1.6 Non-Actionable Subsidies

As has already been indicated, certain subsidies are not actionable, namely subsidies which are not specific and subsidies which fall within certain exempted categories. The exempted categories comprise certain subsidies for research activities, certain regional subsidies and certain environmental subsidies. In all

27 GATT 1994, Article VI.

28 See also Basic Regulation, Articles 8 and 9.

29 SCM Agreement, Articles 2.3 and 3.2.

three cases the quantitative and qualitative criteria set out in Article 8 of the SCM Agreement have to be satisfied.[30] The question whether a fiscal subsidy was "actionable" or "non-actionable" did not arise in the *US Foreign Sales Corporation Case* and will not be examined in greater detail here. Suffice it to observe that the issue has arisen in several countervailing cases brought by the European Community against India.[31]

1.7 Countervailing Measures

A WTO member country may take countervailing action against subsidies, other than "non-actionable" subsidies, by imposing countervailing duties or accepting undertakings to increase prices or remove the subsidy. In such cases it is necessary to show that there is a subsidy which is specific, and that imports of the subsidised product are causing injury to the domestic producers of the like product. The only distinction between "prohibited" and "actionable" subsidies for countervailing purposes is that a prohibited subsidy is deemed to be specific.[32] For both prohibited and actionable subsidies, however, it is necessary to prove that injury is being caused.[33] In Community law there is an additional requirement before countervailing measures can be imposed: it must be shown that it is in the Community interest to adopt countervailing measures. It would not, however, be appropriate to take countervailing action if remedies pursued under the SCM Agreement have removed the injury caused by the subsidies.[34]

The procedure for adopting countervailing measures is governed by internal domestic law, which must, nevertheless, conform to the principles laid down by Part IV of the SCM Agreement. The Community has seen to this by incorporating, almost word for word, the provisions of Part IV of the SCM Agreement into the Basic Regulation. The details of the procedure do not concern us here. Suffice it to say that the procedure is usually initiated pursuant to a complaint by the Community producers of the like product to the imported subsidised product.[35] Before the procedure is initiated the Community must enter into consultations with the exporting country to see whether a solution can be

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30 SCM Agreement, Article 8; see also Basic Regulation, Article 4.

31 E.g. *PET film from India*, OJ L316, 10.12.99, p.1 at p. 7, recital (75).

32 SCM Agreement, Article 2.3.

33 GATT 1994, Article VI and SCM Agreement, Article.

34 This follows from the injury requirement for the imposition of countervailing measures. See Basic Regulation, Articles 1(1) and 32.

35 Basic Regulation, Article 10.

worked out.[36] Once the procedure has been initiated, the government of the exporting country, the exporters, the importers in the Community and the Community producers of the like product are all requested to fill out a questionnaire and to submit to an on-the-spot verification of the information given in the questionnaire. There is no obligation to complete a questionnaire or submit to an on-the-spot verification, but failure to do so enables the Commission to make findings on the basis of the facts available.[37] Interested parties including consumer organisations are entitled to a hearing, while the exporting country, exporters, importers and Community producers are also entitled to prior disclosure of the details underlying the essential facts on the basis of which countervailing measures will be adopted.[38] If the Commission determines (i) that there is a subsidy which is specific and which is not in the category of non-actionable subsidies, (ii) that the subsidy is causing injury to the Community industry, and (iii) that it is in the Community interest to adopt protective measures, it may propose to the Council that countervailing duties be imposed.[39] The Council can adopt the proposal by a simple majority. The whole procedure cannot exceed 13 months duration.[40]

Recent examples of imposition of countervailing measures by the European Community for tax subsidies can be found in the case of *Stainless steel bars from India and South Korea*.[41] In the case of India certain categories of producers could claim a corporation tax exemption on profits realised from exports. Not surprisingly, the Commission found that this constituted an export subsidy. The highest individual rate of subsidisation found just for the corporate tax element was 5.9% (although there were other subsidy elements, including excessive drawback of indirect taxes, which took the highest total subsidy margin up to 24.4%). Thus the Indian exporters concerned were made subject to EC countervailing duties of up to 24.4% on their exports of steel bars to the European Community. The fiscal subsidies in South Korea consisted of a variety of provisions allowing tax free reserves to be constituted but these were all less than 0.5% of the export value.

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36 SCM Agreement, Article 13.1.

37 Basic Regulation, Article 28.

38 Basic Regulation, Article 30, and, as far as concerns the Community interest, Article 31.

39 Basic Regulation, Article 15. The Commission may also accept undertakings to remove the subsidy (Article 13) or terminate the proceedings without measures if the case is not made out (Article 14). Note that, during the investigation, the Commission itself has power to impose provisional countervailing duties for a maximum of four months to prevent further injury pending the completion of the investigation (Article 12).

40 Basic Regulation, Article 11(9). This is shorter than the 18 month maximum imposed by Article 11.11 of the SCM Agreement.

41 Commission Regulation (EC) 618/1999, OJ L79, 24.3.99, p.25 (provisional duties).

1.8 Subsidies under the WTO Agreement on Agriculture

By virtue of Article 8 of the Agreement on Agriculture, all WTO members undertake not to provide export subsidies otherwise than in conformity with the Agreement and with the individual commitments specified in Part IV of their schedules to the GATT 1994. Certain types of subsidy listed in Article 9 of the Agreement on Agriculture are subject to reduction commitments. Article 10.1 of the Agreement provides that all subsidies not subject to reduction commitments under Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments; nor shall non-commercial transactions be used to circumvent such commitments.

Export subsidies which conform to the provisions of Part V of the Agreement, that is to say, with Articles 8, 9 and 10, can be subject to countervailing action but are exempt from action based on Article 3 (prohibited subsidies) or Articles 5 or 6 (actionable subsidies) of the SCM Agreement.[42]

The Agriculture Agreement introduced new disciplines on domestic support measures. Generally speaking, domestic support measures which conform fully to the provisions of Article 6 and Annex 2 to the Agreement on Agriculture are non-actionable for the purposes of countervailing duties, and are exempt from actions based on Part III of the SCM Agreement, principally Articles 5 and 6 thereof relating to actionable subsidies.

2.1 The US Foreign Sales Corporation Case

In 1971, at a time of increasing trade deficit, the Nixon administration introduced the Domestic Sales Corporation (DISC) legislation to promote US exports. The European Community objected to the DISC legislation and took the matter before the GATT. In 1981 a GATT panel report was adopted declaring the DISC legislation an illegal subsidy contrary to Article XVI(4) of the GATT 1947. The Panel report was adopted and, at the same time, the GATT Council adopted an understanding that tax systems which only tax income generated within the jurisdiction, like those of most EU Member States, do not constitute export subsidies (hereinafter referred to as "the 1981 GATT Council Action"). This understanding will be examined in greater detail below.
In 1984 the US replaced the DISC scheme with the FSC scheme. The FSC (Foreign Sales Corporation) was designed to be functionally equivalent to the DISC but defendable under GATT 1947.

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[42] SCM Agreement, Article 13(c).

An FSC is a corporation created, organised and maintained in a qualified foreign country or US possession outside US customs territory in accordance with the requirements of sections 921-927 of the US Internal Revenue Code. An FSC is exempt from US tax on a portion of its gross income attributable to "foreign trading gross receipts", i.e. to gross receipts generated by qualifying transactions. Generally, qualifying transactions are those which involve the sale or lease of "export property". Export property is defined as property satisfying five criteria: (a) held for sale or lease; (b) manufactured, produced, grown, or extracted in the US; (c) by a person other than an FSC; (d) sold, leased or rented for use, consumption, or disposition outside the US; and (e) with no more than 50% of its fair market value attributable to exports. An FSC must meet certain requirements as to foreign presence, notably the establishment of a sales office outside the US customs territory, with management of the corporation (other than a small corporation) taking place outside the US and with economic processes with respect to the qualifying transactions taking place outside the US. A portion of the foreign trade income of the FSC is exempt from US tax. Dividends paid by the FSC out of exempt and non-exempt income generally qualify for a deduction of the full amount of the dividend in the hands of the shareholders. Special rules apply to agricultural co-operatives. Under certain circumstances, all the foreign trade income arising from the sale of agricultural or horticultural products of an FSC controlled by a qualified co-operative will be treated as exempt foreign trade income. However there is no shareholder deduction in respect of dividends.[43]

The European Community contested the FSC scheme from its adoption, but the matter was not pursued while the Uruguay Round negotiations were under way. In 1997 the European Community[44] entered into formal bilateral contacts with the US but no solution was found. The European Community therefore invoked the dispute settlement procedure under the WTO Dispute Settlement Understanding and the SCM Agreement. Consultations in December 1997, February 1998 and April 1998 did not result in a mutually acceptable solution, so the European Community asked for a WTO Panel to be established. A Panel was duly established to consider a complaint by the European Communities with respect to "Sections 921-927 of the Internal Revenue Code and related measures establishing special tax treatment for Foreign Sales Corporations". The Panel report was issued on 8th October 1999.[45] According to the report the US had:

(a) except as provided in the Agreement on Agriculture, acted inconsistently with its obligations under Article 3.1(a) of the SCM

[43] This brief summary is synthesised from the Panel Report, paragraphs 2.1 to 2.4.

[44] In fact, the European Community and the European Coal and Steel Community were involved, but reference will only be made to the European Community herein.

[45] WT/DS108/R.

Agreement by granting or maintaining export subsidies prohibited by that provision; and

(b) acted inconsistently with its obligations under Article 3.3 of the Agreement on Agriculture (and consequently with its obligations under Article 8 of that Agreement):

- by providing export subsidies listed in Article 9.1 (d) of the Agreement on Agriculture in excess of the quantity commitment levels specified in the United States' Schedule in respect of wheat; and

- by providing export subsidies listed in Article 9.1 (d) of the Agreement on Agriculture in respect of all unscheduled products.[46]

The Panel report was adopted and the US was given until 1st October 2000 to withdraw the FSC scheme, but the US appealed. The Appellate Body's report, issued on 24th February 2000, confirmed the findings of the Panel.[47] The Panel report is some 294 pages compared with 61 pages for the Appellate Body's report. There were many procedural and substantive issues, many of which lost their relevance as the case evolved. The discussion below will concentrate on the main strand of the argumentation, namely did the FSC regime constitute an export subsidy and/or a domestic input subsidy prohibited by the SCM Agreement and the WTO Agreement on Agriculture, and, if so, had the European Community adduced sufficient evidence of the existence of such subsidy.

2.2 The FSC Regime Constituted An Export Subsidy Prohibited by the SCM Agreement

In order to come to the conclusion that the FSC regime constituted a prohibited export subsidy, the Panel had first to determine whether there was a subsidy. The answer to this question turned on whether, within the meaning of Article 1.1(a)(ii) of the SCM Agreement, " revenue which is otherwise due, is forgone ...". Second the Panel had to determine whether the FSC regime conferred a benefit. Having found that revenue was indeed foregone and that a benefit was thereby conferred, the Panel had to decide whether the subsidy thus determined was contingent on export performance or on use of domestic inputs and

46 Panel Report, para. 8.1.

47 WT/DS108/AB/R.

therefore "prohibited". The question whether the FSC regime provides benefits contingent upon export performance appears to have been conceded implicitly by the US when it criticised the simplistic approach of the European Community in the following terms: "the EC, in effect, has done nothing more than point out what is plain for all to see - namely, that the FSC is a tax exemption which pertains to exports."[48] The Panel itself had no difficulty in concluding that the FSC tax exemptions were specifically related to exports and fell within item (e) of the Illustrative list of export subsidies. This point was not appealed by the US. The whole thrust of the US appeal was that it could not be said that revenue otherwise due had been foregone within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement when read in the light of footnote 59 to that Agreement and the 1981 GATT Council Action.

The Panel considered that, in determining whether revenue was otherwise due, one had to look at the tax regime of the country alleged to be granting a subsidy and examine what would be the situation under that regime "but for" the measure complained of.[49] The Panel observed that, "viewed as an integrated whole, the exemptions provided by the FSC scheme represent a systematic effort by the United States to exempt certain types of income which would be taxable in the absence of the FSC scheme."[50] The Appellate Body supported the Panel's approach in the instant case, but observed that the "but for" test would not always be appropriate. The Appellate Body considered that it would not be difficult to circumvent the "but for" test by designing a tax regime under which there would be no general rule that applied formally to the revenues in question, "but for" the contested measure.[51] The Appellate Body preferred to say that a WTO member country is free to tax or not to tax any particular categories of revenues it wishes, provided it respects its WTO obligations in both cases. "What is 'otherwise due', therefore, depends on the rules of taxation that each Member, by its own choice, establishes for itself".[52]

Next, in response to arguments raised by the US, the Panel considered whether the reading of the term "otherwise due" was affected by the 1981 GATT Council Action. As already mentioned, the 1981 GATT Council Action arose out of four disputes, commonly known as the Tax Legislation cases. These cases involved tax measures of France, Belgium, the Netherlands and US, each

[48] Panel report, paragraph 7.112.

[49] Panel report, paragraphs 7.41 to 7.48.

[50] Panel report, paragraph 7.100.

[51] Appellate Body report, paragraph 91.

[52] Appellate Body report, paragraph 90, last sentence.

of which was alleged to involve export subsidies contrary to Article XVI(4) of GATT 1947.[53] The Panel reports in the Tax Legislation cases were highly controversial and resulted in several years of deadlock. By the time the reports were adopted some of the parties had become parties to the Tokyo Round Subsidies Code. When the reports were adopted the GATT Council issued the following statement:

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

The Panel concluded that the 1981 GATT Council Action was not a legal instrument with binding legal force on all contracting parties and so did not form part of the GATT 1994. Although the Panel went on to find that the 1981 Council Action was a decision which guided the WTO under Article XVI(1) of the WTO Agreement, it considered that the 1981 GATT Council Action was not relevant to the dispute because it was limited to Article XVI(4) of the GATT 1947 which differs "dramatically" from the export subsidy disciplines in the SCM Agreement.

The Panel then considered whether the reading of the term "otherwise due" was affected by footnote 59 to item (e) of the Illustrative list of export subsidies set out in Annex I to the SCM Agreement. The US argued that footnote 59 shows that tax on income arising from foreign economic processes is not "otherwise due". Footnote 59 reads as follows:

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[53] Article XVI (4) provided as follows:

> Further, as from 1st January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product at a price lower than the comparable price chargd for the like product to buyers in the domestic market. Until 31st December 1957 no contracting party shall extend the scope of any such subsidisation beyond that exsisting on 1st January 1955 by the introduction of new, or the extension of existing, subsidies.

> "The Members recognise that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected.[54] 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 prices 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 practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of 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 double taxation of foreign source income earned by its enterprises or the enterprises of another Member."

The Panel observed that there is nothing in footnote 59 to show that, where a WTO member country chooses to tax income from foreign economic processes, and decides in a selective manner to exclude certain categories of such income from taxation, revenue is not foregone.[55]

Thus, in summary, the Panel found that revenue was clearly foregone and this was not affected by the 1981 GATT Council Action or by footnote 59 to the SCM Agreement.

In so far as the US appeal related to the question whether revenue was foregone, the arguments were limited to saying that footnote 59 as confirmed by the 1981 GATT Council Action showed that the FSC regime was not an export subsidy. The Appellate Body chose to analyse footnote 59 sentence by sentence - a cumbersome way of proceeding.[56] The Appellate Body disposed of the first sentence by briefly remarking that the FSC regime does not involve the deferral of direct taxes. The second sentence expresses the arm's length principle in allocating export sales revenues. The US argument was that it is implicit in the arm's length principle that a WTO member country is not obliged to tax foreign source income, and if it does tax such income, it may tax

[54] This sentence is transposed in the Basic Regulation, Article 3(4)(a). The rest of footnote 59 is not transposed in the Basic Regulation.

[55] Panel report, paragraph 7.92.

[56] Appellate Body report, paragraphs 97 to 100.

it less than it taxes domestic-source income. Since there is no requirement to tax export-related foreign source income the US argued that a government cannot be said to forego revenue "otherwise due" if it elects to tax such income. The Appellate Body pointed out the fallacy in this argument. In principle, WTO law does not require that any form of income be subject to direct taxation, and so, on the US argument, revenue would never be foregone. The Appellate Body went on to observe that the real issue was not whether a WTO member country was or was not obliged to tax a particular category of foreign source income. Rather, having decided to tax a particular category of foreign source income, namely foreign source income that is effectively connected with a trade or business within the United States, the question was whether the US was permitted to carve out an export contingent exemption from the category of foreign source income that is taxed under its other rules of taxation. The Appellate Body took the view that the second sentence of footnote 59 of the SCM Agreement did not address this question.

The third and fourth sentences of footnote 59 relate to remedies and so were found by the Appellate Body to have no bearing on the matter at issue.

The fifth sentence provides food for thought. The US argued that the FSC regime was a measure to avoid double taxation and so was not an export subsidy prohibited by item (e) of the Illustrative List of Export Subsidies set out in Annex I to the SCM Agreement. At first sight, this would seem to be the strongest argument that the US made in relation to footnote 59, although the result would depend on a detailed analysis of the way the FSC regime actually worked. The Appellate Body refused to entertain this argument on the grounds that the matter had not been raised before the Panel and therefore the Appellate Body had no jurisdiction to rule on the matter.[57]

Next, the US argued that the 1981 GATT Council Action referred to above was an "authoritative interpretation" of Article XVI(4) of the GATT 1947 that has "general" application binding all GATT members and so was incorporated into GATT 1994 when the Uruguay Round agreements were signed. The Appellate Body decided that the 1981 GATT Council Action was limited to resolving a particular dispute and was not of general application. This conclusion was supported by the fact that, when the 1981 GATT Council Action was adopted, the Chairman of the Council issued a statement according to which the action did "not affect the rights and obligations of the contracting parties". The Appellate Body therefore upheld the Panel's finding that the 1981 GATT Council Action was not any "other decision" under paragraph 1(b)(iv) of the

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[57] Appellate Body report, paragraphs 101 and 102.

language incorporating the GATT 1947 into the WTO Agreement and did not therefore form part of the GATT 1994.[58]

Notwithstanding the fact that the 1981 Council Action did not form part of the GATT 1994, the Appellate Body examined whether the 1981 GATT Council Action could provide "guidance". The US submitted that the 1981 GATT Council Action, read together with footnote 59 to the SCM Agreement provided guidance as to whether or not the FSC regime was an export subsidy. The Appellate Body observed that the 1981 GATT Council Action interpreted Article XVI(4) of GATT 1947 at a time when the Tokyo Round Subsidies Code had just been signed. The Council Chairman's statement issued at the time that the 1981 Council Action did not affect the Tokyo Round Subsidies Code. From this the Appellate Body concluded that the 1981 GATT Council Action could not have affected the SCM Agreement which did not even exist in 1981 and which, in any event, was a quite different measure. Article XVI(4) of the GATT 1947 prohibits export subsidies only when they result in the export sale of a product at a price lower than the "comparable price charged for the like product to buyers in the domestic market" whereas Article 3.1(a) of the SCM Agreement contains a much broader prohibition of any subsidy which is "contingent on export performance".[59]

In wrapping up its findings in relation to Article 3.1(a) of the SCM Agreement, the Appellate Body observed that, even if the 1981 GATT Council Action should be taken into consideration, it did not provide an answer to the question whether having decided to tax a particular category of foreign-source income, namely foreign source income that is "effectively connected with a trade or business within the United States", the United States may provide an export contingent exemption from the category of foreign source income that is taxed under its other rules of taxation.[60]

2.3 The Export Subsidy Elements of the FSC Regime were Inconsistent with the WTO Agreement on Agriculture

The Panel found that the US FSC regime provided export subsidies of the kind listed in Article 9.1 (d) of the Agreement on Agriculture in excess of the quantity commitment levels specified in the US Schedule in respect of wheat. More generally, the Panel found that the US FSC regime provided export

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58 Appellate Body report, paragraphs 104 to 114.

59 Appellate Body report, paragraphs 115 to 119.

60 Appellate Body report, paragraph 120.

subsidies listed in Article 9.1(d) in respect of all unscheduled products. Article 9.1(d) sets out one of the categories of export subsidy in respect of which WTO member countries have undertaken reduction commitments. This category is:

> "the provision of subsidies to reduce the costs of marketing exports of agricultural products (other than widely available export promotion and advisory services including handling, upgrading and other processing costs, and the costs of international transport and freight."

The Panel considered that the term "the costs of marketing exports" was wide enough to encompass the costs arising from corporate taxation of the profits of marketing exports. The Appellate Body did not agree with this approach. It considered that if corporate taxation fell within this category, then so too did practically any other cost of doing business.[61] The Appellate Body therefore examined the alternative claim made by the Community under Articles 8 and 10.1 of the Agreement on Agriculture. Article 8 provides that:

> "Each Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member's Schedule."
>
> while Article 10.1 provides that:
>
>> "Export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments."

The Appellate Body observed that the FSC regime creates a legal entitlement for an FSC to receive export subsidies not listed in Article 9.1 of the Agreement on Agriculture with respect to both scheduled and unscheduled products. Moreover, there is no limitation on the amount of exempt foreign trade income that can be earned by an FSC. Therefore there is no mechanism for stemming or otherwise controlling the flow of FSC subsidies that may be claimed with respect to any agricultural product.[62] Article 3.3 of the Agreement on Agriculture prohibits a WTO member country from providing export subsidies listed in Article 9.1 to any unscheduled agricultural products and limits the amount of such subsidies on scheduled agricultural products. Since the FSC regime allows unlimited export subsidies to be provided, the Appellate Body concluded that the regime threatened to lead to circumvention of export subsidy commitments in breach of Article 10.1. It followed,

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[61] Appellate Body Report, paragraph 131.

[62] Appellate Body Report, paragraph 149.

therefore, that the US had acted inconsistently with its obligation under Article 8 of the Agreement on Agriculture "not to provide export subsidies otherwise than in accordance with this Agreement".[63]

2.4 No Need to Rule on Whether the FSC Regime Constituted a Domestic Input Subsidy

Before the Panel the European Community claimed that the FSC benefits under the FSC regime are contingent upon the use of domestic over imported goods. This claim was based on the fact that the definition of export property in Section 927(a)(1)(C) of the US Internal Revenue Code provides that export property is property "not more than 50% of the market value of which is attributable to articles imported into the United States". The Panel considered that it did not need to examine this claim since it had already found that the FSC regime constituted a prohibited export subsidy.[64] The European Community therefore made a counter-appeal in the event that the Appellate Body reversed or modified some aspect of the Panel's findings so that it would be necessary to complete the Panel's work or in the event that the Appellate Body considered that the US could implement the recommendations and rulings of the Dispute Settlement Body in this case without removing the requirement in section 927(a)(1)(C) of the Internal Revenue Code just cited. The Appellate Body refused to entertain this counter-appeal on the grounds that, since it had upheld all the Panel's findings under the SCM Agreement, there was no need to complete the Panel's work. Second, the Appellate Body refused to speculate on the ways in which the US might choose to implement the rulings and recommendations of the Dispute Settlement Body.[65]

The position taken by the Panel and the Appellate Body may appear surprising, upon a cursory reading. However, a closer examination of the way the FSC regime functioned will demonstrate that abolition of the export subsidy element in the FSC regime would necessarily result in abolition of the domestic input element. The Panel's explanation of this point is clearer than that given by the Appellate Body. As the Panel rightly observed, the definition of export property served merely to define the scope of the export contingent tax exemption available under the FSC regime. In order to comply with the Appellate Body's recommendation the US would have to abolish the tax exemption under the FSC regime. Once this had been abolished, the definition

63 Appellate Body Report, paragraphs 150 to 154.

64 Panel Report, paragraph 7.132.

65 Appellate Body report, paragraph 175.

of export property would cease to have any purpose. There was therefore, no need for the Panel or the Appellate Body to rule on the issue of domestic inputs. Indeed, the Panel noted in footnote 698 to its Report that the parties concentrated all their arguments on Article 3.1(a) of the SCM Agreement and the issues relating to Article 3.1(b) were not thoroughly explored by either party.

2.5 The Requirement that the Claimant Produce Evidence of the Existence and Nature of the Subsidy

Before the Panel the US entered a preliminary objection that the claim by the European Community under Article 3 of the SCM Agreement should be dismissed because the request for consultations did not include a "statement of available evidence" as required by Article 4.2 of the SCM Agreement. The European Community argued that, by referring to Sections 921-927 of the Internal Revenue Code, it had identified the legal provisions which contained all the necessary evidence of the existence of a prohibited subsidy. The Panel was non-committal on whether the European Community had supplied a full statement of the available evidence. In any event, the Panel was of the opinion that there was no disposition of the Dispute Settlement Understanding or the SCM Agreement which required it to dismiss a claim under Article 3 of the SCM Agreement as a consequence of a failure to comply with Article 4.2 of that Agreement.[66] Moreover, the Panel rejected the US's argument that its rights to due process had been violated by the failure of the European Community to provide a statement of available evidence.[67] The Appellate Body did not approve of the Panel's "relaxed treatment" of the obligation of the claimant to provide not merely evidence of the existence of the subsidy but also of its character. Notwithstanding this, the Appellate Body upheld the Panel's findings on different grounds. The Appellate Body observed that the first time the US raised the formal objection to the European Community's request for consultations was more than a year after such request was made, during which time three sets of consultations had been held. In the light of these circumstances the Appellate Body was of the opinion that the US could not ask that the European Community's claim be dismissed for want of an adequate statement of available evidence with regard to the existence and nature of the subsidy in question. In coming to this conclusion, the Appellate Body relied on the obligation imposed on to WTO member countries by Article 3.10 of the Dispute Settlement Understanding to engage in dispute settlement procedures

66 Panel Report, paragraph 7.7.

67 Panel Report, paragraph 7.10.

"in good faith in an effort to resolve the dispute".[68] The final word of the Appellate Body on this point could well be adopted by other tribunals: "The procedural rules ... are to promote, not the development of litigation techniques, but simply the fair, prompt and effective resolution of ... disputes".

3.0 Conclusion

The *US Foreign Sales Corporation Case* shows that, by signing up to the WTO Agreements, WTO member countries have effectively fettered their sovereign freedom of taxation. In the *US Foreign Sales Corporation Case* the Appellate Body went out of its way to say that its ruling does not oblige a WTO member country to choose one kind of tax system over another. In particular, it stated that the ruling does not address the relative merits of "worldwide" and "territorial" systems of taxation.[69] Nevertheless, the inescapable fact is that, whatever system of taxation a WTO member country chooses, it must apply that system in a manner which is neutral vis-à-vis earnings from export performance. This is true not only for industrial goods but also for agricultural goods, except to the extent that the subsidy elements in respect of agricultural products fall within the commitments contained in Part IV of that member's Schedule to the GATT 1994. The *US Foreign Sales Corporation Case* is interesting also for the way in which it transforms what at first sight appears to be an issue for trade lawyers into an issue for tax lawyers. Since the US FSC regime conferred benefits contingent on export performance, any subsidy element was necessarily a prohibited subsidy within the meaning of the SCM Agreement and therefore actionable without proof of any "adverse effects".[70] All the argument, therefore, turned on an analysis of the fiscal effects of the scheme. If, on the other hand, the tax scheme under challenge had not been contingent on export performance, but had provided reduced taxation for a particular sector of US industrial production, irrespective of whether the goods were exported or sold domestically, that would have been a subsidy specific to the particular sector in question. Such a subsidy would not have been a "prohibited" subsidy, but would have been actionable if it had been shown to be causing injury to a Community industry, to be nullifying or impairing benefits to the European Community or to be causing "serious prejudice"[71]. In such a hypothesis, the fiscal aspects of the case might well have been eclipsed by arguments typical of any anti-dumping or subsidy dispute.

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68 Appellate Body Report, paragraph 166.

69 Appellate Body Report, paragraph 179.

70 SCM Agreement, Article 5.

71 As defined by Article 6 of the SCM Agreement.

It is interesting to consider what might have happened if the US FSC regime had been the subject of a countervailing proceeding under the Basic Regulation. For this to happen, a particular Community industry, let us say "the widget industry", would have had to file a complaint with the European Commission making out a *prima facie* case that the US producer-exporters of widgets were causing injury to the Community industry by reason of the increased quantities of widgets exported to the Community, the low prices of such widgets and the adverse effects of such increased volumes and low prices on the Community industry. In addition, the complaint would have had to make out a *prima facie* case that the exports of US widgets were subsidised. This might not appear all that difficult at first sight: it would simply be a matter of convincing the case handlers of the Commission's anti-dumping/anti-subsidy unit that the US FSC regime constitutes the foregoing of revenue which is contingent on export performance and is therefore deemed to be specific. However, assuming that the arguments made in the complaint prevailed throughout the 13-month investigation period so as to result in the imposition of countervailing duties, the US Government would almost certainly have invoked the WTO Dispute Settlement Understanding and the SCM Agreement in order to contest the finding that there was a prohibited export subsidy. Thus the case would have ended up with a WTO Panel examining the same issue as in the "direct" action discussed above. It should also be observed that the US budgetary cost of the FSC regime was around US$ 3.5 billion per year for annual exports worth around US$ 250 billion, which explains why the European Community was concerned generally about the scheme. It can be seen that, on average, the rate of subsidisation was 1.4% which is scarcely above the 1% *de minimis* threshold for the imposition of countervailing measures.[72] Thus few industries would probably have found it worthwhile to bring a countervailing complaint limited to their particular sector of activity. Such individual action would only have been worthwhile in relatively few cases where there was a concentration of use of the FSC regime so that the rate of subsidisation was well above the average for US exporters as a whole.

Until the Uruguay Round of multilateral trade negotiations gave birth to an Agreement on Agriculture, the Community was reluctant to take countervailing proceedings against imports of subsidised products from third countries, for fear of attracting retaliation against its own subsidies granted under the Common Agricultural Policy.[73] The Agreement on Agriculture now defines

72 SCM Agreement, Article 11.9; Basic Regulation, Article 14(5).

73. Thus at the end of 1994 only two products were subject to EC countervailing measures compared with over 60 products subject to anti-dumping measures - Thirteenth Annual Report from the Commission to the European Parliament on the Community's Anti-dumping and Anti-Subsidy Activities (1994) COM(95)309 final, at Annex Q thereof.

clearly the permissible types of subsidisation of agricultural produce. Since the Uruguay Round there has been a marked increase in the number of countervailing cases brought by the European Community against exporting countries.[74] These cases have involved subsidy elements arising, *inter alia*, out of excessive drawback of indirect taxes, and/or exemption from direct taxes.

Looked at from a fiscal point of view, a countervailing duty can be likened, very broadly speaking, to an anti-avoidance measure whereby the fiscal advantage of establishing production in a country with a favourable tax regime is neutralised by a compensating charge to tax or disallowance of expenses in a country without the favourable tax regime. This analogy serves to illustrate how EC countervailing law is an essential part of strategic international tax planning alongside EC corporate tax law, EC indirect taxation and EC customs law. This, combined with the possibility of assisting governments in bringing "direct" actions under WTO dispute settlement mechanisms, opens up new vistas for EC tax practitioners and heralds new styles of practice in which collaboration with trade lawyers and economists will be essential.

[74] No cases were initiated in 1995 and 1996. Then, in 1997, four countervailing investigations were initiated, five in 1998 and four in 1999.