

The FSC/ETI Controversy

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Gestation of the Dispute

The current conflict between the U.S. and the European Communities (EC)² regarding taxation of U.S. exports can be traced back to 1971, when the U.S. Congress created Domestic International Sales Corporations (DISCs)³ in an effort to replicate the tax benefits enjoyed by offshore, related exporters in (then) western European countries.⁴ The EC filed a complaint⁵ alleging the DISC legislation was an export subsidy and thus violated Article XVI:4 of the General Agreement on Tariffs and Trade (GATT 1947).⁶ The U.S. responded by filing similar complaints regarding the territorial income tax practices of Belgium, France, and the Netherlands.⁷ In July 1973, the GATT Council established panels to adjudicate the four

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² The EC is one of the “three pillars” of the European Union, the others being the Common Foreign and Security Policy and the Cooperation in Justice and Home Affairs. *See* Treaty on European Union, Feb. 7, 1992, 1992 O.J. (C 191) 1, 5-58 (titles II, III, IV establishing the EC); George A. Bermann et al., *Cases and Materials on European Community Law* 3 (Supp. 1998).

³ Revenue Act of 1971, Pub. L. No. 92-178, § 501; 85 Stat. 497 (1971).

⁴ *See* GATT Doc. C/M/87 (May 29, 1973 mtg.) at 5. One of those tax benefits was refund of VATs when goods were exported. *See* S. Rep. No. 92-437, at 90 (1971), *reprinted in* 1971 U.S.C.C.A.N. 1825, 1996 (“[O]ther major trading nations encourage foreign trade by domestic producers in one form or another. Where value added taxes or multistage sales taxes are used to any appreciable extent, the practice is to refund taxes paid by the exporter at the time of export and to impose these taxes on importers.”).

⁵ GATT Doc. L/3851 (May 1, 1973).

⁶ General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194 (hereinafter GATT 1947). GATT 1947 art. XVI:4 read:

Further, as from 1 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 for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. Until 31 December 1957 no contracting party shall extend the scope of any such subsidization beyond that existing on 1 January 1955 by the introduction of new, or the extension of existing, subsidies.

⁷ GATT Doc. L/3860 (May 17, 1973).

complaints.⁸ The panel decisions, issued in late 1976, determined that the identified practices of all four nations “had effects” that violated Article XVI:4.⁹ However, adoption of those reports required consensus,¹⁰ at least in practice, and because all four nations disputed the panels’ findings, the GATT Council did not adopt the panel reports until they were modified by the 1981 Understanding.¹¹ That Understanding stated:

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.¹²

The Understanding was accompanied by a paraphrase of a statement made in connection with its adoption by the Chairman of the Council:

Following the adoption of these reports the Chairman noted that the Council’s decision and understanding does not mean that the parties adhering to Article XVI:4 are forbidden from taxing the profits on transactions beyond their borders, it only means that they are not required to do so. He noted further that the decision does not modify the existing GATT rules in Article XVI:4 as they

⁸ WTO, Report of the Panel, *United States – Tax Treatment for “Foreign Sales Corporations,”* WT/DS108/R (Oct. 8, 1999) para. 7.52 (visited Jan. 16, 2003) <<http://docsonline.wto.org:80/DDFDdocuments/t/WT/DS/108R.doc>> (hereinafter, *FSC Panel*). These four cases and their resulting decisions are collectively termed the “Tax Legislation Cases.” *Id.*

⁹ *Id.* & n.616 (citing *Tax Legislation – United States Tax Legislation (DISC)*, L/4422, BISD 23S/98, Report of the panel adopted December 7-8, 1981 para. 74; *Tax Legislation – Income Tax Practice Maintained By France*, L/4423, BISD 23S/114, Report of the panel adopted December 7-8, 1981 para. 58; *Tax Legislation – Income Tax Practice Maintained By Belgium*, L/4424, BISD 23S/127, Report of the panel adopted December 7-8, 1981 para. 40; *Tax Legislation – Income Tax Practice Maintained By The Netherlands*, L/4425, BISD 23S/137, Report of the panel adopted December 7-8, 1981 para. 40).

¹⁰ John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 Am. J. Int’l L. 747, 757 (1978).

¹¹ *Tax Legislation*, L/5271, BISD 28S/114, December 7-8, 1981.

¹² *Id.*

relate to the taxation of exported goods. He noted also that this decision does not affect and is not affected by the Agreement on the Interpretation and Application of Articles VI, XVI and XXIII. Finally, he noted that the adoption of these reports together with the understanding does not affect the rights and obligations of contracting parties under the General Agreement.¹³

The U.S. interpreted the 1981 Understanding as a road map for conforming the DISC legislation to the U.S.'s GATT responsibilities,¹⁴ and on July 18, 1984, it replaced DISCs with Foreign Sales Corporations (FSCs).¹⁵ Where DISCs had been domestic corporations involved in export activities,¹⁶ FSCs had to be non-U.S. corporations so that, pursuant to the 1981 Understanding, their activities would constitute "economic processes . . . outside the territorial limits" of the U.S.¹⁷ The EC protested the FSC legislation immediately and held formal consultations with the U.S. under GATT 1947 Article XXII on March 26, 1985.¹⁸ Following creation of the WTO in 1994,¹⁹ the EC again requested consultations on November 18, 1997, and subsequently requested establishment of a panel to adjudicate its complaint.²⁰

¹³ *Id.*

¹⁴ *FSC Panel*, *supra* note 8, para. 4.310; *see Treasury Explains Foreign Sales Corporation Proposal*, Tax Notes, Feb. 6, 1984, at 440-41 ("The bill was drafted with four objectives: to meet U.S. obligations under GATT; to be revenue neutral with the DISC; to preserve to the extent possible the position of existing DISC users; and to provide incentives for small business.").

¹⁵ Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 801-805, 98 Stat. 494, 985-1003 (codified at I.R.C. §§ 921-927).

¹⁶ I.R.C. § 992(a)(1).

¹⁷ *Tax Legislation*, *supra* note 11; I.R.C. § 922(a)(1)(A) (requiring creation or organization of FSCs in U.S. possessions or foreign countries that meet the information exchange requirements set forth in I.R.C. § 927(e)).

¹⁸ *See* GATT Doc. SR.41/3 (Nov. 26, 1985 mtg.); *see also FSC Panel*, *supra* note 8, para. 4.177.

¹⁹ Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, Uruguay Round of Multilateral Trade Negotiations[:] Legal Instruments Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations Done at Marrakesh on 15 April 1994, vol. 1 (1994) (visited Jan. 16, 2003) <http://www.wto.org/english/docs_e/legal_e/04-wto.doc> (hereinafter WTO Agreement).

²⁰ *FSC Panel*, *supra* note 8, paras. 1.1-1.3.

The FSC Panel Decision

The EC's three-part challenge alleged first that the FSC and, independently, its administrative transfer pricing rules, were a subsidy contingent on export performance contrary to Articles 1²¹ and 3.1(a)²² of the WTO Agreement on Subsidies and Countervailing Measures (SCM)²³ because exporters participating in the FSC program benefited from "government revenue . . . otherwise due [that was] foregone."²⁴ Second, the EC alleged that the FSC subsidy also contravened SCM Article 3.1(b)²⁵ because it was contingent on the use of domestic over imported goods.²⁶ Third, the EC contended that the FSC subsidy violated the WTO Agreement on Agriculture (AA)²⁷ both with respect to scheduled and unscheduled items.²⁸ The Panel agreed with the EC's first and third challenges,²⁹ but it sidestepped the second, stating that its decision that the FSC as a whole was a prohibited export subsidy made independent

²¹ Art. 1.1 reads, in relevant part, "[A] subsidy shall be deemed to exist if: (a)(1) there is a financial contribution by a government or any public body . . . where: . . . (ii) government revenue that is otherwise due is foregone or not collected (e.g., fiscal incentives such as tax credits); . . . and (b) a benefit is thereby conferred." (Footnote omitted). *See* Agreement on Subsidies and Countervailing Measures, *infra* note 23.

²² Art. 3.1(a) reads "Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited: (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I." (Footnotes omitted.) *See* Agreement on Subsidies and Countervailing Measures, *infra* note 23.

²³ Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Uruguay Round of Multilateral Trade Negotiations[:] Legal Instruments Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations Done at Marrakesh on 15 April 1994, vol. 27 (1994) (visited Jan. 16, 2003) <http://www.wto.org/english/docs_e/legal_e/24-scm.doc> (hereinafter SCM).

²⁴ *FSC Panel*, *supra* note 8, para. 7.35.

²⁵ SCM art. 3.1(b) reads "Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited: . . . (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods." SCM, *supra* note 23.

²⁶ *FSC Panel*, *supra* note 8, para. 7.131.

²⁷ Agreement on Agriculture, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Uruguay Round of Multilateral Trade Negotiations[:] Legal Instruments Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations Done at Marrakesh on 15 April 1994, vol. 27 (1994) (visited Jan. 16, 2003) <http://www.wto.org/english/docs_e/legal_e/14-ag.doc> (hereinafter AA).

²⁸ *FSC Panel*, *supra* note 8, para. 7.133.

²⁹ *Id.* para. 8.1.

consideration of FSC's compliance with SCM Article 3.1(b) unnecessary and inappropriate.³⁰ This article does not examine the resolution of the third claim because the Panel's analysis involved only the application of particular terms and conditions in the AA to its finding that the FSC was a prohibited export subsidy.³¹

The Panel began by summarizing the various features of the FSC.³² Then, in addressing the "export performance" complaint, the Panel pursued a two-step analysis. First, it examined whether the FSC was a subsidy as that word was defined in SCM Article 1.³³ Concluding that it was, the Panel next analyzed the FSC subsidy in light of the proscriptions of SCM Article 3 and determined that it was a prohibited export subsidy.³⁴ Within each of these determinations, the Panel considered the U.S. argument that the 1981 GATT Understanding³⁵ and footnote 59 in

³⁰ *Id.* para. 7.132. On similar grounds, the Panel also declined to address the EC's claim that the FSC's administrative pricing rules constituted a separate and independent violation of SCM art. 3.1(a). *Id.* para. 7.128.

³¹ *Id.* paras. 7.133-7.177.

³² *Id.* paras. 2.1-2.8.

³³ *Id.* paras. 7.39-7.103. *See supra* note 21 (relevant text of art. 1).

³⁴ *FSC Panel, supra* note 8, paras. 7.104-7.123.

³⁵ *Tax Legislation, supra* note 11 and accompanying text.

SCM Annex I(e)³⁶ enunciated a “legal principle” that validated the FSC’s limited nontaxation of export income.³⁷

With respect to the determination whether the FSC was a subsidy under SCM Article 1, the Panel again divided its task into two parts: whether the FSC’s exclusion from gross income of certain foreign trade income constituted a “financial contribution” because tax revenue otherwise due was foregone,³⁸ and, if so, whether that contribution was a “benefit” to the recipient.³⁹ As a preliminary matter, the Panel decided that whether revenue otherwise due was foregone required a “but for” test that compared the tax assessed under FSC with the tax regime that “would exist but for” the FSC.⁴⁰

The U.S. effectively disputed this test, arguing that, regardless of the tax that would apply in the absence of FSC, the GATT 1981 Understanding and footnote 59 in SCM Annex I(e) authorized selective nontaxation of extraterritorial “economic processes.”⁴¹ The U.S. referred to

³⁶ Footnote 59 reads:

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 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 the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

SCM, *supra* note 23, at Annex I.

³⁷ *FSC Panel*, *supra* note 8, paras. 7.50-7.51, 7.86-7.92; 7.113-7.120.

³⁸ *Id.* paras. 7.39-7.102.

³⁹ *Id.* para. 7.103.

⁴⁰ *Id.* paras. 7.41-7.48.

⁴¹ *Id.* paras. 4.324-4.331, 4.362-4.382, 4.396-4.399, 4.429-4.433, 4.523-4.542, 4.672-4.732, 4.800-4.803, 4.984-4.989, 4.1004-4.1012, 4.1032, 4.1037-4.1038, 4.1106, 4.1114, 4.1150-4.1154, 4.1161-4.1186, 4.1225, 4.1227.

this concept as the “controlling legal principle” on which the Panel should rely,⁴² and fully one-third of the U.S. argument to the Panel revolved around the enunciation, explanation, and reiteration of this principle.⁴³

First, the U.S. argued that the 1981 Understanding made taxation of offshore transactions optional, either in whole or in part,⁴⁴ and that it governed the Panel as an “authoritative interpretation” of GATT 1947 Article XVI:4.⁴⁵ The Panel determined that the Understanding was not controlling because it did not bind all the parties to GATT, and therefore was neither an “other decision”⁴⁶ under the General Agreement on Tariffs and Trade 1994 (GATT 1994) paragraph 1(b)(iv)⁴⁷ nor a “subsequent practice” of GATT⁴⁸ under Article 31 of the Vienna Convention on the Law of Treaties (VCLT).⁴⁹ It also determined that, while the 1981

⁴² *Id.* paras. 4.431, 4.523, 4.773, 4.1132, 7.86-7.87.

⁴³ The 176 paragraphs listed *supra* in note 41 constitute 1/3 of the 532 paragraphs devoted to U.S. argument in the Panel’s report.

⁴⁴ *FSC Panel, supra* note 8, paras. 4.698-4.699.

⁴⁵ *Id.* paras. 4.533, 7.50.

⁴⁶ *Id.* para. 7.74.

⁴⁷ General Agreement on Tariffs and Trade 1994, Apr. 15, 1994, Uruguay Round of Multilateral Trade Negotiations[:] Legal Instruments Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations Done at Marrakesh on 15 April 1994, vol. 1, 1867 U.N.T.S. 190, 33 I.L.M 1153 (1994) (hereinafter GATT 1994).

⁴⁸ *FSC Panel, supra* note 8, para. 7.76.

⁴⁹ Vienna Convention on the Law of Treaties, 8 I.L.M. 679, 691-92 (1969) (hereinafter VCLT). Article 31, titled “General rule of interpretation,” reads:

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 - (a) any agreement relating to the treaty which was made between all the parties in connexion [sic] with the conclusion of the treaty;
 - (b) any instrument which was made by one or more parties in connexion [sic] with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context:
 - (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
 - (c) any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties so intended.

Understanding *was* a decision under Article XVI:1 of the WTO Agreement,⁵⁰ it was not relevant to the current dispute because the requirements of GATT 1947 Article XVI:4⁵¹ underlying the 1981 Understanding “differ dramatically from the export subsidy disciplines in the SCM Agreement.”⁵²

Next, with respect to footnote 59 in SCM Annex I(e),⁵³ the U.S. argued that the inclusion of language regarding the arm’s length standard implied that “income from foreign economic processes may be exempted from direct taxes.”⁵⁴ The Panel agreed *arguendo* but stated that the U.S. had made “an unwarranted leap of logic from the proposition that ‘income arising from foreign economic processes may be exempted from direct taxes’ to the proposition that [the U.S. was] ‘free to exempt all of such income *or just part of it*’ (emphasis added).”⁵⁵ The Panel then concluded that, while “a decision . . . not to tax *any* income arising from foreign economic processes” might not “represent the foregoing of revenue ‘otherwise due’” (emphasis added), there was nothing in footnote 59 to support selective exclusion from taxation of limited categories of offshore income.⁵⁶ Having thus vitiated the U.S.’s “foreign economic processes” argument, it was an easy matter for the Panel to conclude that the FSC did result in the beneficial

The VCLT has been signed, ratified by, acceded to, or succeeded to by 59.6%, or 87 of the current 146 members of the WTO. See *The Organization[,], Members and Observers*, (visited Apr. 13, 2003) <http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm> (listing the 146 WTO members as of Apr. 4, 2003); *1. Vienna Convention on the Law of Treaties . . . Participants*, (visited Apr. 13, 2003) <<http://untreaty.un.org/English/sample/EnglishInternetBible/partI/chapterXXIII/treaty1.asp>> (listing 110 countries as participants in the VCLT, 87 of which are also WTO members).

⁵⁰ *FSC Panel*, *supra* note 8, para. 7.77. Article XVI:1 reads, “Except as otherwise provided under this Agreement or the Multilateral Trade Agreements, the WTO shall be guided by the decisions, procedures and customary practices followed by the CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947.” WTO Agreement, *supra* note 19.

⁵¹ See GATT 1947 art. XVI:4, *supra* note 6.

⁵² *FSC Panel*, *supra* note 8, para. 7.79.

⁵³ See *supra* note 36.

⁵⁴ *FSC Panel*, *supra* note 8, para. 4.366.

⁵⁵ *Id.* paras. 7.91-7.92 (footnote 663 to paragraph 7.92 notes that the material quoted therein by the panel is from paragraph 4.699).

⁵⁶ *Id.* para. 7.92.

foregoing of revenue otherwise due,⁵⁷ that it was therefore a subsidy under SCM Article 1,⁵⁸ and that its clear contingency on export transactions made it a violation of SCM Article 3.1(a).⁵⁹

The FSC Appellate Decision

Both sides appealed the Panel's decision, with the U.S. arguing the Panel erred in failing to recognize controlling authority in the 1981 Understanding and SCM Annex I(e) footnote 59,⁶⁰ and the EC arguing the Panel erred in declining to reach its SCM Article 3.1(b) content-contingency complaint.⁶¹ The Appellate Body affirmed that the FSC was a prohibited export subsidy under SCM Article 3.1(a), reversed a portion of the Panel's finding that the FSC violated the AA, and declined to address the EC's SCM Article 3.1(b) issue.⁶²

The U.S. took a new tack in argument to the Appellate Body. In addition to reiterating the 1981 Understanding/footnote 59 arguments it had made to the Panel, it seized on the last sentence in footnote 59 ("Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member")⁶³ and asserted that the FSC was exempt from SCM Article 3.1(a) because it was a measure to avoid double taxation.⁶⁴ The Appellate Body declined to review this argument

⁵⁷ *Id.* para. 7.98, 7.103.

⁵⁸ *Id.* paras. 7.102-7.103.

⁵⁹ *Id.* para. 7.108.

⁶⁰ WTO, Report of the Appellate Body, *United States – Tax Treatment for "Foreign Sales Corporations,"* WT/DS108/AB/R (Feb. 24, 2000) paras. 23-30 (visited Jan. 16, 2003) <<http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108ABR.doc>> (hereinafter *FSC Appeal*).

⁶¹ *Id.* paras. 66-68. The EC also appealed the Panel's decision not to reach the issue whether the FSC's administrative pricing rules were an independent violation of SCM art. 3.1(a). *Id.* paras. 64-65. Because the Appellate Body affirmed the Panel's conclusions, it too did not reach this issue. *Id.* paras. 172-173.

⁶² *Id.* paras. 174-177.

⁶³ *See supra* note 36.

⁶⁴ *FSC Appeal, supra* note 60, paras. 26, 86, 101.

because it found that the U.S., despite mention of this issue in one of its written submissions,⁶⁵ had not argued it to the Panel.⁶⁶ In support of its conclusion, the Appellate Body noted the Panel's finding that the U.S. had not argued the last sentence of footnote 59 was "relevant to this dispute."⁶⁷

Assuming *arguendo* that the Appellate Body's decision was erroneous, it was probably harmless because if the Appellate Body had considered the U.S.'s double-taxation argument, it likely would have ruled against it. That conclusion would have been grounded in the VCLT, "ordinary meaning"⁶⁸ of the phrase "taking measures to avoid . . . double taxation" in footnote 59. The Appellate Body, guided by VCLT Article 31,⁶⁹ would have looked for the ordinary meaning of the phrase "taking measures . . ." and discovered, in *The New Shorter Oxford English Dictionary*, that when the noun "measure" refers to a "legislative enactment" like the ETI, it means "a plan or course of action intended to attain some object."⁷⁰ In the same

⁶⁵ See *FSC Panel*, *supra* note 8, para. 4.348 ("[T]he FSC is designed to prevent double taxation of export income earned outside the United States by exempting a portion of the FSC's income from taxation. Income thus exempted is not eligible for double taxation relief using the foreign tax credit mechanism.").

⁶⁶ *FSC Appeal*, *supra* note 60, paras. 101-103.

⁶⁷ *FSC Panel*, *supra* note 8, para. 7.118, *cited in FSC Appeal*, *supra* note 60, para. 101.

⁶⁸ See VCLT, *supra* note 49.

⁶⁹ *Id.* Although the Appellate Body did not refer to the VCLT in this decision, it has frequently referred to it as an authoritative source in prior and subsequent decisions. See, e.g., WTO, Report of The Appellate Body, *United States – Continued Dumping and Subsidy Offset Act of 2000*, WT/DS234/AB/R (Jan. 16, 2003) para. 296 (visited Mar. 26, 2003) <<http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/234ABR.doc>>; WTO, Report of the Appellate Body, *United States - Definitive Safeguard Measures on Imports of Circular Welded Carbon Quality Line Pipe from Korea*, WT/DS202/AB/R (Feb. 15, 2002) para. 159 (visited Mar. 26, 2003) <<http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/202ABR.doc>> ("As always in our treaty interpretation, we take the approach of the [VCLT]"); WTO, Report of the Appellate Body, *Argentina - Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R (Dec. 14, 1999) para. 88 n.76 (visited Mar. 26, 2003) <<http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/121ABR.doc>> ("One of the corollaries of the 'general rule of interpretation' in the Vienna Convention is that interpretation must give meaning and effect to all the terms of a treaty.").

⁷⁰ *The New Shorter Oxford English Dictionary* 1726 (1993). *The New Shorter Oxford English Dictionary* was the dictionary cited by the Appellate Body in its decision. *FSC Appeal*, *supra* note 60, paras. 129 & n.148, 144 n.157, 148 n.160.

dictionary, the Panel could also have discovered that one meaning of the verb “take” is “to select or use for a particular purpose.”⁷¹

Using these definitions, the Appellate Body would have concluded that the ordinary meaning of the phrase “taking measures to avoid . . . double taxation” required intent, just as the EC⁷² and Canada⁷³ had argued. The U.S. had argued the FSC *was* intended to provide double-taxation relief,⁷⁴ but the fact that FSC benefits could be received regardless of offshore taxation⁷⁵ would have seriously undercut this position, especially when the U.S. had admitted that the tax regimes of the European countries it was trying to emulate through FSC *did* require offshore taxation, at least nominally.⁷⁶ Therefore, the Appellate Body would have concluded that, regardless of any inadvertent double taxation relief provided to FSCs, that result was not intended, and thus the FSC was not exempt from the strictures of SCM Article 3.1(a) pursuant to the last sentence of footnote 59.

The Appellate Body recommended that the Dispute Settlement Body (DSB) require the U.S. to bring the FSC into compliance with SCM Article 3,⁷⁷ and on November 15, 2000, U.S. President Bill Clinton signed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000

⁷¹ The New Shorter Oxford English Dictionary, *supra* note 70, at 3207.

⁷² *FSC Panel*, *supra* note 8, para. 4.952 (arguing that the U.S. could not rely on the last sentence of footnote 59 because “the FSC scheme is not designed to reduce double taxation”).

⁷³ *Id.* paras. 5.13 (“The FSC programme was never intended to alleviate double taxation, but rather to enhance United States exports.”), 5.14 (“many FSCs are located in low or tax free territories in which double taxation is clearly not a consideration”), 5.28. Canada was one of the three third parties who argued to the Panel.

⁷⁴ *See supra* note 65; *see also FSC Panel*, *supra* note 8, para. 4.1019 (“A FSC is eligible for double taxation relief only through the partial exemption itself, which is equivalent to the double taxation relief available under a territorial tax system.”).

⁷⁵ *See* I.R.C. §§ 921-927.

⁷⁶ *See FSC Panel*, *supra* note 8, paras. 4.809-4.811 (noting the Dutch requirement that offshore sales be “subject to tax” outside the Netherlands), 4.1043 (noting that French tax relief is conditioned on income being subject to tax in the country where earned), 4.1046 (noting that Belgian tax relief is available for offshore income subject to tax at source).

⁷⁷ *FSC Appeal*, *supra* note 60, para. 178.

(ETI).⁷⁸ The stated purpose of the ETI was to comply with the WTO FSC ruling.⁷⁹ However, two days later, on November 17, the EC requested consultations⁸⁰ and, following their predictable failure, filed another request with the WTO for establishment of a panel to hear its complaint.⁸¹

The ETI Panel Decision

The EC's three-part complaint alleged that (1) the ETI was an export subsidy prohibited both by the SCM and the AA, (2) the ETI's foreign content limitation violated both SCM Article 3.1(b)⁸² and GATT 1994 Article III:4,⁸³ and (3) the U.S. had failed to comply with its obligation to withdraw all FSC subsidies.⁸⁴ The Panel agreed with the EC on all three counts.⁸⁵

⁷⁸ Pub. L. No. 106-519; 114 Stat. 2423 (2000) (codified at I.R.C. §§ 114, 941-943).

⁷⁹ WTO, Report of the Panel, *United States – Tax Treatment for “Foreign Sales Corporations” Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/RW (Aug. 20, 2001) para. 8.95 n.197 (visited Jan. 16, 2003) (available in seven parts beginning with <<http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108RW-00.doc>> and ending with <<http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108RW-06.doc>>) (hereinafter *ETI Panel*).

⁸⁰ See WTO, Request for Consultations, *United States – Tax Treatment for “Foreign Sales Corporations” Recourse by the European Communities to Article 21.5 of the DSU*, WT/DS108/14 (Nov. 21, 2000) at 2 (visited Jan. 16, 2003) <<http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108-14.doc>>; see also WT/DS108/14/Corr.1 (Dec. 14, 2000) (visited Jan. 16, 2003) <<http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108-14C1.doc>>.

⁸¹ See WTO, Request for the Establishment of a Panel, *United States – Tax Treatment for “Foreign Sales Corporations” Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/16 (Dec. 8, 2000) at 1-2 (visited Jan. 16, 2003) <<http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108-16.doc>>; see also *ETI Panel*, *supra* note 79, paras. 1.6-1.8.

⁸² See *supra* note 25.

⁸³ GATT 1994 art. III:4 reads, in relevant part:

The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.

ETI Panel, *supra* note 79, para. 8.126; see also GATT 1994, *supra* note 47.

⁸⁴ *ETI Panel*, *supra* note 79, para. 3.1.

⁸⁵ *Id.* para. 9.1. As with the preceding discussion of the FSC case, the Panel's decision regarding violation of the AA is not discussed because it is derivative of the conclusion that ETI was a prohibited export subsidy.

Regarding part one of the EC's challenge, the ETI Panel first determined that ETI was a subsidy under SCM Article 1⁸⁶ and then decided that it was a prohibited subsidy under SCM Article 3.1(a).⁸⁷ The Panel began by quoting the Appellate Body's approach to SCM Article 1 in the FSC case, which said that "otherwise due" required a comparison of the revenue entitlement with and without the challenged provision under the subject country's tax rules.⁸⁸ Then, looking at what it called the "integrated whole,"⁸⁹ the Panel determined that I.R.C. § 114(a)'s exclusion of extraterritorial income from gross income just had too many exceptions to be the "rule,"⁹⁰ and that 114 was thus no more than a carve-out that left the existing I.R.C. § 61⁹¹ basically unchanged.⁹² That the U.S. tried to characterize the income addressed by I.R.C. § 114 as a "category,"⁹³ a term the Appellate Body had used in its FSC opinion,⁹⁴ was unpersuasive because ETI's "highly selective qualitative conditions and quantitative requirements" left so much extraterritorial income still subject to tax.⁹⁵ Therefore, under SCM Article 1, ETI did provide a financial contribution due to the foregoing of revenue otherwise due, and this contribution was a benefit to the taxpayer.⁹⁶

⁸⁶ *Id.* paras. 8.4-8.48.

⁸⁷ *Id.* para. 8.75; *see supra* note 22 (text of art. 3.1(a)). This approach was the same as that taken by the FSC Panel, *see supra* text accompanying notes 33-34, which is not surprising in light of the facts that 1) the membership of the ETI and FSC Panels was identical and 2) the Appellate Body had validated this approach in its review of the FSC Panel's decision. *Id.* paras. 1.10, 8.2 n.56 (citing *FSC Appeal, supra* note 60, para. 89).

⁸⁸ *ETI Panel, supra* note 79, paras. 8.10, 8.13, 8.17.

⁸⁹ *Id.* para. 8.23.

⁹⁰ I.R.C. § 114 reads, in relevant part, "(a) EXCLUSION. – Gross income does not include extraterritorial income. (b) EXCEPTION. – Subsection (a) shall not apply to extraterritorial income which is not qualifying foreign trade income as determined under subpart E of part III of subchapter N."

⁹¹ I.R.C. § 61 defines "gross income" as "all income from whatever source derived," "[e]xcept as otherwise provided in this subtitle."

⁹² *ETI Panel, supra* note 79, paras. 8.26-8.29.

⁹³ *Id.* para. 8.32.

⁹⁴ *Id.* para. 8.31 (citing *FSC Appeal, supra* note 60, paras. 90, 98-99, 120).

⁹⁵ *Id.* paras. 8.40, 8.43.

⁹⁶ *Id.* paras. 8.45-8.48.

The Panel then turned its attention to SCM Article 3, to determine whether the ETI subsidy was prohibited because it was contingent on export performance.⁹⁷ The U.S. made an “export precondition” argument, contending that the ETI was not contingent on export performance because there were ways to qualify for ETI benefits without exporting.⁹⁸ The EC countered that, regardless of how many ways the subsidy could be earned without exporting, U.S.-produced goods *did* have to be exported.⁹⁹ Looking at I.R.C. § 943(a)(1)¹⁰⁰ in particular, the Panel agreed with the EC.¹⁰¹

The U.S. tried to analogize to the specificity proscriptions in SCM Article 2 by arguing that, just as specificity could be ameliorated by extension of a benefit to a larger group of recipients, so could export-dependency be ameliorated by the addition of non-export avenues to a particular subsidy.¹⁰² The Panel would have none of it. It noted that, while specificity and non-specificity are mutually exclusive, the export-contingent and non-export-contingent methods of qualifying for the ETI subsidy were not.¹⁰³ The Panel even ridiculed the U.S. argument, saying that the notion that a subsidy “entirely irrelevant to export activity . . . can effectively remove export contingency” was “manifestly unreasonable” and “would have the practical effect of

⁹⁷ *Id.* para. 8.49.

⁹⁸ *Id.* para. 8.51.

⁹⁹ *Id.* para. 8.52.

¹⁰⁰ I.R.C. § 943(a)(1) defines “qualifying foreign trade property,” the sale of which generates “foreign trading gross receipts” and “foreign trade income,” as property

- (A) manufactured, produced, grown, or extracted within or outside the United States,
- (B) held primarily for sale, lease, or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and
- (C) not more than 50 percent of the fair market value of which is attributable to--
 - (i) articles manufactured, produced, grown, or extracted outside the United States, and
 - (ii) direct costs for labor (determined under the principles of section 263A) performed outside the United States.

¹⁰¹ *ETI Panel*, *supra* note 79, paras. 8.57-8.60.

¹⁰² *Id.* para. 8.65.

¹⁰³ *Id.* paras. 8.66-8.67.

reducing the disciplines of the SCM Agreement to ineffectiveness and inutility.”¹⁰⁴ The way to neutralize export-contingency, said the Panel, was to “grant the equivalent subsidy also” on goods sold directly into and for use in the domestic market.¹⁰⁵ Therefore, the ETI subsidy was export-contingent in contravention of SCM Article 3.1(a).¹⁰⁶

In response to the U.S. argument that the ETI subsidy was exempted from SCM Article 3.1(a) by footnote 59 in SCM Annex I,¹⁰⁷ the Panel arrived at the hypothetical conclusion outlined *supra* in the discussion of the FSC case,¹⁰⁸ but by a different route. The Panel first decided that “foreign-source income” should not necessarily be determined by reference to the “domestic laws of the Member invoking the footnote,” but that it had to refer to income “susceptible to ‘double taxation.’”¹⁰⁹ Next, the Panel said the term “to avoid” indicated that a measure needed to have avoidance of double taxation as its purpose.¹¹⁰ However, due to the “different ways that international commerce can be structured,” such a measure did not need to “avoid double taxation entirely, exclusively, or precisely.”¹¹¹ Whether the ETI had avoidance of double taxation as its purpose was to be determined by reviewing ETI’s “overall structure, design and operation . . . in the context of the broader [U.S.] tax system.”¹¹²

The Panel concluded ETI did not have avoidance of double taxation as its purpose based on the cumulative indications of three factors. First, ETI benefits could be based on “income

¹⁰⁴ *Id.* paras. 8.68-8.70.

¹⁰⁵ *Id.* para. 8.71. *See also id.* paras. 8.72-8.74.

¹⁰⁶ *Id.* para. 8.75.

¹⁰⁷ *Id.* paras. 8.82-8.84.

¹⁰⁸ *See supra* text accompanying notes 68-76.

¹⁰⁹ *ETI Panel, supra* note 79, para. 8.93.

¹¹⁰ *Id.* para. 8.94.

¹¹¹ *Id.* para. 8.95.

¹¹² *Id.*

which would rarely be taxable in another jurisdiction.”¹¹³ Second, and conversely, ETI did not target “a range of income which *is* potentially subject to taxation in other jurisdictions.”¹¹⁴ Finally, ETI did not mesh with the U.S.’s extensive system of bilateral tax treaties because, in some cases, it overlapped them, and in other cases, it failed “to cover situations where such agreements did not exist.”¹¹⁵ Therefore, ETI did not “fall within the scope of the fifth sentence of footnote 59.”¹¹⁶ Due to this resolution of the U.S. claim regarding footnote 59, the Panel did not reach the issue whether a statute that *did* qualify under footnote 59 as a measure to avoid double-taxation would also fall within the scope of footnote 5 in Article 3.1(a) and therefore be permitted under SCM.¹¹⁷

Regarding part two of the EC’s complaint, challenging the ETI’s fifty percent “foreign articles/labour limitation” as a violation both of GATT 1994 Article III:4¹¹⁸ and SCM Article 3.1(b),¹¹⁹ the Panel found in favor of the EC regarding the GATT article and then declined to address the same issue in the context of SCM Article 3.1(b).¹²⁰ Although the Panel broke GATT 1994 Article III:4 into three elements – whether the imported and domestic products were “like products,” whether the ETI was a “law, regulation, or requirement affecting their internal sale,” and whether the imported products were accorded less favorable treatment than domestic products¹²¹ – it found in the EC’s favor on the first two with little analysis.¹²² Regarding the third element, however, the Panel first noted first that “no less favourable treatment” requires

¹¹³ *Id.* paras. 8.98, 8.99, 8.101.

¹¹⁴ *Id.* paras. 8.97, 8.103-8.104.

¹¹⁵ *Id.* paras. 8.98, 8.100, 8.105.

¹¹⁶ *Id.* para. 8.107.

¹¹⁷ *Id.* para. 8.108.

¹¹⁸ *See supra* note 83.

¹¹⁹ *See supra* note 25.

¹²⁰ *ETI Panel, supra* note 79, paras. 8.160-8.162.

¹²¹ *Id.* para. 8.127; *see supra* note 83 (text of GATT 1994 art. III:4).

¹²² *ETI Panel, supra* note 79, paras. 8.130-8.149.

“effective equality of opportunities.”¹²³ Then it concluded that, while ETI did not compel a U.S. producer to use U.S. inputs,¹²⁴ it did treat imported products less favorably than parallel domestic supplies because it placed a limit on the former and no limit on the latter.¹²⁵ The fact that taxpayers could qualify for ETI’s benefits without using any domestic inputs at all did not change the “fundamental fact that, as far as goods are concerned, the foreign articles/labour limitation creates an incentive to use domestic rather than imported goods.”¹²⁶ Just as the availability of ETI benefits to non-exporters did not negate the export-contingency for U.S. producers,¹²⁷ the availability of ETI benefits to nonusers of domestic inputs did not “vitiating the fact that [the “foreign articles/labour limitation”] inherently advantage[d] domestic goods and that less favourable treatment [was] thereby accorded to imported goods.”¹²⁸ Therefore, ETI did violate GATT 1994 Article III:4.

The ETI Appellate Decision

The U.S. immediately appealed the ETI Panel’s decisions.¹²⁹ The Appellate Body affirmed all the ETI Panel’s conclusions with one minor, procedural exception.¹³⁰ Further, the Appellate Body approved without significant changes in analysis the ETI Panel’s bifurcation of ETI in its export contingency and foreign articles/labour limitation decisions¹³¹ and the Panel’s

¹²³ *Id.* para. 8.128.

¹²⁴ *Id.* para. 8.151.

¹²⁵ *Id.* para. 8.155.

¹²⁶ *Id.* para. 8.157.

¹²⁷ *Id.* para. 8.64. *See supra* text accompanying notes 102-106.

¹²⁸ *ETI Panel*, *supra* note 79, para. 8.157.

¹²⁹ *See* World Trade Organization (WTO), Report of the Appellate Body, *United States – Tax Treatment for “Foreign Sales Corporations” Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/AB/RW (Jan. 14, 2002) paras. 7-9 (visited Jan. 16, 2003) <<http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108ABRW.doc>> (hereinafter *ETI Appeal*).

¹³⁰ *Id.* para. 256.

¹³¹ *Id.* paras. 114-119, 202-206.

determination that the U.S. had not complied with the DSB's mandate to dismantle the FSC.¹³² However, with respect to two issues – the calculation of revenue otherwise due under SCM Article 1 and ETI's status as a double-taxation-relief measure under the last sentence of footnote 59 – the Appellate Body supported the Panel's conclusions with markedly different reasoning.¹³³

Regarding the first issue – revenue otherwise due – the Appellate Body noted that, although the U.S. had argued that ETI applied only to foreign-source income, the Panel had structured its “but for” test in terms of the “general” rule of taxation, I.R.C. § 61,¹³⁴ and the revenue that would be due with and without the ETI exception to that rule.¹³⁵ The Appellate Body accepted *arguendo* the U.S.'s “foreign-source only” claim and therefore based its “otherwise due” benchmark on I.R.C. §§ 1, 11, 61(a), 63(a), 901, and 904, which together set up a regime for taxing all gross income (foreign and domestic) less deductions and then allowing a credit for foreign taxes paid.¹³⁶ Because ETI was discretionary,¹³⁷ the Appellate Body concluded that any taxpayer who elected it could be expected to have done so because that choice would result in a lower tax than she would pay under the otherwise-applicable foreign tax credit regime.¹³⁸ Therefore, the ETI did result in a foregoing of tax otherwise due, and the Panel, while employing a different reasoning, did not err in concluding that its benefits constituted a financial contribution under SCM Article I.¹³⁹

¹³² *Id.* paras. 226-231.

¹³³ *See id.* paras. 91-106, 121-186.

¹³⁴ *See supra* note 91.

¹³⁵ *Id.* paras. 91-92.

¹³⁶ *Id.* paras. 99-100.

¹³⁷ *Id.* para. 103.

¹³⁸ *Id.* para. 104. The Appellate Body correctly noted that a taxpayer may not claim the benefits of both ETI and foreign tax credits for the same transaction. *Id.* paras. 95, 181 (citing I.R.C. § 114(d)).

¹³⁹ *Id.* para. 105-106.

The second issue regarding which the Appellate Body's reasoning differed from the Panel's – ETI's status as a double-taxation-avoidance (DTA) measure under the last sentence of footnote 59 – occupied twenty-two of the fifty-six pages devoted to analysis in the opinion.¹⁴⁰ The Appellate Body preceded its examination of the issue with decisions on three preliminary matters: (1) the burden of proof applicable to footnote-59 compliance, (2) a definition of foreign-source income, and (3) two standards applicable to footnote-59-compliant DTA measures. Regarding burden of proof, the Appellate Body determined that the U.S. had the burden of proof on ETI's footnote-59 compliance because footnote 59 does not circumscribe SCM Article 3.1(a), removing DTA subsidies from its purview, but acts rather as an affirmative defense, permitting DTA subsidies even though they are prohibited by Article 3.1(a).¹⁴¹ Regarding the meaning of "foreign-source income" in footnote 59, the Appellate Body decided that, because footnote 59 is a "tax-related provision in an international trade treaty,"¹⁴² "foreign-source income" means income so linked to activities in a State where the taxpayer is not a citizen or resident that the income could be taxed by that State under international principles of nonresident taxation.¹⁴³ Regarding the standards applicable to footnote-59-compliant DTA measures, the Appellate Body made two determinations: (1) that foreign-source income need not actually be taxed to be the subject of a footnote-59 DTA measure that uses the "exemption" method,¹⁴⁴ and (2) that the DTA measures addressed in footnote 59 need not "grant relief from all double tax burdens."¹⁴⁵

Having resolved these preliminary matters, the Appellate Body made the following ten findings:

¹⁴⁰ *Id.* paras. 121-186.

¹⁴¹ *Id.* paras. 128-133; *see supra* note 22 (text of art. 3.1(a)).

¹⁴² *ETI Appeal, supra* note 129, para. 142.

¹⁴³ *Id.* paras. 142-145.

¹⁴⁴ *Id.* para. 146.

¹⁴⁵ *Id.* para. 148.

(1) ETI's legislative history does mention a DTA goal.¹⁴⁶

(2) ETI's foreign-economic-processes requirement "establishes a link between *some part* of the qualifying transactions . . . and a 'foreign' State" (emphasis added).¹⁴⁷

(3) The footnote-59 exception for DTA subsidies applies only to the foreign-source income in ETI transactions; that is, the income "generated by and properly attributable to activities that [actually] occur in a 'foreign' State."¹⁴⁸

(4) The definitions in I.R.C. §§ 942(a)(1), 114(e), and 941(b)(1) of "foreign trading gross receipts," "extraterritorial income," and "foreign trade income," respectively, do not differentiate between domestic and foreign-source receipts or income.¹⁴⁹

(5) The 1.2% and 15% methods of calculating qualifying foreign trade income (QFTI) under I.R.C. §§ 941(a)(1) and 942(b)(4) effectively allow blending or bundling of domestic and foreign-source income, as the example in the House Report and further examples based on it show, because U.S.-based manufacturing profits that have no "activity link" to a foreign State nevertheless can be included in the QFTI calculation.¹⁵⁰

(6) The 30% method of calculating QFTI under I.R.C. § 941(a)(1) and (c)(1)(A) *does* limit QFTI to income properly allocable to foreign activities, but situations governed by I.R.C. § 941(c)(1)(B), regarding sale or lease of qualifying foreign trade property (QFTP), still have their domestic and foreign-source portions bundled.¹⁵¹

¹⁴⁶ *Id.* para. 150.

¹⁴⁷ *Id.* paras. 151-153.

¹⁴⁸ *Id.* para. 154.

¹⁴⁹ *Id.* para. 155.

¹⁵⁰ *Id.* paras. 156-158.

¹⁵¹ *Id.* paras. 169-171. If I.R.C. § 941(c)(2) applies, the bundling of domestic manufacturing activities with foreign-source income is avoided, but any non-manufacturing domestic income is still blended in. *Id.* paras. 172-173.

(7) The presence of the “properly allocable” rule in I.R.C. § 941(c)(1)(A) and the exclusion of domestic manufacturing by I.R.C. § 941(c)(2) “make[] all the more striking the omission of any such restrictions where QFTI is calculated using . . . the 1.2[%] and 15[%] rules.”¹⁵²

(8) The “free ride” given by I.R.C. § 942(c)(1) to taxpayers with declared foreign trading gross receipts of \$5 million or less, allowing them to shelter purely domestic income through ETI’s subsidy without any compliance with the foreign economic processes requirement, mitigates against ETI being a DTA measure under footnote 59.¹⁵³ The fact that income is received for property that was exported is not enough to make that income foreign-source; there must be activities in the foreign jurisdiction generating that income.¹⁵⁴

(9) The “free ride” given to income from the “performance of services ‘related and subsidiary’ to the sale or lease of qualifying property under [I.R.C. §] 942(a)(1)(C)” allows potential sheltering of purely domestic income.¹⁵⁵

(10) The fact that taxpayers can choose between the ETI regime and the foreign tax credit regime means that ETI will most likely be used to shelter income earned from domestic activities by those with few or low foreign tax credits.¹⁵⁶

Therefore, because the ETI, viewed as a whole, did not exempt only foreign-source income, and in fact could “systematically result in a tax exemption for income that ha[d] no link with a ‘foreign’ State and that would not be regarded as foreign-source under any of the widely accepted principles of taxation,” the Appellate Body determined that the ETI did not “fall within

¹⁵² *Id.* para. 174.

¹⁵³ *Id.* para. 175.

¹⁵⁴ *Id.* para. 176.

¹⁵⁵ *Id.* paras. 178-180.

¹⁵⁶ *Id.* paras. 181-183.

the justification available under the fifth sentence of [footnote 59 in SCM Article 3.1(a) Annex I].”¹⁵⁷

Arbitration Regarding Countermeasures

When the EC requested consultations on the ETI in late 2000, it simultaneously requested authority to “impose countermeasures and suspend concessions . . . in the amount of US\$ 4,043 million per year.”¹⁵⁸ The U.S. immediately requested arbitration of this request under Article 22.6 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU),¹⁵⁹ and the arbitration process was suspended by mutual consent during the panel and Appellate Body deliberations.¹⁶⁰ When arbitration resumed following the Appellate Body’s decision in January 2002, the U.S. agreed that the total, worldwide value of the FSC/ETI subsidy was roughly the same as the EC’s proposed countermeasures.¹⁶¹ However, it argued that those countermeasures should be limited to US\$ 1,110 million, an amount it said approximated the trade impact of the FSC/ETI acts on the EC.¹⁶² The original panel, sitting as arbitrator pursuant to DSU Article 22.6,¹⁶³ used a two-step process to determine that the amount requested by the

¹⁵⁷ *Id.* paras. 184-186.

¹⁵⁸ WTO, Decision of the Arbitrator, *United States – Tax Treatment for “Foreign Sales Corporations” Recourse to Arbitration by the United States under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement*, WT/DS108/ARB (Aug. 30, 2002) para. 1.4 (visited Jan. 16, 2003) <<http://docsonline.wto.org:80/DDFDdocuments/t/WT/DS/108ARB.doc>> (hereinafter *Arbitration Decision*).

¹⁵⁹ Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, Uruguay Round of Multilateral Trade Negotiations[:] Legal Instruments Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations Done at Marrakesh on 15 April 1994, vol. 31 (1994) (visited Jan. 16, 2003) <http://www.wto.org/english/docs_e/legal_e/28-dsu.doc>.

¹⁶⁰ WTO, *United States – Tax Treatment for “Foreign Sales Corporations”* [–] Understanding between the European Communities and the United States Regarding Procedures under Articles 21 and 22 of the DSU, WT/DS108/12 (Oct. 15, 2000) para. 8 (visited Jan. 16, 2003) <<http://docsonline.wto.org:80/DDFDdocuments/t/WT/DS/108-12.doc>>.

¹⁶¹ *Arbitration Decision*, *supra* note 158, paras. 3.1, 6.15. The precise U.S. estimation was US\$ 4,125 million. *Id.* para. 3.1.

¹⁶² *Id.* paras. 3.1, 5.29.

¹⁶³ *Id.* para. 1.7.

EC was both “appropriate” and not “disproportionate” under SCM Article 4.10 and 4.11. Those two sections read as follows:

- 4.10 In the event the recommendation of the DSB is not followed within the time-period specified by the panel, which shall commence from the date of adoption of the panel’s report or the Appellate Body’s report, the DSB shall grant authorization to the complaining Member to take appropriate⁹ countermeasures, unless the DSB decides by consensus to reject the request.

⁹ This expression is not meant to allow countermeasures that are disproportionate in light of the fact that the subsidies dealt with under these provisions are prohibited.

- 4.11 In the event a party to the dispute requests arbitration under paragraph 6 of Article 22 of the Dispute Settlement Understanding (“DSU”), the arbitrator shall determine whether the countermeasures are appropriate.¹⁰

¹⁰ This expression is not meant to allow countermeasures that are disproportionate in light of the fact that the subsidies dealt with under these provisions are prohibited.¹⁶⁴

The arbitrator’s first step was analysis of the SCM requirements for countermeasures. In beginning, the arbitrator noted that DSU Article 3.2 required it “to clarify the existing provisions of [the WTO] agreements in accordance with customary rules of interpretation of public international law.”¹⁶⁵ Those “customary rules,” it said, were “reflected” in the Vienna Convention on the Law of Treaties, and it quoted the portion of VCLT Article 31 that requires a treaty to be “interpreted in good faith in accordance with the ordinary meaning to be given to terms of the treaty in their context and in the light of its object and purpose.”¹⁶⁶

Following the mandate of VCLT Article 31, the arbitrator then proceeded to analyze four terms from SCM 4.10 and 4.11 – “appropriate,” “countermeasures,” “disproportionate” and “in

¹⁶⁴ SCM, *supra* note 23.

¹⁶⁵ *Arbitration Decision*, *supra* note 158, para. 4.7.

¹⁶⁶ *Id.*; for the full text of VCLT art. 31, *see supra* note 49.

light of” – first in terms of their ordinary meanings, next in the context of other SCM articles and the DSU, and finally in light of the object and purpose of the SCM and the WTO Agreement.¹⁶⁷ First, regarding the terms’ ordinary meanings, the arbitrator found that “countermeasures,” generally, were intended to “neutralize” a contrary action;¹⁶⁸ that “appropriate” indicated both suitability and flexibility;¹⁶⁹ that “disproportionate” suggested a poor relationship;¹⁷⁰ and that “in light of” indicated “an element [here, the per se illegality of export subsidies under SCM 3.1(a)] that is to pervade or colour the whole assessment.”¹⁷¹ Together, the ordinary meanings of these terms suggested that appropriate countermeasures would cancel out the prohibited subsidy and would not be poorly related to that task in light of the subsidy’s illegal character.

Next, regarding the meaning of the four terms in context, the arbitrator noted SCM Articles 7.9 and 9¹⁷² require countermeasures to be directly related to the adverse effects suffered by the complaining country.¹⁷³ It concluded that the absence of a similar requirement in Article 4.10-4.11 showed an intent by the drafters that appropriate countermeasures under Article 4 not be limited to trade effects.¹⁷⁴ It noted that, to the extent DSU Article 22.4 required countermeasures to be related to trade effects, SCM Article 4.10 and 4.11 were “special or additional rules” that, under DSU Article 1.2, prevailed over the DSU in the event of a conflict.¹⁷⁵

¹⁶⁷ *Arbitration Decision*, *supra* note 158, paras. 5.1-5.62.

¹⁶⁸ *Id.* para. 5.4.

¹⁶⁹ *Id.* paras. 5.12-5.13, 5.19.

¹⁷⁰ *Id.* para. 5.17.

¹⁷¹ *Id.* para. 5.21; *see also* para. 5.23.

¹⁷² *See id.* para. 5.32 n.56 (noting that the arbitrator considered Article 9 “helpful . . . in understanding the overall architecture of the [SCM] with respect to the different types of subsidies it sought and seeks to address,” despite the fact that, pursuant to Article 31, Article 9 was no longer in force at the time of the arbitration).

¹⁷³ *Id.* para. 5.32.

¹⁷⁴ *Id.* para. 5.34-5.43, 5.48.

¹⁷⁵ *Id.* para. 5.47.

Finally, regarding the object and purpose of the SCM and the WTO Agreement,¹⁷⁶ the arbitrator found that the object of SCM Article 4.10 was to “secure compliance” with the DSB’s recommendation that a prohibited subsidy be withdrawn and to counteract – to neutralize – noncompliance with that recommendation.¹⁷⁷ It emphasized the importance of withdrawal by noting that withdrawal was the only recommendation the DSB was permitted to make regarding prohibited subsidies.¹⁷⁸ It further noted (1) that this purpose of enforcing withdrawal was congruent with DSU Article 3.7, which lists withdrawal of offending measures as the first objective of dispute settlement, and (2) that enforcing withdrawal served one of the purposes of the dispute settlement mechanism as enunciated in DSU Article 3.2: preservation of the rights and obligations of WTO members.¹⁷⁹ Therefore, proposed countermeasures under SCM 4.10 and 4.11 should be considered appropriate as long as they were not unrelated to the purpose of inducing compliance with the DSB’s recommendation, and the determination whether they were disproportionate should take into account the illegal character of the prohibited subsidy.¹⁸⁰

Having determined the SCM requirements for countermeasures, the arbitrator’s second step was to apply its textual analysis to the arguments of the parties.¹⁸¹ Regarding the EC position, it found that the virtual arithmetic equivalence between the value of the FSC/ETI subsidy and the proposed countermeasures was a strong indication the countermeasures were not disproportionate to the “gravity of the breach and the nature of the upset in the balance of rights and obligations in question.”¹⁸² Because the subsidy was funded by foregone tax revenue, this equivalence was also important because it made the proposed countermeasures not

¹⁷⁶ See SCM, *supra* note 23; WTO Agreement, *supra* note 19.

¹⁷⁷ *Arbitration Decision*, *supra* note 158, para. 5.52-5.53.

¹⁷⁸ *Id.* para. 5.52.

¹⁷⁹ *Id.* para. 5.54-5.55

¹⁸⁰ *Id.* para. 5.62.

¹⁸¹ *Id.* paras. 6.1-6.64.

¹⁸² *Id.* paras. 6.6, 6.15; *see also* 6.9, 6.11.

disproportionate to the benefit of the subsidy to U.S. exporters and, concurrently, to the cost of the subsidy to the U.S. treasury.¹⁸³ Therefore, because there was a reasonable relationship between the EC's proposed countermeasures and both the value of the FSC/ETI subsidy and its patent illegality, the arbitrator found those countermeasures could be appropriate under SCM 4.10 and 4.11.¹⁸⁴

Regarding the U.S. position – that the EC's countermeasures should be limited to the adverse trade effects it had suffered – the arbitrator stated that the U.S. had provided no basis for concluding that the “proxy” it offered for the FSC/ETI subsidy's effect on the EC (the dollar value of the subsidy multiplied by the 26.8%, the EC's share of world trade) was valid even as a proxy.¹⁸⁵ On the contrary, past disputes, such as *Brazil – Aircraft*, had revealed that “export subsidies usually operate with a multiplying effect,” such that the resulting trade effects are greater than the subsidy amount.¹⁸⁶ The U.S. had also proffered other methods for calculating the subsidy's adverse trade effects, but the arbitrator found that their results did not prove that the trade effects were different from the proposed countermeasures.¹⁸⁷ Therefore, even if the arbitrator had agreed that the countermeasures should be limited to adverse trade effects on the EC, it still would have found the EC's proposed amount appropriate under SCM 4.10 and 4.11 because it was not disproportionate.¹⁸⁸

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¹⁸³ *Id.* paras. 6.18-6.6.22. I agree that the parallel between the countermeasures and the benefit to U.S. exporters supports a conclusion of non-disproportion, but I find the arbitrator's parallel to the cost of the subsidy to the U.S. treasury puzzling and ultimately unpersuasive.

¹⁸⁴ *Id.* paras. 6.25, 6.31.

¹⁸⁵ *Id.* paras. 6.36-6.38.

¹⁸⁶ *Id.* para. 6.42 n.88 (quoting WTO, Decision by the Arbitrators, *Brazil – Export Financing Programme for Aircraft*[,] *Recourse to Arbitration by Brazil under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement*, WT/DS46/ARB (Aug. 28, 2000) para. 3.54 (visited Jan. 22, 2003) <<http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/46ARB.doc>>).

¹⁸⁷ *Id.* para. 6.54.

¹⁸⁸ *Id.* para. 6.57.