OPENING STATEMENT OF THE UNITED STATES

I. INTRODUCTION

1.1. Mr. Chairman and Members of the Division, this case is extraordinarily important to the United States and to the world economy. Few things are as central to a country's sovereignty as how it raises revenue. As the Appellate Body has said, the WTO rules do not "compel Members to choose a particular kind of tax system."

1.2. Although the Panel in this case acknowledged this fundamental principle, the Panel failed to uphold it. The necessary implication of the Panel's analysis is that the WTO may second-guess the reasonableness of a Member's decisions regarding the most basic elements of its tax *system.* However, it is not the role of the WTO to substitute its judgment for the judgment of a Member's own lawmakers in this regard.

1.3. The Panel would require the United States to tax foreign income that a territorial tax system is seemingly allowed <u>not</u> to tax. Not only would this usurp the freedom of choice recognized by this Appellate Body, it would contravene the underlying principle of neutrality and deny the most basic international parity. If the Panel Report stands, the only way the United States could maintain parity with the tax systems of other countries would be through comprehensive reform-- by scrapping our entire tax system and starting over.

1.4. But even that might not be enough. The Panel Report includes so many newly-created rules--mostly vague and subjective and sometimes contradictory--that it is impossible to know what type of tax system would be acceptable. Whatever rules ultimately govern this case must be workable and clear. Legislators cannot develop clear rules to implement a WTO decision if that decision is not <u>itself</u> grounded in clear rules.

1.5. The analysis of the Panel in this case places at risk tax systems throughout Europe and around the world. For example, the broad and subjective approach employed by the Panel in addressing the issue of measures to avoid double tax--which is an issue of first impression--calls into question measures incorporated, in the tax systems of every Member.

1.6. If the Panel Report were allowed to stand, the world trading system would be faced with a continuation of the stalemate first created by the 1976 Tax Legislation Cases. What ensued from those cases was a "Thirty Years War" that will continue to rage if the Appellate Body does not step in and confirm that Members are indeed free to establish and rely on their individual normative tax systems.

1.7. The Panel Report is <u>not</u> faithful either to the text of the controlling agreements or to the holdings of this Appellate Body. It should be reversed, for reasons that Mr. Jones will now urge. The Appellate Body must ensure that this long-standing dispute is resolved through rules and standards that are clear, practical, and that respect the sovereignty of all WTO Members to structure their own tax systems and maintain tax parity. Anything less would only lead to further disagreement and dispute.

II. ARGUMENT: NO SUBSIDY IS CREATED BY THE ETI

2.1. The principal question before us is whether the United States has provided a prohibited export subsidy under Article 3.1(a) of the SCM Agreement. The term "subsidy" is defined for this purpose in Article 1.1 to mean foregoing the collection of taxes "otherwise due." As the Appellate Body has stated, to determine whether taxes are "otherwise due" requires us to evaluate whether the challenged tax provision departs from the "normative benchmark" of the Nation's taxing system.

2.2. The Panel failed to conduct this required analysis. Instead, the Panel simply reasoned that any exclusion from gross income has the character of a subsidy because, in the absence of the exclusion, the income would "otherwise" be subject to tax. The Panel concluded that, because there is no <u>express</u> exclusion for extraterritorial income in the U.S. system in the absence of the challenged provision, the exclusion <u>must</u> be a "subsidy" —- for it allows a reduction of taxes "<u>otherwise</u> due."

2.3. The Panel's simplistic reasoning is clearly flawed. It fails to recognize that a Nation's "normative benchmark" of taxation is often expressed in the deductions and exclusions that it allows as well as in the provisions that impose the tax. That is to say, in determining the "normative benchmark" of taxation, you must look both at what is taxed and what is not taxed. An income tax is, by definition, a tax on net income, not on. gross income. Viewed from this proper perspective, the ETI exclusion is clearly consistent with, and a part of, the normative tax system of the United States.

2.4. It is helpful at the outset to clarify how our normative tax system works. Our tax system has been described as a "worldwide" system of taxation, which nominally would reach the income of a U.S. corporation wherever earned. Under that system, however, the United States has always allowed U.S. taxpayers who make foreign sales of goods to structure their affairs in a manner that allocates the domestic portion of their income to the United States and the foreign portion abroad. The traditional method for structuring such transactions in the U.S. system has been to make these sales through a foreign-incorporated subsidiary. In that situation, only the portion of the income recognized as domestic is then taxed to the U.S. entity; the portion that is recognized as foreign is not taxed by the U.S.

2.5. In this respect, our system is analogous to the standard "territorial" model, which allows domestic taxpayers to locate a portion of their profits abroad simply by forming a "permanent establishment" in a foreign country. While a "permanent establishment" sounds like a bricks and mortar facility, it may be simply the foreign location of a sales agent for the domestic company, as the OECD commentary makes clear.

2.6. In enacting the ETI, the United States (i) preserved its longstanding "normative" system of allowing resident taxpayers to structure their transactions to locate abroad the foreign-allocated portion of their foreign sales income (ii) but did so in a direct fashion that no longer requires the formation of a foreign subsidiary to make foreign sales. Instead, in a fashion analogous to the permanent establishment requirement of other Nations, the ETI requires that foreign sales be solicited, negotiated or contracted by a U.S. taxpayer abroad. And, when the statutory requirements for foreign activities are satisfied, the ETI makes a direct allocation of the sales income between the domestic and foreign portion and imposes a tax in the United States only on the domestic portion.

2.7. The operation of our normative system, and of the ETI, must be understood in the context of other related provisions of our very complicated tax structure. As early as 1962, the United States became concerned that our normative system of taxation would allow a controlled foreign subsidiary to be located in a tax haven nation and thereby avoid all taxes on the foreign-allocated portion of the sales income. To address this abuse, Congress enacted what is known as Subpart F of our Internal Revenue Code. While retaining our "normative benchmark" rule for foreign sales made through subsidiaries located in countries with normal rates of tax (IRC 954 (b) (4)), Subpart F establishes an anti-abuse rule that requires U.S. companies with subsidiaries incorporated in low-tax or no-tax countries to recognize both the domestic and the foreign-allocated portion of the income from such transactions.

2.8. Many other Nations did not join our efforts to discourage the use of tax havens. For example, under the territorial model, a company may form a foreign subsidiary or locate a branch in a tax haven country and make sales abroad without paying any taxes on the foreign-allocated portion of the sales income. Nations that apply the "territorial" principle in that manner thereby obtain an economic advantage for their export trade.

2.9. As we explain in our submission, the statutory method by which ETI applies our "normative benchmark" of taxation is through a formal redefinition of the concept of "gross income" in Section 61 of the Code. Section 61 has long specified that "gross income" includes income from all sources except that it does not include items excluded by other provisions of the Code. And, Section 114 of the Code now expressly provides that extraterritorial income--foreign-allocated portion of foreign sales income--is not encompassed within the general definition of gross income in Section 61. The ETI is thus now an express component of the formal definition of our concept of gross income. That formal definition is an application of, and not a departure from, our historic normative benchmark principles of taxation.

2.10. Because extraterritorial income is not encompassed within the concept of. "gross income," there is no provision of our law that purports to tax that income apart from, or "but for," the challenged provision. Thus, looking either to the normative benchmarks of our system or the mechanical 'but for" test that was applied by the Panel in the PSC case, the exclusion of extraterritorial income under Section 114(a) does not forego taxes "otherwise due" under our system.

2.11. It therefore is not a "subsidy" under Article 1 of the SCM agreement. Under the longstanding "normative" rules both of the United States and of territorial systems of taxation, taxpayers have always been able to structure their affairs in a manner that separates the foreign-allocated portion of foreign sales income from the domestic portion and subjects only the domestic portion to domestic taxation.

2.12. As I will explain in a few moments, this allocation of taxing authority flows from the principle of avoiding double taxation on international transactions--it does not represent a "subsidy" within the meaning of the SCM agreement.

III. ARGUMENT: THE ETI IS NOT EXPORT CONTINGENT

3.1. Second, even when a subsidy in fact exists under Article 1, it is not prohibited by Article 3.1(a) unless it is "contingent on export performance." As the Appellate Body has emphasized in prior decisions, this means that export must be a necessary condition of receiving the subsidy-- that is, that the subsidy can be received only by exporting.

3.2. That condition of export contingency is not present under either the territorial system or the ETI. Under both systems, a domestic corporation may produce goods for foreign sales either through facilities located at home or abroad. It may also produce such goods abroad through a foreign subsidiary. Because export is thus clearly not required for the ETI to apply, there is plainly no de jure requirement of export under the statute.

3.3. In decisions such as Canada-Aircraft, the Appellate Body has emphasized that the fact that exporters are included within the group of those who may benefit from a challenged provision does not make that benefit "contingent" on exports. Footnote 4 to Article 3.1 also makes that point expressly, by stating that the fact that a subsidy is granted to enterprises that export does not make it an export-contingent subsidy.

3.4. Where the Panel went wrong in this case was by focusing not on the actual operation of the ETI but by instead creating and then criticizing a purely hypothetical statute that would apply only to goods manufactured in the United States. The Panel stated that, under this purely hypothetical scheme, such goods could only benefit if they were exported, and concluded that as to such goods that sort of statute would provide an export-contingent subsidy.

3.5. The ETI, however, obviously does not apply in the fashion hypothesized by the Panel. Instead, the ETI applies to all taxpayers wherever their operations are located. Since any taxpayer is free to obtain the benefit of the ETI--or of any territorial system for that matter-- by locating or completing production activities abroad, the Panel was plainly wrong in stating that the ETI provides a subsidy that, as a matter of law, is "tied to" or "contingent on" export performance.

3.6. There is also no basis for saying that the ETI is contingent on export performance on a de facto basis. Indeed, no de facto challenge was presented in this case, and the Panel expressly declined to make any such determination. Furthermore, no record was assembled that would permit any such analysis to be made. In fact, the only evidence adduced on this point was United States Exhibit 9, which explains how domestic manufacturers can and do locate facilities abroad to produce goods abroad and thereby earn foreign source income that is excluded from U.S. tax under the ETI.

3.7. The EC offered no evidence to rebut this de facto demonstration that the ETI is not export contingent. And, it bears emphasis that if the ETI were regarded as export-contingent simply because exporters are among those who may benefit from it, any territorial system would obviously be equally flawed.

IV. ARGUMENT: THE ETI IS A VALID MEASURE TO AVOID DOUBLE TAXATION

4.1. Third, even a measure that establishes an export-contingent subsidy is not prohibited under the SCM Agreement if it is part of a "measure to avoid the double taxation of foreign source income." This settled rule has been an indispensable part of international subsidies agreements since 1979. And it is expressly set forth in footnote 59 to the Illustrative List of Export Subsidies that is referenced in Section 3.1(a) of the SCM agreement.

4.2. As OECD commentary acknowledges, there are two widely accepted types of measures for avoiding double taxation: a credit for foreign taxes paid and an exemption of income derived in foreign transactions. The U.S. tax system, like the systems of most developed nations, employs a mixture of tax credit and tax exemption provisions. The exemption method applied by the ETI unquestionably qualifies as one of the two accepted methods employed throughout the world to avoid a double tax on income.

4.3. None of the Panel's four criticisms of the ETI as such a measure holds up. First, the Panel suggested that the ETI is "too broad," for it exempts income that other Nations may not tax. The Panel ultimately acknowledged, however, that this objection is not compelling. For example, the territorial model may similarly be said to be "too broad," for it exempts income from domestic taxation without regard to whether taxes are in fact charged by any foreign government.

4.4. Moreover, the United states submitted evidence in this case that <u>many</u> Nations--such as the United Kingdom, Chinese Taipei and Saudi Arabia--have tax regimes that are broad enough to reach the foreign-source income that is excluded from our tax by the ETI. No rebuttal of that evidence was offered by the EC or adopted by the Panel. Instead, the Panel ultimately disclaimed independent reliance on the assertion that the ETI exclusion is "too broad."

4.5. The Panel nonetheless went on to make the seemingly inconsistent criticism that the ETI is "too narrow." The Panel asserted that it is too narrow because it is not available unless the goods are sold for consumption or use <u>outside</u> the United States. This objection is also not valid.

4.6. If goods manufactured in the United States are <u>ostensibly</u> sold overseas but then returned for use in the United States, the ETI exclusion does not apply simply because the income is <u>not</u> foreign source even in part—<u>it is exclusively U.S. source.</u> There is no foreign source income to exclude when U.S. goods are sold in the U.S., and thus no foreign source income to exclude under the ETI in that situation.

4.7. Alternatively, if goods are manufactured abroad and then sold for use in the United States, the United States again does not exclude the sale income under the ETI but for a different reason--which is that we retain primary taxing jurisdiction over domestic sale transactions. With respect to sales occurring in our country, we ordinarily look to the <u>foreign</u> Nation to exclude the U.S. portion of income from its tax base, just as we exclude the foreign-allocated portion of income for foreign sales under the complementary provisions of the ETI.

4.8. The ETI exclusion cannot properly be criticized as "too narrow" because it looks to foreign governments to cooperate in this manner in the avoidance of double taxation. By authorizing measures to avoid double taxation, the SCM agreement does not require <u>any</u> Nation <u>always</u> to defer to foreign taxation when both Nations have a claim to tax a transaction. <u>No</u> model of taxation requires the complete forfeiture of basic taxing jurisdiction contemplated by the Panel's improper objection that the ETI is "too narrow"--and no Nation follows the model that the Panel would purport to require.

4.9. Third, the Panel suggested that unilateral measures to avoid double taxation are simply unnecessary because many treaties now address this issue on a bilateral basis. Any suggestion that treaties are the <u>only</u> proper remedy for double taxation is, of course, flatly contrary to the provisions of the SCM agreement that expressly protect the right of Nations to adopt measures <u>of their own</u> to avoid double taxation.

4.10. Finally, and most curiously, the Panel stated that while none of these objections are <u>independently</u> dispositive, somehow <u>on balance</u> they support a conclusion that the ETI is not a measure to avoid double taxation. The personal and subjective character of the Panel's reasoning is emphasized by the Panel's extraordinary and undiplomatic assertion that no "legislator" could "reasonably" view the ETI measure as one that seeks to avoid double taxation.

4.11. We do not know where the Panel has obtained the insight to determine how a "reasonable legislator" forms his conclusions. What is clear to us, however, is that several hundred reasonable legislators reviewed the text of the ETI, considered the legislative reports that explain how it serves to avoid double taxation on foreign transactions, and voted to enact it with that purpose in mind.

4.12. As this Appellate Body has noted in cases such as Japan-Alcoholic Beverages, legislators function in a complex world. Domestic legislation cannot resolve, and should not be expected to resolve, all theoretical double tax issues in order to qualify as a "measure to avoid double taxation." The SCM agreement provides great latitude and discretion to legislators in adopting such measures--for the controlling provision emphasizes that nothing in the subsidy agreement "limits" the measures that may be adopted for this purpose.

4.13. There is, in short, no basis in the text of the SCM agreement for the Panel to act as a "super legislator" to determine what "reasonable" measures are needed to avoid double taxation. That determination is expressly left to the discretion of each Nation under the Agreement; it has not been delegated to the WTO.

4.14. The issue presented in this case has now been a source of international tension for over three decades. What is needed in this context is clear guidance and administrable standards. Instead, the Panel has adopted a broad, non-textual approach that places the ordinary tax laws of every Nation at risk. This threatens to extend, rather than resolve, this longstanding international dispute

V. ARGUMENT: THE ETI DOES NOT VIOLATE GATT ARTICLE III::4

5.1. The Panel also addressed an issue of secondary and less fundamental importance--which is whether one narrow feature of the ETI violates Article III:4 of the GATT. That Article requires that foreign products be given "treatment no less favorable" than domestic products under laws affecting their domestic sale or use. The Panel concluded that Article III:4 is violated by a provision in the ETI that permits the foreign source portion of sale income to be excluded only when no more than 50% of the fair market value of the item consists of foreign articles and foreign labor inputs.

5.2. Under the decision of the Appellate Body in Korea-Beef, the Panel's de jure conclusion cannot be sustained because the challenged provision does not "necessarily" create a preference for domestic over foreign articles. Instead, the record demonstrates that the 50% requirement can be met whenever other components of value--- such as intangibles like patents or other licenses, or profits, or rents or any other input-- form at least 50% of the ultimate value of the article. And, these other components of value may have either a foreign or U.S. source.

5.3. Because the challenged measure may be satisfied in numerous ways that do not require any use of U.S. goods, it cannot be said "necessarily" to create any preference for domestic over foreign goods in violation of Article III:4. And, here, as in Korea-Beef, the Panel failed to make a de facto inquiry into whether, as applied, the measure would have the practical consequence of reducing the opportunity of foreign goods to compete with domestic goods. Mere speculation by the Panel about how the statute might operate is no substitute for the actual factual inquiry required before a de facto violation could be determined.

VI: CONCLUSION

6.1. In summary, the ETI is not a subsidy because it is consistent with the longstanding "normative benchmark" rules of 1.1.5. taxation. The income excluded under the ETI is not export-contingent, either as a matter of law or as a matter of fact, for it may be earned without regard to whether the goods are exported or produced abroad. The ETI falls within the broad compass of permissible measures that Nations may adopt to avoid double taxation. And, the ETI does not establish a de jure preference for U.S. over foreign goods.

6.2. The Panel's contrary determinations are incorrect, and we respectfully request that they be reversed by the Appellate Body.