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BACKGROUND ON LATEST DEVELOPMENTS IN THE FSC TRADE DISPUTE (MEMO/00/84)

1. Questions on WTO procedures: sanctions, list and amount

(1) What are the WTO procedural steps that the EU is required to take in order to protect its economic interests and its WTO rights?

Although the procedural agreements signed by the EU and the US on 29 September do not apply to the situation where the US has failed to adopt the FSC replacement legislation by 1 November, the EU will nevertheless agree to follow these procedures as the US has adopted the replacement legislation soon after the WTO deadline.

The EU will therefore take the following steps in the WTO:

- on 17 November the EU has made a request for suspension of concessions to the WTO, indicating a list of products and an amount. This is so because, given the interpretation of the Dispute Settlement Understanding defended by the US during the banana dispute, failure to do so will result in the EU losing its rights.

- the EU will challenge the WTO compatibility of the US legislation by requesting a compliance panel in the WTO.

The arbitration work will then be suspended until the compliance panel has ruled on the legality of the new US legislation.

(2) Why does the EU need to present a list of products to the WTO?

Failure to do so will put our WTO rights at risk. It has also been the consistent practice of WTO members, including the US in both the bananas and hormones cases, to present a list of products when requesting authorisation to suspend concessions.

(3) How big is the list and what products are included on it?

The list of products that the EU has submitted to the WTO avoids premature and unnecessary effects on trade flows while at the same time complying with WTO obligations. At this stage the list includes chapters of the Common Customs Tariff without identifying individual products. The chapters selected are those where the EU has found that there are products that could be subject to sanctions without negatively affecting the EU industry and consumers as the degree of dependency from the US is low and there are alternative sources of supply available either within the EU or in third countries.

This list constitutes the universe of products within which the EU will select products to be subject to sanctions if the new US legislation is again condemned by the WTO. The scope of the final list will depend on the WTO arbitrators' decision on the amount of sanctions the EU is entitled to apply.

The Commission will consult with Member States and industry in selecting individual products that can be subject to sanctions.

(4) Has the EU considered presenting a list equivalent to the whole Common Customs Tariff?

This is a possibility that has been excluded as it is legally uncertain and does not provide any comfort to the EU industry. On the contrary, the approach taken by the EU excludes from sanctions many sensitive sectors for the EU industry while leaving open the final choice of products on the basis of the criteria explained above.

(5) But, the list to be presented seems much larger than the amount of sanctions requested, why is this?

In fact it is larger than the amount requested so that the EU could select from this list the products that will finally be subject to sanctions. However the EU will not impose sanctions on all those products. Once the WTO arbitrators rule on the amount, the EU will have to submit to the WTO a final selection of products of a value equivalent to the amount found by the arbitrators.

(6) Why does the EU need to include an amount in its request for authorisation to suspend concessions?

As in the case of the list, to indicate an amount in the request for suspension of concessions is a legal obligation necessary to protect our rights.

(7) The latest press reports talk about a figure which is very high, between $4 and $26 billion, is this correct?

In accordance with the most recent WTO precedents, the EU can request authorisation to suspend concessions for the amount of the FSC subsidy. The EU has calculated the value of the subsidy at $ 4.043 million.

(8) Will the EU impose such an amount of retaliation if the new US FSC legislation is condemned again by the WTO?

In the case of export subsidies, sanctions are aimed at persuading the defaulting country to eliminate the illegal subsidy because its effects are heavily prejudicial to all WTO members. In line with the decision of the WTO arbitrators, the EU will decide on the appropriate level of sanctions to be applied in this case.

(9) During the banana dispute the US did not hesitate to impose sanctions when it considered that the EU did not comply with its WTO obligations. Why has the EU decided to act differently in an identical situation?

It is important to clarify that the EU is not giving up its rights to impose sanctions. However, as it has always defended, sanctions can only be imposed after the WTO has ruled on the legality of the measure. It is for the WTO to be "judge and jury" and no one else. That is why if the US adopts implementing legislation, the EU will request the establishment of a compliance panel to examine its legality and if the WTO condemns the law, then the EU will seek authorisation to impose sanctions. This has always been the EU position.

2. Questions on the FSC Scheme and the FSC Replacement legislation

(10) Why did the EU challenge the FSC legislation?

The FSC scheme is an across the board export subsidy that benefits all type of US companies and products. European companies have been complaining about FSC subsidies, either individually or as one of a number of subsidies granted to US firms, for quite some time. However, the factor that made the EU start this case was the rapidly increasing amount of FSC subsidies being granted in recent years and its global effect on EU companies' performance.

The FSC gives a massive export subsidy, now worth over $4 billion dollars per year, which benefits around half of US exports, which compete directly with EU products. However, certain sources consider the real amount of the subsidies to be substantially higher.

If we take into account that the FSC scheme has been in place since 1985, it is easy to understand the magnitude of subsidisation being granted to US companies to the detriment of their world wide competitors, among them, EU companies.

(11) Why is the EU challenging the FSC replacement legislation?

This new system is basically identical to the FSC scheme. It provides that US companies will not be taxed on part of the income obtained from export sales if they export goods which are manufactured with more then 50% of US inputs. If the products are sold within the US or if they are made with less than 50% of US inputs, then all the income generated by the sale will be taxed.

A company's tax burden on income derived from these export activities will be reduced between 15 to 30%.

Furthermore, the proposed legislation includes transitional provisions that extend the application of the condemned FSC scheme, perpetuating the existing violation of the WTO rules at least until 1 January 2002.

(12) But is it not true that the new US legislation is not a subsidy, as it excludes "extraterritorial income" from taxation, just as the European tax systems do?

This is a totally incorrect statement. Simply reading the text of the law it can be realised that the contrary is true. The US law first provides that "extraterritorial income" will not be taxed. Then that the previous provision will only apply to "extraterritorial income" from certain transactions that comply with the particular requirements established by the law (sales outside the US,
with more than 50% US inputs, etc). Therefore it provides for an exception to a general rule, as every transactions that does not match the criteria established by the law will be taxed, under the guise of a general principle.

In other words, it is like a car dealer that advertises a 20% discount on all its sales but just below he indicates that this offer is only valid for model (A). The simplest way to write this would be to say: 20% discount for all sales of model (A). The result in both cases is the same, but the way to draft it is different. That is exactly what the US law does under the cover of benefiting everybody, only one model, in this case US exports, actually benefits from the discount (tax break).

(13) Even if it is a subsidy, the fact that not only companies exporting from the US but also US companies located outside the US can benefit from it eliminates the export contingency element condemned in the FSC scheme?

Maybe the best way to illustrate the fallacy of this is also to use an example. If hunting elephants is prohibited by an international treaty, a national law which allows elephants to be hunted will not be brought in line with the treaty if a new law is passed saying that also giraffes can be hunted. The violation of the treaty continues and will not be remedied by adding giraffes to the law as elephants can continue to be hunted in breach of the treaty.

The same situation is present in the FSC replacement act. The fact of adding US companies located abroad to the universe of beneficiaries of the new law does not remove the violation as for those companies located within the US the only way to benefit from the FSC replacement act is by exporting.

(14) Were not the FSC and its replacement legislation an attempt from the US to apply the territorial tax systems principle to its tax system?

There are several reasons why the FSC and its replacement legislation were not intended to replicate the effects of territorial systems. First, it provides for a tax break to export sales while territorial systems do not. Second, it exempts income that is generated in the US, while territorial systems only exempt income derived from activities carried out abroad. Third, it does not apply arms-length transfer price rules to properly allocate taxable income, allowing domestic income to escape taxation. Fourth, it is not intended to avoid double taxation as FSCs are established in tax havens while territorial systems provide for special anti-avoidance rules. Fifth, the inclusion of an obligation to use more than 50% US inputs has nothing to do with either territorial or world-wide systems.

(15) Don't US companies suffer a disadvantage vis-à-vis EU companies from the fact that US taxes are paid on income generated outside the US while EU companies only pay taxes for income generated within Europe?

The decision not to tax economic activities abroad is an internationally recognised method to avoid that companies are taxed twice. The application of this fundamental principle of fairness in international taxation should not surprise anybody.

If the US considers that its tax regime is disadvantageous to its companies it is completely free to change it the way it wants. It can replicate the tax system of its competitor, improve it, create a completely different one, etc. The only thing it cannot do is to provide export subsidies, in particular as a response to an allegedly disadvantageous situation resulting from its own sovereign
choice on tax matters.

(16) Are not US companies disadvantaged vis-à-vis their European counterparts by the fact that VAT is not collected on exports?

This allegation is false and does not stand up to serious analysis. VAT, as a consumption tax, is never paid by EU firms on their sales, it is only paid by the consumer. Companies are simply the vehicles to collect the tax, but if a company pays more VAT to its suppliers than what it has received from its customers, it will be reimbursed. Therefore, if a product is not consumed in the
EU there is no reason why it should pay VAT as it will be subject to the consumption tax of the country where it will be consumed. Moreover, VAT, although administered in a different way, is equivalent to the sales taxes charged by US states which are not collected on exports.

To conclude on this question it should be said that the VAT exemption on exports is explicitly permitted in the WTO.

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