Brazil – Certain Measures Concerning Taxation and Charges

(WT/DS472)

Third Party Submission of Australia

Geneva, 15 September 2015
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INTRODUCTION

1. Australia considers that these proceedings under the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) raise significant questions of legal interpretation concerning the obligations of WTO Members under the General Agreement on Tariffs and Trade 1994 (GATT 1994).

2. Australia has systemic and commercial concerns with the nature and design of Brazil’s assistance programs provided through tax preferences, in particular as they relate to the automotive sector.

3. The issues which Australia will address in this submission are:

   (a) The relationship between Articles III:2, III:5 and III:8(b) of GATT 1994;

   (b) The scope of Article III:5 of GATT 1994; and

   (c) Compliance with Article III:4 of GATT 1994 and the test for favourable treatment.

A. Relationship between Articles III:2, III:5 and III:8(b) of GATT 1994

4. A central issue in this case is whether Brazil’s measures in the automotive sector includes a prohibited local content requirement.

5. The European Union (EU) in its overview of the legal issues in dispute states (footnotes omitted):

   Indeed, the most prominent feature embedded in the Brazilian measures at issue is tax discrimination against imported goods, particularly through the use of tax advantages tied to local content requirements.¹

6. In describing Brazil’s measure, the EU states:

   Under the INOVAR-AUTO programme, Brazil provides tax advantages with respect to the Tax on Industrial Products (“IPI”). The tax advantages primarily consist in a reduction of the IPI tax burden on the sale of the products (motor vehicles) covered by the programme.²

7. The essential features of Brazil’s measure are further stated by the EU to be:

   …the essential features of the April 2012 system, namely the existence of an IPI surcharge, of a system of tax credits to offset the surcharge, and of a link between

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¹ EU’s First Written Submission to the Panel, para 91.
² EU’s First Written Submission to the Panel, para 183.
the tax credits and expenditures made in Brazil (notably on automotive components and tools), remain in the version of INOVAR AUTO 2012 currently applied.³

8. Article III:2 of GATT 1994 states:

The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.*

9. Article III:5 of GATT 1994 states:

No contracting party shall establish or maintain any internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions which requires, directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources. Moreover, no contracting party shall otherwise apply internal quantitative regulations in a manner contrary to the principles set forth in paragraph 1.*

10. Brazil relies on Article III:8(b) of GATT 1994 in justifying its compliance with both Article III:2 and Article III:5 of GATT 1994. Article III:8(b) of GATT 1994 permits the payment of subsidies exclusively to domestic producers, and states (emphasis added):

The provisions of this Article shall not prevent the payment of subsidies exclusively to domestic producers, including payments to domestic producers derived from the proceeds of internal taxes or charges applied consistently with the provisions of this Article and subsidies effected through governmental purchases of domestic products.

11. Australia considers that Article III:2, III:5 and III:8(b) need to be read together. Australia does not contest the right of Members to promote industrial development, including through the provision of assistance programs. However, in doing so, Members also need to uphold the rules preventing discriminatory taxes or internal quantitative regulations.

12. Assistance in interpreting Article III:8(b) of GATT 1994 was provided by the Panel in Indonesia – Autos:

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³ EU’s First Written Submission to the Panel, para 200.
We consider that the purpose of Article III:8(b) is to confirm that subsidies to producers do not violate Article III of GATT, so long as they do not have any component that introduces discrimination between imported and domestic products.4

13. This guidance from the Panel confirms the role of Article III:8(b) of GATT 1994 to allow subsidies to be paid to producers which do not discriminate between imported and domestic products, such as by having local content requirements.

14. It is important that the distinction is retained between the permitted payment of a subsidy exclusively to domestic producers, and a subsidy which is contingent on the use of domestic over imported goods and thereby prohibited under Article III:5 of GATT 1994 and Article 3.1(b) of the WTO Agreement on Subsidies and Countervailing Measures (SCM).

15. Australia notes that what is accepted to be a legitimate payment to domestic producers needs to be narrowly interpreted in line with the requirements of GATT 1994 and also the SCM. If paragraph 8(b) was interpreted broadly, any discrimination against imports could be qualified as a subsidy to domestic producers and thus render the discipline of Article III of GATT 1994 meaningless.

B. Scope of Article III:5 of GATT 1994 on ‘processing of products’

16. Article III:5 of GATT 1994 states (emphasis added):

No contracting party shall establish or maintain any internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions which requires, directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources. Moreover, no contracting party shall otherwise apply internal quantitative regulations in a manner contrary to the principles set forth in paragraph 1.*

17. The EU points to the number of “processing or production steps” required by Brazil as being a local content requirement which must increase over time in order to qualify under the program (emphasis added):

Manufacturing motor vehicles involves a certain number of processing or production steps. Thus, when the INOVAR-AUTO programme sets a minimum number of processing steps to be performed in Brazil, it is in fact defining in a quantitative manner the minimum threshold of local content for

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4 Interim Review Indonesia - Auto’s para 14.43. The Interim Review is part of the findings of the Panel Report.
a product to be eligible and retain the tax incentives under the INOVAR-AUTO programme.5

18. The EU considers that Article III:5 of GATT 1994 forbids:

…that a "specified … proportion" of that processing must be supplied from domestic sources. Therefore, Article III:5 rules out regulations that require, directly or indirectly, that a certain proportion of an industrial process takes place domestically…6

19. Brazil provides in its defense that its requirements relate to production only and do not violate Article III:5 of GATT 1994 (footnotes omitted):

The European Union argues that the production-step requirements under INOVAR-AUTO violate Article III:5 (the other requirements are not at issue). However, the production-step requirements set out in the INOVAR-AUTO do not establish an obligation to source goods domestically, contrary to what the European Union has asserted; they only require that certain stages of production be performed in Brazil. There are no requirements regarding amounts or proportions of products as there are no requirements regarding products at all.

20. Brazil contends that the EU’s interpretation of Article III:5 of GATT 1994 is incorrect and is an attempt to “stretch”7 the limits of Article III:5 of GATT 1994 to inappropriately include production subsidies.

21. In Australia’s view, Article III:5 of GATT 1994 provides that local content requirements are prohibited. The first sentence relates to quantitative regulation. This means that any internal regulation which requires the mixture, processing or use of products based on domestically sourced products is inconsistent with Article III:5 of GATT 1994.

22. In its First Written Submission Brazil addresses the meaning of “quantitative regulation” stating (emphasis added, footnotes omitted):

Although there is no jurisprudence regarding the term internal quantitative regulations in Article III:5, the Panel in EC-Banana interpreted the term "quantitative" in Article XIII as follows: "the Panel notes that the word 'quantitative' means [p]ossessing quantity, magnitude, or spatial extent'; [t]hat is, or may be, considered with respect to the quantity or quantities involved; estimated or estimable by quantity.”8

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5 EU’s First Written Submission to the Panel, para 413.
6 EU’s First Written Submission to the Panel, para 144.
7 Brazil’s First Written Submission to the Panel, para 592.
8 Brazil’s First Written Submission to the Panel, para 272.
23. Australia supports this interpretation of the term ‘quantitative’, which relates to having an identifiable quantitative amount, for the purposes of Article III:5 of GATT 1994. This accords with the ordinary meaning of the text. Article III:5 of GATT 1994 should be seen to prohibit any regulation which requires a quantity of local content.

24. The reference in Article III:5 of GATT 1994 to processing does not mean that, when read with Article III:8(b) of GATT 1994, a Member may not subsidise processing activities within its territory. Rather, in Australia’s view, the first sentence of Article III:5 of GATT 1994 means that where a Member provides subsidies designed to encourage manufacturing activities within its territory, including for specific industry sectors, it must do so consistent with Article III:5 of GATT 1994, that is, it must not directly or indirectly require the use of domestic products.

25. Australia contends that a distinction needs to be made between the payment of subsidies which encourage manufacturing activities as opposed to the payment of subsidies to manufacturing activities where there are effectively local content requirements. Setting a minimum number of stages in manufacturing activities in order to receive a benefit or qualify for a benefit (the tax credit), could amount to an internal quantitative regulation which may contravene Article III:5 of GATT 1994 by, for example, indirectly requiring a portion of the product to be supplied by domestic sources.

26. Further, it will be necessary for the panel to consider whether Brazil’s measure is an internal quantitative regulation inconsistent with Article III:5 of GATT 1994. In carrying out its examination, an issue the Panel may wish to examine is whether requiring a minimum number of processing activities be carried out in Brazil in order to receive a tax credit amounts to an internal quantitative regulation which requires, directly or indirectly, a specified amount or proportion of any product be supplied from domestic sources.

C. Article III:4 of GATT 1994 - Less favourable treatment

27. A further issue in this dispute is whether Brazil’s measure accords less favourable treatment to imported goods, in breach of Article III:4 of GATT 1994.

28. To benefit from the INOVAR-AUTO programme companies need to be “accredited”.

29. There are three types of "accreditation" (habilitação):

(i) for domestic manufacturers;

(ii) for domestic distributors without manufacturing activities in Brazil; and

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9 EU’s First Written Submission to the Panel, para 207.
(iii) for investors in domestic manufacturing capacity ("newcomers").

30. Those eligible beneficiaries were based on motor vehicle producers establishing a manufacturing presence in the Brazilian market and including meeting local content and other performance requirements.

31. In Australia’s view Brazil’s measure effectively created a framework or mechanism which has entrenched discrimination in Brazil’s market. For manufacturers planning a manufacturing presence in Brazil, there are also quantitative and value limits on using tax credits on imported vehicles.

32. This means that eligible companies in Brazil cannot utilize their credits where they see fit or import competitively without meeting performance requirements in Brazil. Credits granted to companies with plans to manufacture in Brazil during factory construction are limited to a specific volume of imports based on a formula related to the envisaged production capacity of the company.

33. GATT Article III:4 1994 states (emphasis added):

   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. The provisions of this paragraph shall not prevent the application of differential internal transportation charges which are based exclusively on the economic operation of the means of transport and not on the nationality of the product.

34. In order to make out a breach of Article III:4 of GATT 1994, three elements must be established: (i) that the imported and domestic products at issue are 'like products'; (ii) that the measure at issue is a 'law, regulation, or requirement affecting their internal sale, offering for sale, purchase, transportation, distribution, or use; and (iii) that the imported products are accorded 'less favourable' treatment than that accorded to like domestic products.

35. The third element, that the imported products are accorded 'less favourable' treatment than that accorded to like domestic products, is examined below.

36. Australia submits that in considering this issue, the Panel should have regard to the test used by the Appellate Body in Korea – Various Measures on Beef. In that case the Appellate Body stated (emphasis added):

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10 EU’s First Written Submission to the Panel para 208 (footnotes omitted).
11 Appellate Body Report, Korea – Various Measures on Beef, paragraph 133.
A formal difference in treatment between imported and like domestic products is thus neither necessary, nor sufficient, to show a violation of Article III:4. **Whether or not imported products are treated "less favourably" than like domestic products should be assessed instead by examining whether a measure modifies the conditions of competition in the relevant market to the detriment of imported products.**

37. When considering the application of Article III:4 of GATT 1994, the Panel should also have regard to Article III:1 of GATT 1994 as a general principle that informs the rest of Article III of GATT 1994. The Appellate Body in *Japan – Taxes on Alcoholic Beverages* stated:

> The purpose of Article III:1 is to establish this general principle as a guide to understanding and interpreting the specific obligations contained in Article III:2 and in the other paragraphs of Article III, while respecting, and not diminishing in any way, the meaning of words actually used in the texts of those other paragraphs.

38. In considering the two provisions together, the Appellate Body in *EC – Asbestos* stated:

> This interpretation must, therefore, reflect that, in endeavoring to ensure "equality of competitive conditions", the "general principle" in Article III seeks to prevent Members from applying internal taxes and regulations in a manner which affects the competitive relationship, in the marketplace, between the domestic and imported products involved, “so as to afford protection to domestic production.”

39. Australia notes the focus of this examination is whether Brazil’s measure affects the competitive relationship in the marketplace between domestic and imported goods. In line with the difference in the text between Articles III:2 and III:4 of GATT 1994 there is jurisprudence that Article III:4 of GATT 1994 does not require separate examination of whether a measure affords protection to domestic production, in *EC – Bananas III* the Appellate Body states:

> Article III:4 does not specifically refer to Article III:1. Therefore, a determination of whether there has been a violation of Article III:4 does not require a separate consideration of whether a measure "afford[s] protection to domestic production".

40. Thus the test concerns whether Brazil has applied internal taxes and regulations in a manner which affects competitive relationships in the marketplace.

41. Matters which the EU puts forward as being inconsistent with Article III:4 of GATT 1994 include:

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12 Appellate Body in *Korea – Various Measures on Beef*, paragraph 137.
…for a company to have access to the INOVAR-AUTO programme, it must invest a given proportion of its revenues in R&D and/or engineering in Brazil, and, in the case of manufacturers, comply with a minimum number of manufacturing steps in Brazil.16

42. In its defense, Brazil asserts that these requirements do not benefit domestic industry:

…the accreditation requirements under INOVAR-AUTO are not a benefit given to accredited companies. On the contrary, they are obligations imposed on the companies in exchange of their participation in the programme.17

43. In line with the jurisprudence provided above, Australia submits that the question the Panel must address for the purposes of Article III:4 of GATT 1994 is whether Brazil’s measures affects competitive relationships in the marketplace.

44. There is jurisprudence which supports a wide interpretation of “affecting”. In Canada — Autos, the Panel in a finding not addressed by the Appellate Body, interpreted the term “affecting” as having a broad scope of application and as referring to measures which have an effect on imported goods (emphasis added):

With respect to whether the CVA requirements affect the ‘internal sale, … or use’ of products, we note that, as stated by the Appellate Body, the ordinary meaning of the word ‘affecting’ implies a measure that has ‘an effect on’ and thus indicates a broad scope of application.

The word ‘affecting’ in Article III:4 of the GATT 1994 has been interpreted to cover not only laws and regulations which directly govern the conditions of sale or purchase but also any laws or regulations which might adversely modify the conditions of competition between domestic and imported products.18

45. Given the broad interpretation of “affecting”, and the broad and encompassing nature of Brazil’s measure and its significant tax implications, it is likely it would be seen as affecting competition.

46. In Japan - Alcoholic Beverages, the Appellate Body found that the combination of customs duties and internal taxation meant that an equality of competitive conditions was not guaranteed.19 In Korea - Beef the Appellate Body found that the effect the dual market had on competition (rather than the simple existence of the

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16 EU’s First Written Submission to the Panel, para 368.
17 Brazil’s First Written Submission to the Panel, para 576.
18 Panel Report, Canada Autos, paras 523-524.
19 Appellate Body Report, Japan –Alcoholic Beverages, page 31
the dual market itself) resulted in the measures being discriminatory. Thus, Australia submits that the Panel may look to a range of criteria to determine whether an equality of competitive conditions exists, and should examine those criteria in the light of the fundamental effect that the measure has on competition.

47. In considering a particular rule and condition for entitlement to the 30 percentage point reduction of the IPI tax rates, the EU noted:

…it applies only to imports of vehicles of the same brand as those manufactured by the accredited company.

48. This means that only those companies which have established a manufacturing presence in Brazil are able to import vehicles “of the same brand”. This significantly alters the terms of competition in the Brazilian market. It is equally difficult to see how otherwise this is a relevant obligation to impose on a company for their participation in the program. This raises concerns of Brazil’s compliance with Article III:4 of GATT 1994.

CONCLUSION

49. In considering whether Brazil’s measure contains a prohibited local content requirement, a distinction needs to be maintained by the Panel between the permitted payment of a subsidy to producers and a prohibited subsidy requiring local content.

50. Australia considers that Article III:2, III:5 and III:8(b) need to be read together. Australia does not contest the right of Members to promote industrial development, including through the provision of assistance programs. However, in doing so, Members also need to uphold the rules preventing discriminatory taxes or internal quantitative regulations.

51. Where a Member provides subsidies designed to encourage manufacturing activities within its territory, including for specific industry sectors, it must do so consistent with Article III:5 of GATT 1994, that is, it must not require the use of domestic products or require any quantitative regulation.

52. Australia contends that Brazil’s INOVAR-AUTO program is in breach of III:4 of GATT 1994 due to less favourable treatment to imported goods which impacts on competitive relationships conditions so as to afford protection to domestic competition.

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21 Appellate Body Report, Korea – Various Measures on Beef, paragraphs 58, 142-144; Appellate Body Report, EC – Asbestos, paragraph 123.
22 EU’s First Written Submission to the Panel, para 297.