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A Defenseless Policy?: An Analysis of China's Integrated Circuit Industry Tax Rebate Programs under WTO Laws

Cheng Wang†

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I. Introduction

In the mid-1980s, the People’s Republic of China (“China” or the “PRC”) began to improve its semiconductor manufacturing capability.1 Two decades later, the gap between U.S. and Chinese semiconductor manufacturing technology has significantly narrowed. Today, China’s most advanced semiconductor manufacturing facilities can produce integrated circuits (“IC”) that are less than one generation behind the most advanced IC’s in the semiconductor industry.2 China’s stated goal is to become self-sufficient in the production of semiconductors for its domestic market and to develop technology that is competitive on the world market.3 This strategic goal is being pursued for both economic and national security reasons and is directed by a series of five-year economic plans and projects that focus on high-technology industries. For example, in China’s Tenth Five-Year Plan on Information Industry,4 it is envisaged that by 2005, the value of information technology products manufactured by China will reach RMB 2,500 billion (approximately $300 billion) with a 20% annual growth rate.5 Its corresponding industrial value-added will increase to RMB 320 billion (approximately $38 billion), sales revenue will reach RMB 1,500 billion (approximately $180 billion), and exports volume will increase to $100 billion, at an average growth rate of 15% per year.6 By 2005, China is set to

2 Id.
3 Id.
5 Id.
6 Id.
have an annual production capacity of 20 billion integrated circuits, 400 billion electronic chips, and 18 million sets of microcomputers.\(^7\)

Against the backdrop of the Chinese government’s efforts to foster the IC industry, a number of incentive programs and policies favoring domestic IC fabricators and designers have been formulated and implemented since 2000. A landmark government document to this effect is the *Circular Regarding Issuance of Certain Policies Concerning the Development of the Software and Integrated Circuit Industry*\(^8\) issued by the State Council of the PRC (the highest level of government institution in China’s central executive hierarchy) on June 24, 2000 (“Circular No. 18”).\(^9\) This document introduces a number of preferential policies for software and IC industries, ranging from financing to taxation, labor, and intellectual property issues.\(^10\) Subsequent to the promulgation of Circular No. 18, China’s ministerial and local government agencies issued a number of implementing rules and specific guidelines in order to carry out the policies articulated in Circular No. 18.\(^11\) Some of these government documents provide enterprises involved in China’s software and IC industries with more government incentives than those contained in Circular No. 18.\(^12\)

Driven by these favorable investment incentive policies and the relatively low labor costs in China, more and more leading IC fabricators and equipment suppliers have been rushing to China to establish their facilities since the implementation of Circular No. 18 and its subsequent legislations. For example, Motorola has built a $1.9 billion fabrication facility in Tianjin, IBM has announced plans to build a large-scale semiconductor packaging and test base in Shanghai, NEC has invested in a semiconductor

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\(^7\) *Id.*


\(^10\) *See id.*

\(^11\) *See discussion infra Part II.A.2.*

\(^12\) *Id.*
fabrication joint venture in Shanghai with registered capital of $700 million, and Intel and AMD have built their wholly-owned semiconductor assembly and test facilities in Shanghai and Suzhou respectively, each with total investments exceeding $100 million.13 In addition, Taiwan, the world's largest producer of semiconductors, has also established nineteen semiconductor fabrication plants in Shanghai, Beijing, Songjiang, and Suzhou in an attempt to be part of the success of the Mainland China.14

Nevertheless, contemporaneous to the success of these industry-spurring policies, complaints from foreign semiconductor industry groups and governments also surfaced. The complainants, led by the Semiconductor Industry Association ("SIA") and the U.S. government, claimed that incentive policies have unjustifiably discriminated against foreign semiconductor manufacturers and designers and, therefore, violate the rules of the WTO, of which China has been a Member since 2001.15 The focus of attack on China's unfair trade policies are the value-added tax ("VAT") rebate programs as applied in the IC industry and as provided for in Circular No. 18, together with its subsequent legislations.16 The discontent is described in a statement by the SIA:

China imposes a VAT of 17% on sales of all imported and domestically-produced semiconductors and integrated circuits. However, current Chinese government policy provides for a rebate of the VAT burden in excess of 3% for certain integrated circuits manufactured within China. This discrimination against imported semiconductors through the VAT rebate is inconsistent


16 Id.
with China’s WTO obligations.

GATT Article III (on “National Treatment”) states that a WTO member cannot impose taxes on imported products that are greater than those imposed on domestic products. By rebating the amount of the VAT burden over 3% for local products, while continuing to impose the full 17% VAT on imported semiconductors, the current policy violates this most basic GATT/WTO obligation.

The semiconductor industry is a tremendously competitive business—a fraction of a percent can make the difference in winning or losing a sale. A 14% differential created through WTO inconsistent tax policy is a burden that foreign companies simply can’t overcome in selling into the Chinese market.17

These complaints eventually escalated into a trade policy dispute between the U.S. and Chinese governments. On March 18, 2004, the then U.S. Trade Representative (“USTR”), Robert B. Zoellick, announced that the United States had filed a case with the WTO regarding China’s discriminatory tax rebate policy for ICs.18 This action began the sixty-day consultation period required under the Understanding on Rules and Procedures Governing the Settlement of Disputes19 (“DSU”) of the WTO.

In July 2004, the U.S. and Chinese governments settled the dispute after multiple rounds of consultations and negotiations.20 Under the terms of settlement, China will not certify any new semiconductor products or manufacturers for eligibility for VAT refunds and will no longer offer VAT refunds that favor ICs designed in China.21 Further, by April 1, 2005, China will stop

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17 Testimony of Anne Craib, supra note 15 (emphasis added).


21 See id.
providing VAT refunds on Chinese-fabricated ICs to current beneficiaries.\(^{22}\)

Would China’s VAT policies favoring its IC industries have met the same result if the case had been reviewed by the Dispute Settlement Body (“DSB”) of the WTO? Was China inherently untenable in this trade dispute? This Article attempts to examine these questions and other WTO legal issues brought up by the parties to the dispute. It also tries to identify and assess some possible justifications and defenses available to China under WTO treaties and relevant case law for its IC industry VAT rebate programs. First, Part II introduces the factual background to China’s IC-related VAT rebate programs and preliminary allegations made by the United States and SIA. Against this factual background, a discussion of relevant legal issues involved in this dispute as well as possible defenses that might be available to China against the allegations, are presented in Parts III, IV, and V. Part VI completes the analysis with a look at an issue which, although not raised by the United States in its complaint, has important implications: subsidy. Finally, the concluding remarks of Part VII articulate an overall assessment of the defenses and justifications for China’s government with regard to its VAT rebate programs, as well as some policy suggestions regarding its domestic investment incentive policies vis-à-vis existing WTO rules.

II. Factual Background Relating to the Dispute

A. The IC-Related VAT Rebate Programs and the Legislative Background

1. China’s VAT System

In December 1993, the State Council of the PRC promulgated the Provisional Regulations of the Value-Added Tax of the People’s Republic of China\(^{23}\) ("VAT Regulations"). On December 25, 1993, the Ministry of Finance of the PRC ("MOF") promulgated the Implementing Rules for the Provisional

\(^{22}\) See id.

\(^{23}\) For a full text translation of the VAT Regulations, see HOWARD GENSLER ET AL., A GUIDE TO CHINA’S TAX & BUSINESS LAWS 134-40 (2d ed. 1998).
A DEFENSELESS POLICY?

Regulations of the Value-Added Tax of the People's Republic of China ("VAT Implementing Rules")\(^{24}\) pursuant to the VAT Regulations. These two government regulations established the regulatory foundation of China's VAT system, which is patterned heavily after the VAT system adopted by the majority of Western European countries.\(^{25}\)

The VAT Regulations designate three types of VAT taxpayers: (i) individuals and entities that sell goods; (ii) individuals and entities that provide processing, fixing, or repairing services; and (iii) individuals and entities that import goods into China.\(^{26}\) In general, both the VAT rates for the sale of goods within China and the import of goods into China are 17%.\(^{27}\) For sales or imports of certain necessities, such as grains, edible vegetable oils, public utility products (except electricity), publications, and agricultural instruments, the applicable VAT rate is 13%.\(^{28}\) The VAT rate is 6% for "small scale taxpayers" under the VAT Regulations.\(^{29}\)

Under China's VAT system, the tax is typically collected by the seller of a product and then included in the purchase price charged to the buyer.\(^{30}\) The tax is paid at regular intervals by enterprises to local tax bureaus.\(^{31}\) The amount of the tax payable is calculated by applying the VAT rate to the difference between the price of the product being sold (the output VAT) and the VAT previously paid on direct inputs, provided these inputs can be properly documented (the input VAT).\(^{32}\) The cost of fixed assets

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\(^{24}\) For a full text translation of the VAT Implementing Rules, see *id.* at 141-50.


\(^{26}\) GENSLE ET AL., *supra* note 23, at 141 (Art. 1 of the VAT Regulations).

\(^{27}\) *Id.*

\(^{28}\) *Id.* (Art. 2 of the VAT Regulations).

\(^{29}\) *Id.* at 147 (Art. 24 of the VAT Implementing Rules). "Small scale taxpayers" are those approved by the State Administration of Taxation ("SAT") of the PRC. *Id.* The term is defined in the VAT Implementing Rules to be either (i) manufacturer-sellers whose annual sales subject to VAT are less than RMB 1 million (approximately $120,000) or (ii) wholesalers and retailers whose annual sales subject to VAT are less than RMB 1.8 million (approximately $210,000). *Id.*

\(^{30}\) *Id.* at 141-42 (Arts. 4 and 5 of the VAT Regulations).

\(^{31}\) *Id.* at 147 (Art. 23 of the VAT Regulations).

\(^{32}\) *Id.* at 141 (Arts. 4 and 5 of the VAT Regulations).
and any other costs not directly associated with the production of
the good in question are not allowed to be credited against the
output VAT.\footnote{Id. at 143 (Art. 10(1) of the VAT Regulations).}

For IC products (either sold by domestic manufacturers or
imported from foreign fabricators) involved in the dispute between
China and the United States, the applicable VAT rate is 17%,
unless the taxpayer is a “small scale taxpayer” under the VAT
Regulations and VAT Implementing Rules.\footnote{Id.} The application of
VAT at a typical rate of 17% was not contested in the complaints
made by the U.S. government and industry groups.

2. China’s IC Industry VAT Incentive Programs

\textit{a. VAT Incentive Programs for Domestic IC
Fabricators}

The contentious VAT rebate programs devoted to China’s
domestic IC fabricators are specifically articulated in Circular No.
18, which provides:

Until 2010, VAT will be levied at the statutory rate of 17% on
an ordinary VAT payer’s sale of integrated circuits (including
monocrystal silicon wafers) produced by itself. \textit{The portion of
the actual tax burden in excess of 6% shall be rebated upon
collection} and used by the enterprise to research and develop
new integrated circuits and to expand reproduction.\footnote{Circular No.
18, supra note 8, art. 41 (emphasis added).}

On September 22, 2000, pursuant to \textit{Circular No. 18}, the
MOF, the State Administration of Taxation (“SAT”), and the
General Administration of Customs of the PRC jointly issued the
\textit{Circular on Relevant Tax Policy Issues concerning Encouraging
the Development of Software Industry and Integrated Circuits
implementing guidance with regard to tax preferential policies
articulated in \textit{Circular No. 18}.\footnote{Id. pmbl.}
rebated VAT to eligible domestic IC fabricators should not be subject to income tax. It further defined IC products as those "products performing specified circuits or specified functions through electronic devices integrated with special processing technologies on a semiconductor monocrystal chip or a ceramic chip and sealed within an enclosure." Circular No. 25 also stipulated that, in order to enjoy the VAT rebates articulated in Circular No. 18, a domestic company's qualification as an "IC fabricating enterprise" should be statutorily certified by its initial approval authorities as well as its tax authorities. Such a certification is subject to an annual review mechanism undertaken by the government.

Notwithstanding the definitions provided in Circular No. 25, the "integrated circuits ... produced by itself," as mentioned in Article 41 of Circular No. 18, are still subject to a set of mandatory certification requirements by government authorities to be eligible for the VAT rebate. The certification requirements and procedures are detailed in the Administrative Measures on Certification of Integrated Circuit Designing Enterprises and Products ("IC Certification Measures") issued by the Ministry of Information Industry ("MII") and SAT on March 7, 2002.

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38 Id. art. 2(1).

39 "Monocrystal chip" is also defined in Article 2(1) of Circular No. 25 as "a kind of semiconductor silicon in the state of single crystal." Id.

40 Id.

41 Id. art. 3(2). In China, formation of enterprises is frequently subject to statutory approval by the relevant government agencies. For example, the Ministry of Commerce of the PRC and its local equivalents are the initial approval authorities of all foreign-invested enterprises in China. Id.

42 Id. art. 3(5).


44 According to art. 7 of the IC Certification Measures, in order to enjoy the VAT rebate with regard to domestic IC fabricators set forth in Circular No. 18, the enterprise concerned must submit the application first to the local tax bureau responsible for its taxation for preliminary review. Id. (art. 7 of the IC Certification Measures). After the preliminary review, the local tax bureau would forward the application to the SAT for official certification. Id. The SAT should designate jointly with the MII certain certification agencies to conduct the certification of the applicant and/or its products. Id. In addition, according to Article 11 of the IC Certification Measures, the SAT and the MII are jointly carrying out an annual review system applicable to those certified
On October 22, 2002, the threshold for VAT rebates for domestic IC fabricators was reduced from 6% of the taxpayer’s “actual tax burden” to 3% of its “actual tax burden.” The reduction is embodied in another circular jointly issued by the MOF and SAT: Circular on Relevant Tax Policy Issues Concerning Furthering the Encouragement of Development of Software Industry and Integrated Circuits Industry ("Circular No. 70"). Accordingly, the “effective VAT rate” for eligible domestic IC fabricators has been reduced to 3%.

In addition to the IC industry VAT rebate policy, Circulars No. 18 and No. 25 also provide an exemption from tariff and value added taxes with respect to the importation of equipment and raw materials by certain large scale or “current generation IC fabricators.” To enjoy the zero import VAT rate and tariff rate with respect to their fabrication necessities, these fabricators should meet one of the following two criteria: (i) their total investment is over RMB 8 billion (approximately $1 billion) or (ii) they produce ICs with a linewidth of less than 0.25 microns. Similar to the VAT rebate program introduced above, eligibility for this tariff/VAT exemption policy is also subject to discretionary certification conducted by a series of central government agencies. Compared to the VAT rebate programs, it is much more difficult to obtain such certifications, and the preference is reportedly not widely enjoyed by IC fabricators in foreign investment enterprises.

applicants and/or their products. Id. (art. 11 of the IC Certification Measures). The IC Certification Measures do not specify parameters for products that can be certified as IC products.


47 Circular No. 18, supra note 8; Circular No. 25, supra note 36.

48 Circular No. 18, supra note 8, arts. 42, 44; Circular No. 25, supra note 36, art. 2(3).

49 Circular No. 25, supra note 36, art. 5(2).

50 Chao & Sussman, supra note 13, at 11 (stating that it is difficult to receive a benefit and only four Chinese foreign investment enterprises have met the qualifications).
b. VAT Incentive Programs for Domestic IC Designers

Since IC designing is an integral part of the IC industry development, it is also encouraged through special tax incentives. For example, Article 48 of Circular No. 18 provides:

If an integrated circuit designed by a domestic integrated circuit designing enterprise but truly cannot be fabricated in China, the chips may be produced abroad and, subject to the certification of the processing contract (including its specifications and quantity) by the authority in charge of the [IC] industry, customs duty shall be levied on the import thereof at a provisional preferential rate.\footnote{Circular No. 18, supra note 8, art. 48.}

In October 2002, the preferential tax treatment for IC chips designed in China but fabricated abroad was extended to the area of VAT, pursuant to the Circular on Tax Policies for Imports of Integrated Circuit Products Domestically Designed and Fabricated Abroad\footnote{Circular on Tax Policies for Imports of Integrated Circuit Products Domestically Designed and Fabricated Abroad (2002) [hereinafter Circular No. 140].} jointly issued by the MOF and SAT (“Circular No. 140”). Circular No. 140 provides that, with respect to ICs certified to be designed in China but fabricated abroad, an immediate VAT rebate would also be available for any amount collected in excess of 6% of the value added upon their importation to China.\footnote{Id. art. 1.} Accordingly, subject to certain certification procedures similar to those of the VAT rebate programs for IC fabricators, the “effective VAT rate” for such IC chips would be 6% upon importation, whereas those imported IC chips not certified to be designed in China would still pay the VAT at a rate of 17%.\footnote{It is also worth noting that this VAT rebate policy is retroactively effective as of July 1, 2000. Id. art. 4.}

B. Attacks on the VAT Rebate Programs by the U.S. Industry and Government

U.S. policymakers and semiconductor industry groups have been paying close attention to China’s technology improvements
and industry development with respect to ICs for both political and commercial reasons. In April 2002, members of the General Accounting Office ("GAO") of the U.S. Congress prepared a report urging the U.S. government to tighten technology export controls against China in order to protect U.S. national security and industry interests.\(^5\)

In October 2003, another extensive report was disseminated by SIA, a semiconductor industry group of the United States, claiming that China's preferential VAT treatments had created a cost advantage for its own production and was inconsistent with China's commitments as a member of the WTO and in clear violation of the General Agreement on Tariffs and Trade ("GATT").\(^6\) Specifically, the SIA report stated that the preferential VAT rebate programs applied in China's IC industry had provided "a partial VAT exemption for domestically designed and manufactured integrated circuits, but not imported like products" and appeared to be in clear violation of Article III:2 of the GATT.\(^7\) Further, the SIA reasoned that because the effect of the differential VAT was to protect domestic enterprises, the measure had also run afoul of GATT Article III:1.\(^8\)

In the official Request for Consultation submitted by the USTR to the DSB,\(^9\) the allegation with respect to the violation of the WTO rules was expressed as follows: "The United States therefore believes that these measures are inconsistent with the obligations of China under Articles I and III of the GATT 1994, the Protocol on the Accession of the People's Republic of China (WT/L/432), and Article XVII of [The General Agreement of

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\(^5\) U.S. GEN. ACCT. OFF., supra note 1.


\(^8\) Id.

Trade in Services ("GATS"). According to it, it appears that the battleground of the dispute between the United States and China had been extended to cover Article I of GATT (most-favored nation treatment of trade in goods), Article III of GATT (national treatment on trade in goods), and Article XVII of GATS (national treatment of trade in services).

In the following part of this Article, these issues will be examined and addressed under the relevant WTO treaties and case law. The issues discussed below are not intended to be exhaustive with respect to the dispute between the United States and China.

III. Issues Relating to GATT Article I

A. An Overview of GATT Article I

Article I of GATT imposes obligations on WTO Members to extend most-favored nation ("MFN") treatment to other Members of the organization in the course of trade in goods. Subject to a few exceptions, the MFN obligation under GATT Article I requires a WTO Member to treat activities of a particular foreign country or its citizens at least as favorably as it treats the activities of any other country. In the language of Article I itself, the MFN treatment requires that "any advantage, favor, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in

60 Id.

61 Protocol on the Accession of the People's Republic of China, WT/L/432 [hereinafter Protocol], available at http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN002123.pdf (Nov. 10, 2001). The consistency between the VAT rebate programs and the Protocol should be incorporated in other issues with regard to the consistency with Articles I and III of GATT because the VAT rebate programs with respect to the IC industry are not specifically mentioned in the Protocol. Id. Rather, the Protocol merely contains a general provision on China's VAT system (Section 11.2), which provides that "China shall ensure that internal taxes and charges, including value-added taxes, applied or administered by national or sub-national authorities shall be in conformity with the GATT 1994." Id. Therefore, it is conceivable that if the IC VAT rebate programs are in compliance with GATT, then there should be no issue of a violation of the Protocol here. Id.

62 See GATT, supra note 56, art. I.

63 Id.
or destined for the territories of all other contracting parties.”

The fundamental principle embedded in Article I of GATT is nondiscrimination, which has been central to the post-World War II international trading system. As the Appellate Body stated in its report on Canada – Certain Measures Affecting the Automotive Industry (“Canada – Autos”), the object and purpose of Article I is to “prohibit discrimination among like products originating in or destined for different countries,” and serve as “an incentive for concessions, negotiated reciprocally, to be extended to all other Members on an MFN basis.”

B. The U.S. Challenge to China’s IC-Related VAT Policies Under GATT Article I

It is apparent from the Request for Consultation submitted by the United States, as quoted below, that China’s VAT incentive programs concerning importation of chips designed in China is the target of the attack in connection with GATT Article I. “[W]e understand that China allows for a partial refund of VAT for domestically-designed ICs that, because of technological limitations, are manufactured outside of China. China thus appears to be providing for more favorable treatment of imports from one Member than another . . . .”

The following hypothesis illustrates the MFN issue raised by the United States: if a Chinese IC chip designer designs a type of chip and then has it fabricated in Japan, the importer of such chips from Japan, subject to certification by the Chinese government, can enjoy a partial VAT rebate. But, if the United States is exporting the same type of chip to China and such U.S. fabricated chips are not designed in China, there would be no VAT rebate

64 Id.
66 Canada – Certain Measures Affecting the Automotive Industry, WTO Doc. WT/DS139, 142/AB/R (May 1, 2000) [hereinafter Canada-Autos (Appellate Body)].
67 Id. para. 84.
68 On the other hand, at least on the face of the VAT rebate program for domestic IC fabricators, there is no appearance of any favorable treatment to any specific IC exporting country. As discussed infra, the VAT rebate programs for China’s domestic IC fabricators are more inclined to be charged for violation of Article III of GATT.
69 Request for Consultation, supra note 59 (emphasis added).
available for U.S. chip importers. Therefore, U.S. fabricated chips are discriminated against in comparison to the hypothesized Japanese chips.

C. Discussion of China's VAT Rebate Programs for Domestically Designed ICs Under GATT Article I

1. Order of Examination

In the WTO Panel Report on Indonesia – Certain Measures Affecting the Automobile Industry ("Indonesia – Autos"),\(^70\) the Panel set forth a framework for examining a measure challenged pursuant to Article I of GATT:

The Appellate Body, in Bananas III, confirmed that to establish a violation of Article I, there must be an advantage of the type covered by Article I and which is not accorded unconditionally to all "like products" of all WTO Members. Following this analysis, we shall first examine whether the tax and customs duty benefits are advantages of the types covered by Article I. Second, we shall decide whether the advantages are offered (i) to all like products and (ii) unconditionally.\(^71\)

The following discussion of China's VAT rebate for imported ICs designed in China observes this sequence.

2. Advantages Covered by Article I

There are essentially two types of advantages conferred by the Chinese government in connection with IC chips designed in China but fabricated overseas: i) exemption from tariffs and ii) the rebate of VAT collected upon an import in excess of 6%.\(^72\) Since China is a signatory of the Agreement on the Implementation of the Ministerial Declaration on Trade in Information Technology Products\(^73\) ("ITA"), which requires the elimination of tariffs

\(^70\) Indonesia – Certain Measures Affecting the Automobile Industry, WTO Doc. DS54, 55, 59, 64/R (July 2, 1998) [hereinafter Indonesia – Autos].

\(^71\) Id. para. 14.138.

\(^72\) Circular No. 25, supra note 36, art. 5(2).

imposed on information technology products, the tariff rate for IC chips\textsuperscript{74} imposed by the Chinese government should be 0% for products imported from WTO Member States. Therefore, the tariff exemption policy for imported IC chips designed in China would be unlikely to raise any MFN concerns before the WTO tribunal. The remaining contentious advantage, challenged by the United States as a violation of GATT Article I, appears to be the VAT rebate program for imported ICs.

The advantages referred to in Article I of GATT are not limited to custom duties. A VAT imposed on imported products, which is usually paid by the importers, does seem to fall into the broad language of Article I, which encompasses "charges of any kind imposed on or in connection with importation or exportation," and "any advantage, favour, privilege or immunity."\textsuperscript{75} In fact, VAT for imported goods is typically collected, together with tariffs, by China's customs authorities on behalf of the tax authorities.\textsuperscript{76}

Yet, on closer examination of this policy, the notion of an "advantage" might be clouded by the "rebate" feature as provided in \textit{Circular No. 140}. Based on a literal reading of Article 1 of \textit{Circular No. 140}, the theoretical VAT rate applicable to all imported IC chips, no matter where they are designed, is universally 17%.\textsuperscript{77} \textit{Circular No. 140} requires that Chinese tax authorities \textit{immediately rebate} any VAT levied in excess of 6% to domestic taxpayers, who are ordinarily Chinese IC chip importers, after the chips are imported.\textsuperscript{78} Consequently, China could have argued that its VAT rebate program for imported IC chips is a type of subsidy conferred on domestic IC chip importers rather than an "advantage, favour, privilege or immunity" granted to the IC chip as a "product" under Article I of GATT.\textsuperscript{79} The "subsidy" conferred here is contingent on a Chinese domestic importer's importation of IC chips that are designed in China and are

\textsuperscript{74} IC is a type of information technology product covered under the schedules of the ITA. \textit{See id.} at Section 1 of Attachment A.

\textsuperscript{75} GATT, \textit{supra} note 56, art. I.

\textsuperscript{76} GENSLEER ET AL., \textit{supra} note 23, at 146 (Art. 20 of the VAT Regulations).

\textsuperscript{77} \textit{See Circular No. 140, supra} note 52, art. 1.

\textsuperscript{78} \textit{See id.}

\textsuperscript{79} GATT, \textit{supra} note 56, art. I.
calculated based on 11% (the difference between the 17% mandatory VAT rate and the 6% rebate limit) of the import value.80 By asserting this argument, China might be able to divert the scrutiny of this policy from Article I of GATT to the Agreement on Subsidies and Countervailing Measures81 ("SCM Agreement") of the WTO.82

A counterargument that may be relied upon is the Panel’s ruling in the Indonesia – Autos case in response to Indonesia’s claim of the exclusive application of the SCM Agreement with regard to its sales tax and customs duty exemptions in the contested program.83 The Panel stated:

We have already discussed in Section C above why we consider that the SCM Agreement is not generally the only relevant and applicable agreement to the measures under examination. We found that the obligations contained in the WTO Agreement are generally cumulative and can be complied with simultaneously. We shall, therefore, now proceed to the examination of the claims of the complainants that aspects of the Indonesian car programmes violate the MFN obligations of Article I of GATT.84

The customs duty benefits of the various Indonesian car programmes are explicitly covered by the wording of Article I. As to the tax benefits of these programmes, we note that Article I:1 refers explicitly to “all matters referred to in paragraphs 2 and 4 of Article III”. We have already decided that the tax discrimination aspects of the National Car programme were matters covered by Article III:2 of GATT. Therefore, the customs duty and tax advantages of the February and June 1996

80 Id.


82 Under the SCM Agreement, such a subsidy, contingent on importation of products, is not necessarily prohibited. Id. For further discussion of the IC VAT rebate programs as a type of subsidy, refer infra to Part VI of this Article.


84 Id. para. 14.131 (emphasis added).
car programmes are of the type covered by Article I of GATT.\textsuperscript{85}

While utilizing this counterargument, particular attention must be paid to two important facets upon which Indonesia – Autos was premised when bringing Indonesia’s car programs under the scrutiny of Article I. First, the “customs duty benefits” were “explicitly covered by the wording of Article I.”\textsuperscript{86} Second, Indonesia’s car program was determined to have been “covered by Article III:2 of GATT.”\textsuperscript{87} Such premises are not necessarily discernable in China's IC-related VAT rebate programs because the word “rebate” is not explicitly stipulated in Article I, and it is highly debatable whether the programs are covered by paragraphs 2 or 4 of GATT Article III.\textsuperscript{88} Therefore, conceptually, there should be considerable room for China to distinguish the mechanism of “rebate of already collected tax” from a tax exemption program, which was struck down by the Panel of Indonesia – Autos and the Appellate Body of Canada – Autos as a violation of GATT Article I.\textsuperscript{89} Indeed, the author of this Article is unaware of any WTO Panel or Appellate Body jurisprudence examining a “tax rebate” program under Article I of GATT.

3. Like Products

It is hard to envisage any material dispute between China and the United States on the issue of likeness with respect to the imported IC products. The United States could probably establish the fact that IC chips designed in China and IC chips designed elsewhere have the same structures, characters, functions, end-users, and even tariff classifications. Examined in the light of GATT Article I, it would be difficult for China to argue that IC chips designed in China are not like products of IC chips designed elsewhere, if other characteristics of such products are “like.” To be sure, the distinguishing of like products provided in Article I

\textsuperscript{85} Id. para. 14.139 (emphasis added).

\textsuperscript{86} Id.

\textsuperscript{87} Id.

\textsuperscript{88} The VAT rebate policy for imported chips designed in China was, until now, not challenged by the United States under Article III. See infra Part IV.B. Furthermore, as Part IV.C.1 will discuss, given the provisions of Article III:8(b) of GATT, arts. III:2 or III:4 might not be applicable here. See infra Part IV.C.1.

\textsuperscript{89} See Indonesia – Autos, supra note 70, para 15.1(c); Canada – Autos (Appellate Body), supra note 66, para. 86.
based on the method or history of production was expressly objected by a 1981 GATT Panel Report on Spain — Tariff Treatment of Unroasted Coffee.\textsuperscript{90}

The Panel examined all arguments that had been advanced during the proceedings for the justification of a different tariff treatment for various groups and types of unroasted coffee. It noted that these arguments mainly related to organoleptic differences resulting from geographical factors, cultivation methods, the processing of the beans, and the genetic factor. The Panel did not consider that such differences were sufficient reason to allow for a different tariff treatment. It pointed out that it was not unusual in the case of agricultural products that the taste and aroma of the end-product would differ because of one or several of the above-mentioned factors.

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In light of the foregoing, the Panel concluded that unroasted, non-decaffeinated coffee beans listed in the Spanish Customs Tariff... should be considered as like products within the meaning of Article I:1.\textsuperscript{91}

Nevertheless, China might want to pay close attention to the products included in the complaint by the United States and try to single out those "directly competitive or substitutable products" mingled in the allegations as "like products" under Article I so as to mitigate the disadvantageous position on this point. China might be able to rely on a 1978 GATT Panel Report on EEC — Measures on Animal Feed Proteins for authority.\textsuperscript{92} This document supports a narrow reading of the phrase "like products" in GATT Article I: "The Panel noted that the general most-favoured-nation treatment provided for in Article I:1... did not mention directly competitive or substitutable products. In this regard the Panel did not consider animal, marine and synthetic proteins to be products like those vegetable proteins covered by the measures."\textsuperscript{93}


\textsuperscript{91} Id. paras. 4.6, 4.9 (emphasis added).


\textsuperscript{93} Id. para. 4.20.
The Appellate Body has pointed out in its Report on *Japan–Taxes on Alcoholic Beverages* (*Japan–Alcohol*)\(^{94}\) that determination of both “like products” and “directly competitive and substitutable products” warrants case-by-case study.\(^{95}\) The distinguishing of “like products” from the wider category of “directly competitive and substitutable products” is presumably also decided on a case-by-case basis pursuant to the products’ physical characteristics, common end-users, tariff classifications, and the “market place” (including the elasticity of substitution between products).\(^{96}\)

4. *Origin Specificity and Unconditional Application*

The next issue that would need to be discussed by the WTO tribunal in connection with an Article I violation is whether the “advantage” is granted to “any products originating in or destined for any other country,” and, if so, whether such an advantage is “accorded immediately and unconditionally” to the like products of all other WTO members.\(^{97}\)

In this connection, China could probably make a persuasive argument that the IC rebate policy under the scrutiny of Article I:1 is completely origin-neutral rather than country-specific. Hence, the favorable tax treatment is granted to “some products” (IC chips designed in China) originating in all Members of the WTO rather than “any products originating from a specific country.” In addition, China might argue that although the application of such preferential tax treatment is conditioned on where the chips are designed, such a condition is equally applicable to every Member of the WTO. In this sense, the application of the “conditional tax treatment” is unconditional.

Indeed, China’s VAT rebate program conditioned on the designer of IC chips involves the contentious issue of discrimination based on processes and production methods (“PPMs”) and its compatibility with Article I of GATT. A literal reading of GATT Article I:1 seems to suggest that discrimination

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\(^{94}\) *Japan–Taxes on Alcoholic Beverages*, WTO Doc. WT/DS8,10,11/AB/R (Oct. 4, 1996) [hereinafter *Japan–Alcohol*].

\(^{95}\) See id. at 19-21.

\(^{96}\) See id. at 25.

\(^{97}\) See GATT, supra note 56, art. I:1.
against imported products based on their PPMs is not per se illegal. In other words, the U.S. challenge to this origin-neutral policy carried out by China is not textually supported by Article I. Nevertheless, the jurisprudence of GATT and the WTO appears to have explored this issue further.

In one of the earliest GATT decisions, Belgian Family Allowances, a Panel considered whether Belgium’s levying of a non-product-related PPM tax on imported goods from other countries had violated GATT Article I. The Panel reasoned that the nature of an exporting country’s family allowance program was “irrelevant” to GATT Article I, which does not permit discrimination depending on conditions, and so the Panel struck down the Belgium tax policy. The Panel stated in its report that Article I required Belgium to grant the exemption to every other GATT party regardless of whether a government qualified for the exemption by having a similar family allowance program.

Among the dispute settlement reports in the WTO era, there are two cases litigating the PPM tax programs vis-à-vis GATT Article I, namely Indonesia – Autos and Canada – Autos. Both of the Indonesian and Canadian PPM-based tax programs were struck down by their corresponding WTO adjudicators.

The PPM-based tax programs challenged in Indonesia – Autos concerned the exemption of customs duties and sales taxes on imported products when the exporting manufacturer utilizes a sufficient amount of Indonesian parts or labor. According to the Panel, GATT case law made clear that any advantage “cannot be made conditional on any criteria that is [sic] not related to the imported products itself.” Based upon this premise, the Panel

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99 Id. para. 1.
100 Id. para. 3.
101 Id. para. 5.
102 Id. paras. 3, 6.
103 See Indonesia – Autos, supra note 70, para. 15.1(a); Canada – Certain Measures Affecting the Automotive Industry, WTO Doc. WT/DS139, 142/R (Feb. 11, 2000) [hereinafter Canada-Autos (Panel Report)].
104 Indonesia – Autos, supra note 70, paras. 2.17-18, 2.27-28.
105 Id. para. 14.143.
reasoned:

Indeed, it appears that the design and structure of the June 1996 car programme is such as to allow situations where another Member's like product to a National Car imported by PT PTN from Korea will be subject to much higher duties and sales taxes than those imposed on such National Cars. For example, customs duties as high as 200% can be imposed on finished motor vehicles while an imported National Car benefits from a 0% customs duty. No taxes are imposed on a National Car while an imported like motor vehicle from another Member would be subject to a 35% sales tax. The distinction as to whether one product is subject to 0% duty and the other one is subject to 200% duty or whether one product is subject to 0% sales tax and the other one is subject to a 35% sales tax, depends on whether or not PT TPN had made a "deal" with that exporting company to produce that National Car, and is covered by the authorization of June 1996 with specifications that correspond to those of the Kia car produced only in Korea. In the GATT/WTO, the right of Members cannot be made dependent upon, conditional on or even affected by, any private contractual obligations in place. The existence of these conditions is inconsistent with the provisions of Article 1:1, which provides that tax and customs duty benefits accorded to products of one Member (here on Korean products) be accorded to imported like products from other Members "immediately and unconditionally."

It is interesting to note that, although the Panel of Indonesia – Autos stressed the relationship between the "criteria" and the "product itself," what the Panel really relied on is the origin specificity feature (the de facto discrimination effect of the autos from Korea and autos from other countries) of the criteria and the effect thereof. In the Canada – Autos case, the Panel adopted a more nuanced interpretation of Article I with regard to PPM-based discriminations. The Panel opined that "the fact that conditions attached to such an advantage are not related to the import itself does not necessarily imply that such conditions are discriminatory

106 Id. para. 14.145 (footnote omitted).
107 Id.
with respect to the origin of imported products.” Therefore, contrary to the reasoning of the Panel of Indonesia – Autos, the Panel of Canada – Autos ruled that Canada’s import duty exemption “cannot be held to be inconsistent with Article I:1 simply on the grounds that it is granted on conditions that are not related to the imported products themselves.” Rather, the adjudicator must determine “whether these conditions amount to discrimination between like products of different origins.” The Panel later found that Canada’s tax exemption was origin-specific and concluded that Article I:1 was violated on that ground.

On appeal, the findings of the Panel of Canada – Autos were upheld by the Appellate Body on the ground of de facto discrimination. The interpreting methodology of the Panel in the preceding paragraph was not addressed by the Appellate Body.

While addressing de facto discrimination prohibited under Article I:1, the Appellate Body pointed out that the text of the provision is in no way limited to “on its face” or “de jure” discrimination. The broad application of Article I:1 applies to “any advantage,” not just to “some advantage;” to “any product,” not just to “some products;” and to the like products originating in “all other” Members, not just to the like products from “some”

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108 Canada – Autos (Appellate Body), supra note 66, para. 10.24.
109 Canada – Autos (Panel Report), supra note 103, para. 10.30 (emphasis added).
110 Id.
111 The Appellate Body first observed that although the measures impose no formal restriction on the origin of the imported motor vehicles that are eligible to receive the import duty exemption, in practice the major automotive firms in Canada import only their own make of motor vehicles and those of related companies. Canada – Autos (Appellate Body), supra note 66, para. 10.24). As such, the Appellate Body remarked:

[T]hese privileged motor vehicles are imported by a limited number of designated manufacturers who are required to meet certain performance conditions. In practice, this measure does not accord the same import duty exemption immediately and unconditionally to like motor vehicles of all other Members, as required under Article I:1 of the GATT 1994. The advantage of the import duty exemption is accorded to some motor vehicles originating in certain countries without being accorded to like motor vehicles from all other Members.

Id. para. 85 (emphasis in original).
112 Id. para. 78. 
other Members. Further, the Appellate Body recalled the Panel’s finding that, in practice, the duty exemption is granted to imports from only a small number of countries in which the exporters are affiliated with eligible Canadian manufacturers/importers. Thus, considering both the text of Article I:1 and the Panel’s conclusions about the “practical operation of the measure,” the Appellate Body concluded that Canada had acted inconsistently with GATT Article I:1 by granting an “advantage” to some products from some Members, so that Canada has not “accorded immediately and unconditionally” to “like” products “originating in or destined for the territories of all other Members.”

The jurisprudence of the WTO summarized above appears to reveal the rule that a PPM-based, origin-neutral policy can only be a violation of Article I:1 when it is found to be a de facto discrimination based on the product’s origin. To establish a de facto discrimination that violates GATT Article I, the trading effect of such a policy must be examined and the adjudicators must find discriminating results from such effect.

Applying such rules to the case at hand, the United States might find it hard to establish the discriminatory trading effect. Statistics could have revealed that the United States is currently the largest exporter of IC chips to China.

IV. Issues Relating to GATT Article III

A. An Overview of GATT Article III

The national treatment obligation as embodied in Article III of GATT is another form of non-discrimination requirement. It mandates that a nation must treat within its own borders the goods, services, and persons originating from outside its border in the same manner as it treats those which are of domestic origin. Obviously, an important policy behind this rule is to prevent domestic tax and regulatory policies from being used as protectionist measures that would defeat the purpose of tariff

113 Id. para. 79.
114 Id. para. 80.
115 Id. paras. 79, 80.
116 GATT, supra note 56, art. III.
 bindings. This goal is constantly reaffirmed by the WTO adjudicating body in their dispute settlement reports. For example, in the Appellate Body Report on Japan – Alcohol, the purpose of GATT Article III was explained in the following terms:

The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. More specifically, the purpose of Article III is to ensure that internal measures "not be applied to imported or domestic products so as to afford protection to domestic production." Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products. The intention of the drafters of the Agreement was clearly to treat the imported products in the same way as the like domestic products once they had been cleared through customs. Otherwise indirect protection could be given.

The first paragraph of GATT Article III is a statement of general policy that sets out the national treatment obligation pertaining to the treatment of imported products. It contains a phrase obligating contracting parties to avoid using taxes or regulations "so as to afford protection to domestic production."

The second paragraph of Article III requires that internal taxes on imported products shall not exceed those applied to domestic goods and expressly refers to the general goal of paragraph 1. Specifically, the two sentences in Article III:2 distinguish between two different types of products when a Member is granting national treatment: like products and directly competitive and

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118 Japan – Alcohol, supra note 94, at 16 (footnotes omitted).
119 GATT, supra note 56, art. III:1.
120 Id.
121 Id. art. III:2.
122 The first sentence of Article III:2 reads in its entirety: "[T]he 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 products." Id. (emphasis added.)
According to such a distinction, a complaining party alleging a violation of Article III:2 has two possible avenues. One is to establish that (i) the domestic and the imported products are like products and (ii) the latter products are taxed in excess of the former. The second avenue is to establish that (i) the domestic and the imported products are directly competitive and substitutable products; (ii) the two products are not similarly taxed; and (iii) the dissimilar taxation operates so as to afford protection to domestic production.

The fourth paragraph of Article III imposes essentially the same obligation with respect to regulations and other requirements affecting the internal sale of imported products (other than tax treatments). Paragraphs 5 and 7 of Article III prohibit the use of mixing requirements to favor domestic products.

The rest of the paragraphs of Article III provide for a series of exceptions to the application of general national treatment. Among these exceptions, the most relevant one to the dispute discussed in this Article lies in Article III:8(b), which provides: "[T]he 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."

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123 The second sentence of Article III:2 reads in its entirety: "[M]oreover, no contracting party shall other apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1." Id. The Ad Note of Article III:2 further explains the second sentence of this paragraph and the relations between the two sentences in the following terms:

A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.

Id. (emphasis added).

124 Id. art. III:4.
125 Id. art. III:5, 7.
126 Id. art. III:8-10.
127 Id. art. III:8(b).
B. The U.S. Challenge to China’s IC-Related VAT Programs Under GATT Article III

In the oversimplified Request for Consultations submitted by the United States in connection with China’s VAT on ICs, the charge with respect to China’s violation of GATT Article III was as follows:

China provides for a 17 percent VAT on ICs. However, we understand that enterprises in China are entitled to a partial refund of the VAT on ICs that they have produced, resulting in a lower VAT rate on their products. China therefore appears to be subjecting imported ICs to higher taxes than applied to domestic ICs and to be according less favourable treatment to imported ICs.\(^\text{128}\)

C. Discussion of China’s VAT Rebate Programs for IC Fabricators Under GATT Article III

1. Article III:8(b) and the Applicability of Article III

Before examining the substantive issues pertaining to the national treatment obligations mandated under Article III of GATT, a threshold question is whether Article III should apply at all in this case. Again, a plain reading of the provisions in Circulars Nos. 18, 25, and 70 suggests that the VAT rebate programs implemented therein are highly likely to be “the payment of subsidies exclusively to domestic producers, including payments to domestic producers derived from the proceeds of internal taxes or charges”\(^\text{129}\) as provided in the Article III:8(b) exception.\(^\text{130}\) Indeed, China probably could use the same argument as discussed in Part III.C, \textit{supra}, to distinguish between the notion of a “tax revenue rebate” and the concept of “tax exemption” or “tax discrimination.” Consequently, it is entirely possible that the WTO adjudicator would read China’s VAT rebate programs for IC

\(^{128}\) \textit{Request for Consultation, supra} note 59 (emphasis added). Hence, it is apparent that the target policy of this charge is China’s VAT rebate program for domestic IC fabricators as introduced in Part II.A of this Article.

\(^{129}\) \textit{See Circular No. 18, supra} note 8; \textit{Circular No. 25, supra} note 36; and \textit{Circular No. 70, supra} note 45.

\(^{130}\) GATT, \textit{supra} note 56, art. III:8(b).
fabricators as a type of subsidy, which is explicitly exempted from the application of the national treatment obligation in Article III of GATT.

Nevertheless, a review of the relevant GATT and WTO jurisprudence indicates that the granting of subsidies, in the usual sense, does not automatically furnish a safe harbor for the measure to avoid scrutiny for the applicability of the national treatment obligations under Article III. As the discussion below demonstrates, most of the cases in the history of GATT/WTO jurisprudence have subscribed to a fairly narrow reading of the word “subsidy,” and the DSB has struck down almost all of the assertions of the Article III:8(b) exemption invoked by the countries providing the “subsidies.” Hence, a more thorough analysis of the pertinent regulations is warranted, and a number of qualifiers to the “subsidy” is indispensable to establish an Article III:8(b) exemption.

In the WTO era, the two cases analyzing the Article III:8(b) exemption are Canada – Certain Measures Concerning Periodicals (“Canada – Periodicals”) and Indonesia – Autos. Neither Canada nor Indonesia succeeded in invoking the Article III:8(b) exemption to protect their “subsidy” programs from national treatment scrutiny.

In the Canada – Periodicals dispute, one of the measures at issue related to postal rates charged by the Canadian Post Corporation, a Crown Corporation controlled by the Canadian government. Canada Post applied reduced postal rates to Canadian-owned and Canadian-controlled periodicals meeting certain requirements. These lower postal rates were funded by the Department of Canadian Heritage, which provided funds to Canada Post so that this agency could, in turn, offer the reduced postal rates to eligible Canadian periodicals. Canada argued that

132 Id. para. 35.
133 Indonesia – Autos, supra note 70, para. 14.122.
134 Canada – Periodicals, supra note 131, at 35.
135 Id.
136 Id. at 32.
the reduced postal rate was exempted from the structures of Article III:4 by virtue of Article III:8(b) because the reduced postal rate represented "payment of subsidies exclusively to domestic producers."137 The Panel agreed with Canada and found that the funds provided by the Department of Canadian Heritage passed through Canada Post directly to the eligible Canadian publishers and that, therefore, Canada's funded rate scheme on periodicals qualified under Article III:8(b).138 The Appellate Body subsequently reversed the Panel's finding and found that Article III:8(b) applied only to the payment of subsidies which involves the expenditure of revenue by a government:

In examining the text of Article III:8(b), we believe that the phrase, "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" helps to elucidate the types of subsidies covered by Article III:8(b) of the GATT 1994. It is not an exhaustive list of the kinds of programmes that would qualify as 'the payment of subsidies exclusively to domestic producers', but those words exemplify the kinds of programmes which are exempted from the obligations of Articles III:2 and III:4 of the GATT 1994.

Our textual interpretation is supported by the context of Article III:8(b) examined in relation to Articles III:2 and III:4 of the GATT 1994. Furthermore, the object and purpose of Article III:8(b) is confirmed by the drafting history of Article III. In this context, we refer to the following discussion in the Reports of the Committees and Principal Sub-Committees of the Interim Commission for the International Trade Organization concerning the provision of the Havana Charter for an International Trade Organization that corresponds to Article III:8(b) of the GATT 1994:

This sub-paragraph was redrafted in order to make it clear that nothing in Article 18 could be construed to sanction the exemption of domestic products from internal taxes imposed on like imported products or the remission of such taxes. At the same time the Sub-Committee recorded its view that

137 Id. at 7.
138 Id.
nothing in this sub-paragraph or elsewhere in Article 18 would override the provisions of Section C of Chapter IV.

We do not see a reason to distinguish a reduction of tax rates on a product from a reduction in transportation or postal rates. Indeed, an examination of the text, context, and object and purpose of Article III:8(b) suggests that it was intended to exempt from the obligations of Article III only the payment of subsidies which involves the expenditure of revenue by a government.\textsuperscript{139}

In Indonesia – Autos, the Panel examined certain tax exemptions for domestically produced automobiles and rejected Indonesia's assertion of an Article III:8(b) exemption on similar grounds:

We consider that the purpose of Article III:8(b) is to confirm that subsidies to producers do not violate Article III, so long as they do not have any component that introduces discrimination between imported and domestic products. In our view the wording "payment of subsidies exclusively to domestic producers" exists so as to ensure that only subsidies provided to producers, and not tax or other forms of discrimination on products, be considered subsidies for the purpose of Article III:8(b) of GATT. This is in line with previous GATT panels and WTO Appellate Body reports.

We recall also that the type of interpretation sought by Indonesia was explicitly excluded by the drafters of Article III:8(b) when they rejected a proposal by Cuba at the Havana Conference to amend the Article so as to read:

\textit{The provisions of this Article shall not preclude the exemption of domestic products from internal taxes as a means of indirect subsidization in the cases covered under Article [XVI].}

The arguments submitted by Indonesia that its measures are only governed by the SCM Agreement clearly do not find any support in the wording of Article III:8(b) of GATT. On the contrary, Article III:8(b) confirms that the obligations of Article III and those of Article XVI (and the SCM Agreement) are different and complementary: subsidies to producers are subject to the national treatment provisions of Article III when they

\textsuperscript{139} Id. at 33-34.
discriminate between imported and domestic products.\footnote{Indonesia – Autos, supra note 70, para. 14.43-14.45 (footnotes omitted).}

During the GATT era, the invocation of the Article III:8(b) exception was struck down on three out of four occasions.\footnote{Panel Reports on Italian Discrimination Against Agriculture Machinery (GATT Doc. L/833, adopted on Oct. 23, 1958, B.I.S.D. 7S/60), European Economic Community – Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins (GATT Doc. L/6627, adopted on Jan. 25, 1990, B.I.S.D. 37S/86), United States – Measures Affecting Alcoholic and Malt Beverages (GATT Doc. DS23/R, adopted on June 19, 1992, B.I.S.D. 39S/206). For the reasoning of the GATT Panels in striking down these Article III:8(b) exceptions in these cases, see WORLD TRADE ORGANIZATION, ANALYTICAL INDEX: GUIDE TO GATT LAW AND PRACTICE 194-96 (1995).} The only challenge that withstood scrutiny is contained in the Panel Report of United States – Measures Affecting the Importation, Internal Sales and Use of Tobacco ("U.S. – Tobacco").\footnote{WTO Dispute Panel Report on United States – Measures Affecting the Importation, Internal Sales and Use of Tobacco, WTO Doc. DS44/R (Oct. 4, 1994) [hereinafter U.S. – Tobacco].} In this case, the Panel examined a claim regarding the No Net Cost Assessment ("NNCA") levied on domestic and imported tobacco, the proceeds of which were deposited in an account used to reimburse the U.S. Government for any losses resulting from the domestic tobacco price-support program.\footnote{Id. para. 10.} The Panel distinguished the NNCA program from previous cases and reasoned:

The Panel was cognizant of the fact that a remission of a tax on a product and the payment of a producer subsidy out of the proceeds of such a tax could have the same economic effects. However, the Panel noted that the distinction in Article III:8(b) is a formal one, not one related to the economic impact of a measure. Thus, in view of the explicit language of Article III:8(b), which recognizes that the product-related rules of Article III "shall not prevent the payment of subsidies exclusively to domestic producers", the Panel did not consider, as argued by the complainants, that the payment of a subsidy to tobacco producers out of the proceeds of the NNCA resulted in a form of tax remission inconsistent with Article III:2.
The Panel then considered the complainants' claim that the NNCA was inconsistent with Article III:2, second sentence, because the NNCAs charged on imported tobacco reduced the cost of the price support programme to the domestic tobacco producer, without providing any benefit to imported tobacco. The Panel did not consider that it needed to examine this claim in view of the fact that Article III:8(b), which explicitly recognizes that subsidies to domestic producers are not subject to the national treatment rules of Article III, applies to all provisions of Article III, including that of Article III:2, second sentence.\footnote{id. paras. 109, 111 (emphasis added) (footnotes omitted).}

The rule one can summarize from these cases is that a tax exemption or reduction available exclusively to domestic producers would not trigger the Article III:8(b) exemption. The direct payment of tax revenues derived from a tax applied equally and exclusively to domestic producers qualifies, however, as an Article III:8(b) exemption and, thus, escapes from the national treatment obligation provided for in the remaining paragraphs of Article III.

Given its "payment" nature, China's VAT rebate programs for IC fabricators more closely resemble the NNCA program in the U.S. – Tobacco case rather than the tax exemption or reduction cases of Canada – Periodicals and Indonesia – Autos. Therefore, China should have a strong legal basis to invoke the Article III:8(b) exemption and argue that the national treatment obligations in Articles III:2 and III:4 do not apply.

A counterargument that the United States might be able to raise is that, even though the VAT rebate program is literally worded as an "immediate payment" to domestic IC fabricators from the already collected VAT revenues, Chinese government authorities are not, in fact, implementing the regulations in that manner. Given the loosely drafted government documents and the lack of coherence with respect to tax law enforcement among the local tax bureaus throughout China, it would not be impossible for the United States to find a few manufacturers who are administratively collecting VAT from local IC fabricators according to the "effective tax burden rate" (3%) instead of rebating the tax revenue to such companies after VAT
collection.\textsuperscript{145} Based on such evidence, the United States could argue that despite the fact that the language in the relevant government documents may fulfill the standards for invoking the Article III:8(b) exception, government enforcement of such legislation at certain local levels has factually negated the "payment" nature as required under Article III:8(b). Therefore, the program as a whole, including its local implementation, should be brought under the purview of Article III.

This counterargument involves the vexing issue of what constitutes "measures" challengeable under Articles 3.3, 3.7, 4.2, and 6.2 of the DSU. Generally speaking, the term "measure" is broad enough to encompass legislation, regulations, administrative guidelines, and administrative behaviors.\textsuperscript{146} Therefore, a local tax bureau's disregard for the central government's regulation and the direct application of discriminatory VAT rates to domestic and foreign IC fabricators could be regarded as government behavior and, thus, be challenged as a "measure" under the DSU.\textsuperscript{147} Efforts to exclude the local government agencies' law enforcement from a Panel's review because such "measures" are not included in the Request for Consultations or Request for the Establishment of a Panel by the United States will likely be unhelpful in this regard. The Panel Report on \textit{Japan – Measures Affecting Consumer Photographic Film and Paper},\textsuperscript{148} ("Japan – Film") set the precedent that a measure not "explicitly described" in the panel request could still be reviewed by the WTO adjudicating body as long as it is "subsidiary or so closely related to a 'measure' \textsuperscript{145} For a general discussion on China's legislative process and law enforcement, see Peter Howard Corne, \textit{Creation and Application of Law in the PRC}, 50 AM. J. COMP. L. 369 (2002).

\textsuperscript{146} See JEFF WAINCYMER, WTO LITIGATION: PROCEDURAL ASPECTS OF FORMAL DISPUTE SETTLEMENT 136-37 (2002).

\textsuperscript{147} One of the cases decided by the DSB that appears to support this position is \textit{European Communities - Customs Classification of Certain Computer Equipment}, WTO Doc. WT/DS62, 67, 68/AB/R [hereinafter \textit{EC – Computer Equipment}]. The Appellate Body Report on \textit{EC – Computer Equipment} opined that not only measures of general application but also the application of tariffs by customs authorities were "measures" within the meaning of Article 6.2 of the DSU. \textit{Id.} para. 65.

specifically identified, that the responding party can reasonably be found to have received adequate notice of the scope of the claims asserted by the complaining party. 149 Local implementation of the VAT rebate programs is clearly "subsidiary" or "closely related to" the measure challenged by the United States in this case.

In light of such a possibility, an examination of the VAT rebate programs for IC fabricators under the remaining provisions of GATT Article III still appears to be necessary in order to see the array of arguments on both sides of the case.

2. Violation of Article III:2

Since the VAT rebate program for domestic IC fabricators is a fiscal measure, there should be no doubt that the applicable provision in Article III is paragraph 2 rather than paragraph 4. 150 As described above, the two sentences of Article III:2 govern two types of foreign products, "like products" and "directly competitive and substitutable products," and impose different levels of scrutiny on challenged tax treatments, taxed "in excess of" and "not similarly taxed". 151 The following discussion will examine China’s pertinent VAT rebate programs under both of these sentences.

a. The First Sentence of Article III:2

As mentioned above, the two-tiered test to establish a violation of the first sentence of Article III:2 is (i) the domestic and foreign products are like products and (ii) the latter is taxed in excess of the former. 152 It is well settled that the complainant bears the burden of proof for both tests. 153

Similar to the situation under the review of GATT Article I, 154

149 Id. para. 10.8.

150 As discussed supra, the measures governed by GATT Article III:4 are "law, regulations, or requirement affecting [the imported like products'] internal sale, offering for sale, purchase, transportation, distribution, or use." See Part IV.A of this Article, supra. Tax policies and measures are generally examined under GATT Article II:2.

151 GATT, supra note 56, art. III:2

152 See Canada - Periodicals, supra note 131, at 22.


154 For a discussion of like products under GATT art. I, see supra Part II.C.3.
it would be extremely difficult for China to distinguish the domestically fabricated ICs, enjoying the VAT rebate, from imported ICs and argue that they are not like products. Nonetheless, in determining the likeness of the IC products in dispute, it is worth noting that the WTO adjudicating body is subscribing to a narrow reading of the word "like" and has stressed that it should be determined on a case-by-case basis. Moreover, the Japan – Alcohol Panel also recognized that a sufficiently detailed tariff classification can be a helpful sign of the likeness of domestic and imported products.

The more troublesome issue lies in the second part of the first sentence of Article 111:2: whether the imported ICs are taxed "in excess of" the domestically fabricated ICs? Again, China would still seem to be able to utilize the "rebate" nature of the programs and argue that, given the identical 17% VAT rate applicable to both domestically fabricated ICs and imported like ICs, the latter is not taxed "in excess of" the former. The key feature of this program is that the two types of ICs are dissimilarly "rebated" as opposed to "unequally taxed." It naturally follows that, since a "rebate" is not within the ordinary meaning of the term "taxes or other internal charges," the second test is not satisfied here.

In response, the United States could raise three points to rebut this argument. First, according to the Panel Report on Argentina – Measures Affecting the Export of Bovine Hides and the Import of Finished Leather, ("Argentina-Bovine Hides"), the first sentence of Article 111:2 requires a comparison of actual tax burdens rather than nominal tax burdens. Consequently, the IC-related VAT

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155 Japan – Alcohol, supra note 94, para. 6.21.
156 Id. para. 6.22.
158 Id.
159 See id. In paragraph 11.181-11.184 of its Report, the Panel of Argentina – Bovine Hides reasoned:

Article III:2, first sentence, stipulates that imported products must 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." It is apparent that the application of this Article calls for a comparison of "taxes" or "charges" imposed on imported products with "taxes"
rebate programs exclusively available to China's domestic IC fabricators have caused an excessive "actual tax burden"\(^{160}\) for U.S. IC exporters.

Second, Article 31.1 of the Vienna Convention on the Law of Treaties ("Vienna Convention")\(^{161}\) requires that "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."\(^{162}\) Even though the "tax revenue rebate" is not within the ordinary meaning of the phrase "taxes or other internal charges," it, nonetheless, should be read counter-

or "charges" applied to like domestic products. What is less apparent is under what aspect those taxes or charges are to be compared.

In this regard, it is necessary to recall the purpose of Article III:2, first sentence, which is to ensure "equality of competitive conditions between imported and like domestic products" (footnote omitted). Accordingly, Article III:2, first sentence, is not concerned with taxes or charges as such or the policy purposes Members pursue with them, but with their economic impact on the competitive opportunities of imported and like domestic products. It follows, in our view, that what must be compared are the tax burdens imposed on the taxed products.

We consider that Article III:2, first sentence, requires a comparison of actual tax burdens rather than merely of nominal tax burdens. Were it otherwise, Members could easily evade its disciplines. Thus, even where imported and like domestic products are subject to identical tax rates, the actual tax burden can still be heavier on imported products. This could be the case, for instance, where different methods of computing tax bases lead to a greater actual tax burden for imported products. In this regard, the GATT 1947 panel in Japan – Alcoholic Beverages I has stated that:

"... in assessing whether there is tax discrimination, account is to be taken not only of the rate of the applicable internal tax but also of the taxation methods (e.g. different kinds of internal taxes, direct taxation of the finished product or indirect taxation by taxing the raw materials used in the product during the various stages of its production) and of the rules for the tax collection (e.g. basis of assessment)" (footnote omitted).

It may thus be stated, in more general terms, that a determination of whether an infringement of Article III:2, first sentence, exists must be made on the basis of an overall assessment of the actual tax burdens imposed on imported products, on the one hand, and like domestic products, on the other hand.

Argentina – Bovine Hides, supra note 157, paras. 11.181-11.184.

\(^{160}\) Id.


\(^{162}\) Id. art. 31.1.
intuitively into the meaning of the latter phrase “in the light of” the “object and purpose” of Article III:2. As stated in the Appellate Body Report on Japan – Alcohol, the “broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures.” More specifically, the stated purpose of Article III “is to ensure that internal measures ‘not be applied to imported or domestic products so as to afford protection to domestic production.” China’s reading of the phrase “taxes or other internal charges,” which excludes the rebate of tax revenues, might be viewed as defeating the “object and purpose” of Article III.

Third, the United States could probably use the same strategy as assessed in the discussion with respect to GATT Article III:8(b) to some local Chinese tax bureaus that are collecting VAT at the rate of 3%, irrespective of the “rebate” requirement in various circulars issued by the central government. The U.S. could allege that the implementation of the VAT rebate program is imposing different tax rates as a matter of fact.

b. The Second Sentence of Article III:2

According to the Appellate Body Report of Japan – Alcohol, it is well established that the second sentence of Article III:2 invokes the provision in Article III:1. Three separate issues must be addressed to determine whether an internal tax measure is inconsistent with Article III:1: (i) the imported products and the domestic products are “directly competitive or substitutable products” which are in competition with each other; (ii) the directly competitive or substitutable imported and domestic products are “not similarly taxed;” and (iii) the dissimilar taxation of the directly competitive or substitutable imported domestic

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164 Japan – Alcohol, supra note 94.
166 Japan – Alcohol, supra note 94.
167 See discussion supra Part IV.C.1.
168 Japan – Alcohol, supra note 94, at 18.
products is “applied... so as to afford protection to domestic production.”\textsuperscript{169}

As to the first and the second elements of this three-tiered test, arguments available to both China and the United States, as discussed in the preceding section with respect to the first sentence of Article III:1, can be repeated here.\textsuperscript{170} If China could not establish that the imported ICs are taxed in excess of the domestic ICs, it probably would not be able to convince the adjudicators that they are taxed in a similar manner. As to the directly competitive and substitutable products, all China could argue on a technical level is that such products encompass a larger category of products than the scope of like products. Factors such as physical characteristics, end-users, tariff classifications, marketplace, and econometric criteria, such as the elasticity of substitution, should all be considered in the determination of directly competitive and substitutable products.\textsuperscript{171}

China’s compliance with the second sentence of Article III:2 might be materially jeopardized under the third element of the three-tiered test: whether the measure is applied “so as to afford protection to domestic production.” This is true even though, as is shown below, WTO jurisprudence on how to determine this factor is somewhat unsettled, especially with regard to whether the regulator’s legislative purpose should be taken into account by the WTO adjudicators.

In its Report on Japan – Alcohol, the Appellate Body stated that “although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure.”\textsuperscript{172} Further, the Appellate Body stated that “[t]he very magnitude of the dissimilar taxation in a particular case may be evidence of [its] protective application...”\textsuperscript{173}

\textsuperscript{169} Id. at 24.

\textsuperscript{170} See discussion supra Part IV.C.1.

\textsuperscript{171} Japan – Alcohol, supra note 94, at 25.

\textsuperscript{172} Id. at 29 (emphasis added). Additionally, the Appellate Body in Japan – Alcohol rejected the consideration of the subjective intent of the legislators and regulators in the drafting and enactment of a particular measure, believing that such intent was irrelevant for ascertaining whether a measure is applied “so as to afford protection to domestic production.” Id. at 27.

\textsuperscript{173} Id. at 29.
examining the design, architecture, and structure of Japan’s challenged measures, the Appellate Body concluded that the measures were applied “so as to afford protection of domestic production.” The Appellate Body noted the following facts from the Panel Report:

[T]he combination of customs duties and internal taxation in Japan has the following impact: on one hand, it makes it difficult for foreign-produced shochu to penetrate the Japanese market and, on the other, it does not guarantee equality of competitive conditions between shochu and the rest of “white” and “brown” spirits. Thus, through a combination of high import duties and differentiated internal taxes, Japan manages to “isolate” domestically produced shochu from foreign competition, be it foreign produced shuchu or any other of the mentioned white and brown spirits.

Under this standard, it appears that China’s VAT rebate programs for IC fabricators have almost the same qualities that (i) make it difficult for foreign ICs to penetrate the Chinese market, (ii) fail to guarantee the equality of competitive conditions between domestic ICs and their directly competitive and substitutable products, and (iii) isolate domestic IC fabricators from foreign competition.

Some commentators believe that the WTO adjudicators should look, and actually are looking, at legislative intent when examining whether the measure is applied “so as to afford protection to domestic production.” The protectionist purpose of China’s IC-related VAT rebate programs is, perhaps, even more obvious if examined under this legislative intent approach. To be

174 Id. at 31.
175 Id.
176 See Robert Hudec, GATT/WTO Constraints on National Regulation: Requiem for an “Aim and Effects” Test, 32 INT’L LAW. 619, 620 (1998) (describing the relevance of protectionist intent); Donald Regan, Regulatory Purpose and “Like Products” in Article III:4 of the GATT (With Additional Remarks on Article III:2), 36 J. WORLD TRADE 443, 464 (2002). The Appellate Body imputes this view in at least two of its Reports. See Canada – Periodicals, supra note 131, para. 30 (noting that the design and structure of a Canadian taxation measure was designed to afford protection to domestic periodicals); Chile – Taxes on Alcoholic Beverages, WTO Doc. WT/DS87, 110/R (June 15, 1999), at 48-53 (holding that a Chilean taxation scheme which offered protection to domestic alcoholic beverage production was inconsistent with GATT requirements).
sure, the legislative intent of the IC VAT rebate programs is clearly stated in Chapter One of Circular No. 18, which the author has translated in its entirely as follows:

CHAPTER ONE: POLICY OBJECTIVES

Article 1: By means of policy guidance, capital and talent will be encouraged to flow to the software industry and IC industries, thus, the rapid development of China’s information industry will be further promoted, and [China will be able to] acquire software research and development and production capacity at or close to the level of advanced international standard by 2010, and to become one the major IC development and fabrication bases in the world.

Article 2: [These policies are formulated] to encourage domestic enterprises to make full use of both foreign and domestic resources and make efforts to develop [both domestic and foreign] markets;... to enable domestically fabricated IC products to satisfy most of the domestic market demand and be exported in considerable quantities; and to further narrow the gap with developed countries in [IC] development and production technology.177

V. Issues Relating to GATS Article XVII

A. An Overview of GATS Article XVII

Paragraph 1 of GATS Article XVII states that, for the sectors inscribed in its Schedule (and subject to any conditions and qualifications set out therein), each Member must “accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.”178 As a result, the WTO Members are essentially free to make specific commitments in opening their services markets. The national treatment obligation applies to any sectors or sub-sectors that are listed in the Schedules of each Member (usually

177 Circular No. 18, Ch. 1, supra note 8.

under the titles of "market access" and "national treatment").\footnote{179} Therefore, it bears emphasis that when a WTO Member does not make a specific offer on certain services in its Schedules, it does not have to observe the national treatment obligation imposed in Article XVII of GATS, although it still has to obey the MFN provision in Article II of GATS.\footnote{180}

According to a footnote attached to Paragraph 1 of GATS Article XVII, a WTO Member is not required to provide compensation for any inherent competitive disadvantages that result from the foreign character of the relevant service or service providers. Yet, this does not authorize actions that might modify conditions of competition against services and service suppliers which are already disadvantaged due to their foreign character.

\*B. The U.S. Challenge to China's IC VAT Policies under GATS Article XVII*

In the Request for Consultation submitted by the United States, the allegation of a violation of the GATS national treatment obligation is casually described as follows: "In addition, we understand that China allows for a partial refund of VAT for domestically-designed ICs that, because of technological limitations, are manufactured outside of China. China thus appears to be... discriminating against services and service suppliers of other Members."\footnote{181}

Ostensibly, China's VAT rebate policy for imported IC chips designed in China, as embodied in Circular No. 140, was the focus of the attack again in this context. Presumably, the United States alleged that such a program is granting favorable treatment to IC
chip designers in China because IC chips designed by them may enjoy an up to 11% VAT rebate from the government, while IC chips designed by foreigners cannot enjoy such tax rebates. The Request for Consultation does not point out which kind of services and what types of service suppliers are being discriminated against under China’s VAT rebate policy for imported IC chips designed in China, but it is conceivable from the context of this dispute that the “services” should be “IC designing services,” and the “service suppliers” should be “foreign IC designers.” In order for such services and service suppliers to be discriminated against under this VAT rebate program, the mode of the services should typically be “cross border supply” or “consumption abroad,” and the service suppliers must be located outside the territory of China.

C. Discussion of China’s Domestic IC Designer VAT Incentive Programs Under GATS Article XVII

1. Test for Finding an Inconsistency with GATS Article XVII

The case law in connection with GATS Article XVII has developed a three-prong test for inconsistency, which is described in the Panel Report on European Communities – Regime for the International Sale and Distribution of Bananas (“EC – Bananas”):

In order to establish a breach of the national treatment obligation of Article XVII, three elements need to be demonstrated: (i) the EC has undertaken a commitment in a relevant sector and mode of supply; (ii) the EC has adopted or applied a measure affecting the supply of services in that sector and/or mode of supply; and (iii) the EC’s measure accords to service suppliers of any other Member treatment less favourable than that it accords to the EC’s own like service suppliers.

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184 Id. para. 6.100.
The following analysis of China's VAT rebate policy for domestically designed ICs is discussed in accordance with this methodology.

2. Specific Commitment Made by China

Upon its accession into the WTO, China made its specific commitments with respect to trade in services as an Addendum to the *Report of the Working Party on the Accession of China* ("Services Schedule"). The *Services Schedule* does not contain any reference to the designing services of ICs. However, the silence of the *Services Schedule* in this regard should not be understood to mean that China has not made any specific commitment in the IC designing services sector. A closer look at the *United Nations Provisional Central Production Classification* ("CPC"), upon which Members of the WTO relied on when scheduling their specific commitments under GATS, suggests that IC designing services may be a subset of "engineering design services for industrial processes and production (CPC 86725)," which is a subcategory of "engineering services (CPC 8672)." In the *Services Schedule*, engineering services are explicitly scheduled in "item e" of Part II:A. The commitments made by the Chinese government corresponding to engineering services are provided in the following chart.


187 *Id.*

188 See *Id.*

<table>
<thead>
<tr>
<th>Engineering Services (CPC 8672) &amp; Modes of Supply</th>
<th>Limitation on Market Access</th>
<th>Limitation on National Treatment</th>
<th>Additional Commitments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cross-Border Supply</td>
<td>None for scheme design. Co-operation with Chinese professional organizations is required except scheme designs</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Consumption Abroad</td>
<td>None</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Commercial Presence</td>
<td>Only in the form of joint ventures, with foreign majority ownership permitted. Within five years after China's accession to the WTO, wholly foreign-owned enterprises will be permitted</td>
<td>Foreign Service suppliers shall be registered architects or engineers, or enterprises engaged in architectural, engineering, or urban planning services, in their home country</td>
<td></td>
</tr>
<tr>
<td>Presence of Natural Persons</td>
<td>Unbound, except as indicated in Horizontal Commitments</td>
<td>Unbound, except as indicated in Horizontal Commitments</td>
<td></td>
</tr>
</tbody>
</table>

It follows from the above commitments that, with respect to cross-border supply and consumption abroad of engineering services, China has committed to grant national treatment to foreign service suppliers and will not limit their market access except for the service of “scheme design.”\(^{190}\) Clearly, the VAT rebate program for imported IC chips designed in China is not scheduled here as an exception to the “none” commitment with regard to market access and national treatment. Therefore, there should be no doubt that the first prong of the test as set forth by the Panel Report on EC – Bananas has been satisfied.

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\(^{190}\) The Services Schedule does not provide any definition or explanation of “scheme design.” See Id., supra note 185. Under some circumstances, the term “scheme” may include “electronic circuits” within the scope of its definition. Id. Therefore, this concept may also capture IC designing services, provided that China can furnish sufficient technical evidence to that effect. Id.
3. Measure Affecting Trade in Service

In determining whether a measure affects trade in services, the following comments made by the Appellate Body in its Report on EC – Bananas are worth noting:

In our view, the use of the term “affecting” reflects the intent of the drafters to give a broad reach to the GATS. The ordinary meaning of the word “affecting” implies a measure that has “an effect on”, which indicate a broad scope of application. This interpretation is further reinforced by the conclusions of previous panels that the term “affecting” in the context of Article III of the GATT is wider in scope than such terms as “regulating” or “governing.”

The Appellate Body also upheld the finding by the Panel of EC – Bananas that there is no legal basis for an “a priori exclusion of measures within the EC banana import licensing regime from the scope of the GATS.”

The Appellate Body Report on Canada – Autos provided more detailed guidelines to aid in determining whether a measure is affecting trade in service:

With these treaty provisions in mind, we believe that at least two key legal issues must be examined to determine whether a measure is one “affecting trade in services”: first, whether there is “trade in services” in the sense of Article I:2; and, second, whether the measure in issue “affects” such trade in services within the meaning of Article I:1.

When examining these two requirements, the Appellate Body understood that the first leg of this test was satisfied because Canada did not challenge the fact that there were established suppliers in its market. As to the second leg of this two-pronged test, the Appellate Body pointed out that the challenger of the measure should bear the burden of proof on how exactly a


192 Id.

193 Canada – Autos (Appellate Body), supra note 66, para. 155.

194 Id. para. 157.
particular measure affects trade in goods or services, and the Panel should also examine who supplies such services and how such services are supplied. In other words, the Appellate Body requires the WTO adjudicators to undertake a market analysis to determine whether the measure “affects” trade in services. The specific method of such market analysis was not spelled out in the Appellate Body Report, however.

In light of these rulings, it would be hard for China to argue that the VAT rebate policy for imported IC chips designed in China affects trade in goods only. Given the contingency of the location of chip designers when implementing the VAT rebate upon importation, it is not difficult to envisage that some IC fabricators would prefer to have their chips designed in China in order to enjoy the VAT rebate when exporting the chips to China. However, pursuant to the Appellate Body’s ruling in Canada – Autos, such an assumption is not sufficient to establish the case. The United States would have the obligation to furnish concrete economic data with respect to how the U.S. domestic IC designers have been jeopardized by China’s VAT policy favoring the Chinese chip designers. Given the vast technology gap between Chinese IC designers and their U.S. counterparts, the effect of such a rebate policy could well be statistically de minimus.

4. Like Service/Service Providers

In the Panel Report on EC – Bananas, the Panel addressed the issue of likeness under GATS Article XVII. It concluded:

[I]n our view, the nature and the characteristics of wholesale transactions as such, as well as of each of the different subordinated services mentioned in the headnote to section 6 of the CPC, are “like” when supplied in connection with wholesale services, irrespective of whether these services are supplied with respect to bananas of EC and traditional ACP origin, on the one hand, or with respect to bananas of third-country or non-traditional ACP origin, on the other. Indeed, it seems that each of the different service activities taken individually is virtually the same and can only be distinguished by referring to the origin of the bananas in respect of which the service activity is being

195 Id. paras. 160-64.
196 This finding was not reviewed by the Appellate Body on appeal.
performed. Similarly, in our view, to the extent that entities provide these like services, they are like service suppliers.\textsuperscript{197}

Consequently, it appears that the CPC classification is a vital tool in determining the likeness of services. By contrast, the relevance of likeness of products in connection with the service tends to be minimal. Likewise, the distinction in the mode of supply of services is also not a reliable parameter to determine like services. Indeed, the Panel of Canada – Auto has explicitly rejected using different modes of supply to decide the likeness of services in the context of GATS Article XVII.\textsuperscript{198} Such a proposition was not rejected by the Appellate Body on appeal. As a result, services supplied in a Member of the WTO through mode 3 (commercial presence) and mode 4 (presence of natural persons) can be "like services" of those supplied from territories of other Members through mode 1 (cross-border supply) and mode 2 (consumption abroad).\textsuperscript{199}

In the face of the above WTO case law, it will be hard for China to distinguish the likeness of its domestic IC designing services from the IC designing services provided by U.S. IC designers, despite the fact that they are supplied through different modes and have different niche markets.

5. Less Favorable Treatment

Unlike the jurisprudence under GATT Article III, the WTO jurisprudence regarding the determination of whether an adopted measure accords treatment less favorable to services/service suppliers from foreign countries than that accorded to domestic like counterparts is relatively scarce.

In this regard, a highly analogous case decided by the WTO adjudicating body on the legal issue discussed in this subsection is in the Panel Report on Canada – Autos. The complainants in that case argued that the challenged Canadian Value Added ("CVA") requirements and the duty exemption create an economic incentive for manufacturer beneficiaries to purchase services supplied in Canada, thereby modifying the conditions of competition in favor

\textsuperscript{197} EC – Bananas (Panel Report), supra note 183, para. 7.322.

\textsuperscript{198} Canada – Autos (Panel Report), supra note 103, paras. 10.300-10.301.

\textsuperscript{199} Id. para. 10.307.
of services supplied in Canada.\textsuperscript{200} The Panel noted that the CVA requirements and the duty exemption provide an incentive for the beneficiaries of the import duty exemption to use services supplied within Canada over "like" services supplied in or from the territory of other Members through modes 1 and 2.\textsuperscript{201} This modified the conditions of competition in favor of services supplied within Canada. Although the measures do not distinguish on their face between services supplied by service suppliers of Canada and those supplied by service suppliers of other Members present in Canada, the Panel considered that they are bound to have a "discriminatory effect" against services supplied through modes 1 and 2, which were services of other Members.\textsuperscript{202} On this basis, the Panel concluded that the CVA requirements, operating in conjunction with the duty exemption, accorded less favorable treatment to services of other Members supplied through modes 1 and 2 and are, therefore, inconsistent with Canada's obligations under GATS Article XVII.\textsuperscript{203} This proposition by the Panel was not reviewed by the Appellate Body upon appeal.

There is almost no doubt that the VAT rebate program for imported IC chips designed in China has the "effect" of giving incentives to consumers, both Chinese and foreign, of IC designing services to choose designers located in China, provided that they intend to import such IC chips to China. Such an objective is also stated in the policy goals quoted in the discussions above.\textsuperscript{204}

\textbf{VI. Completing the Analysis: Issues Relating to Subsidies}

As previously mentioned, there is a solid argument that China's VAT rebate programs for IC industry constitute a subsidy to its domestic IC industry and, therefore, was exempted from the application of the national treatment requirement prescribed under

\textsuperscript{200} Id. para. 10.306. The CVA is a set of requirements for the eligible to enjoy, among others, the import duty exemption. Id. One component of the CVA requirement was "maintenance and repair work executed in Canada on buildings, machinery and used production purposes." Id.

\textsuperscript{201} Id. para. 10.307.

\textsuperscript{202} Id. para. 10.307.

\textsuperscript{203} Id. para. 10.308.

\textsuperscript{204} See discussion supra notes 52-54 and accompanying text.
GATT Article III. Nevertheless, bringing the programs out of the purview of GATT Article III does not completely justify them under all WTO rules. The VAT rebate program implemented by the Chinese government should also live up to the legal standards set forth in the SCM Agreement.

A. Can the DSB Raise the Subsidy Issue on Its Own Motion?

In the Request for Consultations submitted by the United States, the subsidy issue was not raised. As the defending party in the dispute settlement proceeding, the Chinese government also did not subject its measure's conformity to the SCM Agreement. Therefore, an inevitable threshold issue for the WTO adjudicators, even before reviewing the subsidy issue in connection with China's VAT rebate programs, would be whether the adjudicators are authorized to review a government measure sua sponte.

The text of the DSU is silent on this issue. Nevertheless, some rulings by the Appellate Body in prior cases have addressed this problem by stating that a panel is fully authorized to review legal issues not raised by the parties on its own motion in exceptional circumstances. The most relevant holding to this effect appears in the Appellate Body Report on Mexico – Anti-Dumping Investigation of High Fructose Corn Syrup (HFCS) from the United States, Recourse to Article 21.5 of the DSU by the United States (“Mexico – HFCS”). In its report, the Appellate Body made it clear that there are at least two instances where a panel comes under a duty to address issues. First, as a matter of due process and the proper exercise of the judicial function, panels are required to address issues that are put before them by the parties to a dispute. Second, panels must address and dispose of certain issues of a fundamental nature, even if the parties to the dispute remain silent on those issues. The Appellate Body defined its

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205 See supra Part IV.C.1.
206 Request for Consultation, supra note 59.
207 See id.
208 WTO Secretariat, Mexico – Anti-Dumping Investigation of High Fructose Corn Syrup (HFCS) from the United States Recourse to Article 21.5 of the DSU by the United States, WTO Doc. WT/DS132/AB/RW (Oct. 22, 2001) [hereinafter Mexico-HFCS].
209 Id. para. 36.
210 Id.
task in the second type of situation as "[determining] whether the 'objections' that Mexico now raises before us are of such a nature that they could have deprived the Panel of its authority to deal with and dispose of the matter."\textsuperscript{211} As an example of what would meet the standard, the Appellate Body recalled its statement in the \textit{United States – Anti-Dumping Act of 1916}\textsuperscript{212} ("U.S. – 1916") that panels must address "jurisdictional" issues on their own initiative.\textsuperscript{213}

Based on this premise, the Appellate Body noted that Mexico had failed to raise clearly before the Panel the issues that it was appealing, so the Panel had no duty to review them as required under the first type of situation.\textsuperscript{214} In examining whether the second situation arose, the Appellate Body found that none of the procedural issues raised by Mexico (such as the lack of consultations, failure to indicate whether consultations had been held, and alleged failure to exercise judgment in deciding whether bringing the action to WTO dispute settlement would be fruitful) were sufficient to trigger this duty.\textsuperscript{215} The Panel was also not required to address these issues on its own motion.\textsuperscript{216}

Turning to the dispute between the United States and China, the United States probably never would want to put the subsidy issue before the Panel or the Appellate Body for review.\textsuperscript{217} As a result, the first situation envisaged in the Appellate Body Report of \textit{Mexico – HFCS} would not be likely to appear. It is also highly doubtful whether the adjudicators would deem the substantive issue of subsidy as depriving it of "authority to deal with and

\textsuperscript{211} \textit{Id.} para. 53.


\textsuperscript{213} See discussion \textit{supra} note 130, and accompanying text.

\textsuperscript{214} \textit{Mexico – HFCS}, \textit{supra} note 208, paras. 39-48.

\textsuperscript{215} \textit{Id.} para. 74.

\textsuperscript{216} \textit{Id.} paras. 51-75.

\textsuperscript{217} In fact, the United States probably does not want the panel to examine China's VAT rebate policy under the \textit{SCM Agreement}, as bringing the programs under the \textit{SCM Agreement} would clearly prejudice the U.S. claim with respect to China's violation of Article III. In other words, it can be read that the United States has, itself, admitted that China's VAT rebate programs are a kind of subsidy and, therefore, should enjoy the exception provided under Article III:8(b) of GATT.
dispose of the matter.\textsuperscript{218} Unlike the issue of jurisdiction in Mexico – HFCS, the Panel’s refusal to consider the issue of subsidy would not in any way impair its ability or authority to consider other issues raised by the United States in its request (such as a violation of Articles I and III of GATT). Consequently, it is unlikely that the adjudicating body would consider it \textit{sua sponte} by applying the two-situation analysis in the Appellate Body Report on Mexico – HFCS.

Another procedural barrier for the United States to raise the subsidy issue in the current dispute lies in the provision of the SCM Agreement itself. No matter what type of subsidy China’s VAT rebate programs fall into, the SCM Agreement requires the United States to request consultation with China before resorting to the WTO dispute settlement tribunal or imposing countervailing measures.\textsuperscript{219} The United States did not request any consultation with China to this effect.

\textbf{B. Substantive Subsidy Issues Relating to China’s VAT Rebate Programs and Their Compliance with the SCM Agreement}

\textit{1. Do China’s VAT Rebate Programs Constitute a Subsidy?}

A subsidy covered under the SCM Agreement must meet two threshold requirements: (i) it must represent a cost to government and a benefit to recipient,\textsuperscript{220} and (ii) it must be specific, in the sense that it must be granted to an enterprise or industry or group of enterprises or industries.\textsuperscript{221}

There is little doubt about China’s satisfaction of these two elements. By definition, the tax rebate constitutes a “direct transfer of funds” as stipulated in Article 1.1(a)(i) of the SCM Agreement. It is also clear from the language of Circular Nos. 18, 25 and 70 that these transfers of funds are exclusively directed at China’s domestic IC fabricators, who have particularly benefited

\textsuperscript{218} See discussion \textit{supra} note 212, and accompanying text.

\textsuperscript{219} SCM Agreement, \textit{supra} note 81, arts. 4, 7, & 9.

\textsuperscript{220} \textit{Ibid.} art. 1.

\textsuperscript{221} \textit{Ibid.} art. 2.
from the rebated tax revenues.\textsuperscript{222} Hence, there seems to be no issue in this regard.

\section*{2. Are China's VAT Rebate Programs Permissible Under the SCM Agreement?}

It is well established in the WTO rules and relevant case law that a subsidy program covered under the \textit{SCM Agreement} is not \textit{per se} illegal.\textsuperscript{223} The \textit{SCM Agreement} classifies subsidies covered thereunder into three classes: prohibited (Article 3), actionable (Article 5), and non-actionable (Article 8).

\subsection*{a. The Lapse of Non-Actionable Subsidies}

According to Article 8.2(a) of the \textit{SCM Agreement}, certain types of assistance for research activities conducted by firms or by higher education or research establishments on a contract basis are non-actionable.\textsuperscript{224} Since part of the goal of China's VAT rebate

\begin{footnotesize}
\begin{enumerate}
\item See Circular No. 18, supra note 8, art. 41; Circular No. 25, supra note 36, art. 2; and Circular No. 70, supra note 45, art. 1.
\item See \textit{SCM Agreement}, supra note 81, art. 8; see also \textit{Indonesia – Autos}, supra note 70, para. 5.148.
\item Article 8.2(a) of the \textit{SCM Agreement} reads in its entirety as follows:

Notwithstanding the provisions of Parts III and V, the following subsidies shall be non-actionable:

(a) assistance for research activities conducted by firms or by higher education or research establishments on a contract basis with firms if:

the assistance covers not more than 75 per cent of the costs of industrial research or 50 per cent of the costs of pre-competitive development activity;

and provided that such assistance is limited exclusively to:

(i) costs of personnel (researchers, technicians and other supporting staff employed exclusively in the research activity);

(ii) costs of instruments, equipment, land and buildings used exclusively and permanently (except when disposed of on a commercial basis) for the research activity;

(iii) costs of consultancy and equivalent services used exclusively for the research activity, including bought-in research, technical knowledge, patents, etc.;

(iv) additional overhead costs incurred directly as a result of the research activity;

(v) other running costs (such as those of materials, supplies and the like), incurred directly as a result of the research activity. (Footnotes omitted.)
\end{enumerate}
\end{footnotesize}
program is to stimulate the country’s research and development of IC products and designing capabilities, \(^{225}\) China might attempt to rely on this provision to justify the subsidy. Yet, even if the VAT rebates to China’s domestic IC fabricators and designers were carried out on a contractual basis and the notification requirement set forth in Article 8.3 of the *SCM Agreement* was satisfied, \(^{226}\) the provision with respect to non-actionable subsidy would no longer be helpful by virtue of the operation of Article 31 of the *SCM Agreement*. Article 31 provides:

> [T]he provisions of . . . Article 8 . . . shall apply for a period of five years, beginning with the date of entry into force of the WTO Agreement. Not later than 180 days before the end of this period, the [WTO Subsidies and Countervailing Measures] Committee shall review the operation of those provisions, with a view to determining whether to extend their application, either as presently drafted or in a modified form, for a further period.\(^{227}\)

Since no consensus has been reached by the Subsidies and Countervailing Measures Committee of the WTO in this regard, Article 8 of the *SCM Agreement* ceased to be operative as of December 31, 1999.\(^{228}\)

As a result, within the current WTO subsidy legal regime, there are only two types of subsidies covered under the *SCM Agreement*: prohibited subsidies and actionable subsidies.\(^{229}\)

### b. Prohibited Subsidies

A subsidy is prohibited if it is either contingent (in law or in fact, solely or partially) upon export performance or contingent

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\(^{225}\) *Id.* art. 8.2(a) (footnotes omitted).

\(^{226}\) From the language of the relevant government documents with respect to the VAT rebate programs, it seems that the rebates are not implemented exclusively for research and development, and their recipients are not required to enter into contracts with the Chinese government. In addition, the author is unaware of any notification by the Chinese government to the WTO with respect to such rebates.

\(^{227}\) *Id.* art. 31.

\(^{228}\) *See id.* *See also,* WTO, *Overview on Agreement on Subsidies and Countervailing Measures*, at http://www.wto.org/english/tratop_e/scm_e/subs_e.htm (last visited on May 6, 2004).

\(^{229}\) *Id.*
(solely or partially) upon the use of domestic over imported goods.\footnote{Id. art. 3.1.}

\textit{(i) Contingency on Export Performance}

It is plain from the wording of Article 3.1(a) of the SCM Agreement that subsidies contingent on export can be either \textit{de jure} or \textit{de facto}.\footnote{Id. art. 3.1(a) n. 4; WTO, \textit{Australia – Subsidies Provided to Producers and Exporters of Automotive Leather}, WTO Doc. WT/DS126/R (May 25, 1999) at 363-73 [hereinafter \textit{Australia – Leather}].} Although one of the policy goals of China’s VAT rebate programs for its IC industry is to enhance the export of IC products and designs,\footnote{Circular No. 18, supra note 8, art. 2.} the relevant government documents do not explicitly state that export performance is a condition to the eligibility or the amount of VAT rebates from the government. Therefore, it would not be difficult for China to establish that the VAT rebate programs fail to contain any export performance contingency.

As to the finding of \textit{de facto} export contingency with respect to China’s VAT rebate programs, relevant DSB reports have shown that an enhanced standard is imposed by the adjudicating body of the WTO.\footnote{See, e.g., \textit{Australia-Leather}, supra note 231.} In the Panel Report on \textit{Australia-Subsidies Provided to Producers and Exporters of Automotive Leather (“Australia-Leather”)}, the Panel reasoned that the terms “contingent... in fact” and “in fact tied to” suggest an interpretation that “requires a close connection between the grant or maintenance of a subsidy and export performance.”\footnote{Id. at 105-06, para. 9.56.} The Panel of \textit{Australia – Leather} further pointed out that “the mere fact that a subsidy is granted to enterprises which export cannot be the sole basis for concluding that a subsidy is ‘in fact’ contingent upon export performance,”\footnote{Id. at 106, para. 9.56.} and so the adjudicators should “examine all the facts concerning the grant or maintenance of the challenged subsidy, including the nature of the subsidy, its structure and operation, and the circumstances in which it was provided.”\footnote{Id. at 106, para. 9.57.}
In the Appellate Body Report on Canada – Measures Affecting the Export of Civilian Aircraft\(^{237}\) ("Canada – Aircraft"), a three-prong test was developed to determine whether a subsidy is *de facto* contingent on export performance: "first, the ‘granting of a subsidy’; second, ‘is... tied to...’; and, third, ‘actual or anticipated exportation or export earnings.’\(^{238}\) While the first and the third prongs denoted in the Appellate Body Report of Canada – Aircraft should not be difficult to discern in China’s VAT rebate programs, the second prong calls for an extensive factual analysis, and standards in locating such “ties” are still murky in the relevant jurisprudence of the WTO.\(^{239}\) The Appellate Body addressed the second prong in its Report on Canada – Aircraft, stating that “a relationship of conditionality of dependence must be demonstrated” and “[i]t does not suffice to demonstrate solely that a government granting a subsidy anticipated that exports would result.”\(^{240}\) The Appellate Body subsequently added in its DSU Article 21.5 review of the Canada – Aircraft case that the high export-orientation of a subsidized industry was not enough for the Appellate Body to find export contingency.\(^{241}\)

What stems from the above analysis is that the United States would bear a strong evidentiary burden of proof to establish the second prong of *de facto* export contingency in the dispute with China. The fact that China’s export of IC products increased during the period of subsidization would not be a determinative factor in this regard.

**(ii) Contingency on Use of Domestic Over-Imported Goods**

The only potential issue under Article 3.1(b) of the SCM Agreement is China’s VAT rebate policy for imported IC chips
designed in China.\textsuperscript{242} To be sure, this rebate program is beneficial to China's domestic importers that import IC chips designed in China.\textsuperscript{243} In other words, this rebate program is contingent on the procurement of domestic "IC design services" over foreign like services.\textsuperscript{244} This "service contingency" feature should effectively relieve China's VAT rebate policy for imported IC chips from the ambit of prohibited subsidy provided in Article 3.1(b) of the SCM Agreement, which only deals with the contingency on the use of domestic goods.\textsuperscript{245}

c. Actionable Subsidies

As noted in Part VI.B.2.a., due to the cease of operation of Article 8 of the SCM Agreement, there are only two types of subsidies covered under the WTO subsidy legal framework.\textsuperscript{246} Therefore, it seems only natural to conclude that if a subsidy satisfies the elements set forth in Articles 1 and 2 of the SCM Agreement but does not fall into the ambit of prohibited subsidies as provided under Article 3 of the SCM Agreement, it will automatically become an actionable subsidy regulated by Articles 5 to 7 of the SCM Agreement.\textsuperscript{247}

The SCM Agreement permits an actionable subsidy unless it causes "adverse effect" to the interests of other Members of WTO.\textsuperscript{248} Article 5 of the SCM Agreement enumerates the types of adverse effect:

(a) injury to the domestic industry of another Member;
(b) nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994 in particular the benefits of concessions bound under Article II of GATT 1994;
(c) serious prejudice to the interests of another Member.\textsuperscript{249}

\textsuperscript{242} See discussion \textit{supra} Part III.
\textsuperscript{243} SCM Agreement, \textit{supra} note 81, art. 3.1(b).
\textsuperscript{244} \textit{Id}.
\textsuperscript{245} \textit{Id}. art. 5.
\textsuperscript{246} See discussion of Art. 8 of the SCM Agreement in Part VI.B.2a of this Article, \textit{supra}.
\textsuperscript{247} SCM Agreement, \textit{supra} note 81, art. 5.
\textsuperscript{248} \textit{Id}.
\textsuperscript{249} \textit{Id}. 
According to footnote 11 of Article 5(a) of the *SCM Agreement*, an adverse effect of injury to another Member's domestic industry requires establishment of the same injury level as set forth in Part V (countervailing duties) of the *SCM Agreement*. Consequently, in order for the United States to assert a domestic industry injury, an investigation in accordance with Article 11 of the *SCM Agreement* is necessary.

As to the second type of adverse effect, nullification or impairment of benefits, the most harmful assertion that could be made by the United States with respect to China's subsidy to the IC industry would be a "non-violation nullification and impairment." In this connection, the relevant case law of the WTO appears in the Panel Report on *United States – Continued Dumping and Subsidy Offset Act of 2000* ("U.S. – Offset Act 2000"). The Panel of *U.S. – Offset Act 2000* noted that in previous WTO cases, a non-violation complaint is a "rather unusual remedy" and that it "should be approached with caution and should remain an exceptional remedy." By citing a GATT-era panel report, the Panel of *U.S. – Offset Act 2000* considered that "non-violation nullification or impairment would arise when the effect of a tariff concession is systematically offset or counteracted by a subsidy programme." The Panel found this approach to be "reasonable" since "a standard of 'systematic offsetting/counteracting' would preserve the exceptional nature" of a non-violation remedy. Similar to the situation under Article 5(a) of the *SCM Agreement* (regarding injury to domestic industry), the establishment of a systematic offsetting or counteracting by the United States should warrant thorough

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250 *Id.* art. 5(a), n. 11. This footnote states that "[t]he term 'injury to the domestic industry' is used here in the same sense as it is used in Part V." *Id.*

251 *Id.* art. 5(a), n. 11, art. 11.

252 If the United States could establish a "violation nullification and impairment," it would have relied more heavily on the specific provision violated by China rather than Article 5 of the *SCM Agreement*.


254 *Id.* para. 7.125.

255 *Id.* paras. 7.126-7.127.

256 *Id.* paras. 7.126-7.127.
investigations by U.S. international trade authorities. It appears to be fairly difficult for the challenger to prove due to the exceptional nature of a non-violation complaint of nullification and impairment.\textsuperscript{257} In addition, in addressing the issue of nullification and impairment, the Panel of \textit{U.S. – Offset Act 2000} noted the relevance of whether Mexico could have reasonably predicted at the completion of the Uruguay Round of trade negotiations that the United States would pass the Offset Act.\textsuperscript{258} By analogy, China could rebut the U.S. argument of possible nullification and impairment by pointing out that \textit{Circulars Nos. 18} and \textit{25} were promulgated before China’s accession to the WTO,\textsuperscript{259} and, therefore, the effect of the circulars should have been reasonably anticipated by the United States.

Finally, the issue of serious prejudice as the third type of adverse effect should be dealt with in conjunction to Article 6 of the \textit{SCM Agreement}, which enumerates a numbers of situations where serious prejudice occurs and situations where serious prejudice does not apply.\textsuperscript{260} In order to qualify for this type of adverse effect, the challenging party must prove any of the following four effects as prescribed in Article 6.3 of the \textit{SCM Agreement}:

\begin{itemize}
  \item[(a)] the effect of displacing or impeding the imports of a like product of another Member into the market of the subsidizing Member;
  \item[(b)] the effect of displacing or impeding the exports of a like product of another Member into a third country market;
  \item[(c)] the effect of a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market; or
  \item[(d)] the effect of any increase in the world market share of the subsidizing Member in a particular subsidized primary product or commodity as compared to its average share during the
\end{itemize}

\textsuperscript{257} \textit{Id.} paras. 7.125-7.127.

\textsuperscript{258} \textit{Id.} para. 7.131.


\textsuperscript{260} \textit{SCM Agreement}, \textit{supra} note 81, art. 6.
previous three year period and where this increase follows a consistent trend over a period when subsidies have been granted.\textsuperscript{261}

Again, without solid facts substantiated by the United States in connection with any of these effects, the WTO adjudicating body will not recognize the adverse effect in the form of serious prejudice.\textsuperscript{262}

\textbf{VII. Conclusion}

Based on an overall assessment of the dispute discussed in this Article, the case is not as one-sided as many critics have suggested.\textsuperscript{263} China and the United States retain some legal grounds in support of their positions. If the case does not settle, China could probably defend its position on procedural and evidentiary grounds. Conversely, for the United States to prevail in the case, it would carry a heavy burden of proof to establish factually a violation (or, as the case may be, non-violation) of China's VAT rebate programs. This assessment reveals again the principle, emphasized by numerous WTO treaty provisions and case law, that discrimination and subsidizing are not \textit{per se} illegal under the WTO legal regime, although they are immediately suspected to run afoul of the WTO rules.\textsuperscript{264}

Nevertheless, even if China could defend itself in the dispute before the WTO tribunal on procedural and evidentiary grounds, this dispute should sufficiently alert China, as well as many other WTO Members implementing the VAT system, to the harms inherent in utilizing a VAT policy to achieve its fiscal objectives. Compared to an income tax, VAT is particularly vulnerable to attacks along the lines of Articles I and III of GATT, presumably due to its inherent product-oriented nature. In fact, China has maintained a preferential income tax exemption system for certain domestic enterprises for a considerable period of time,\textsuperscript{265} and it has

\begin{itemize}
\setlength\itemsep{0em}
\item \textsuperscript{261} \textit{Id.} art. 6.3.
\item \textsuperscript{262} \textit{Id.} art 6.
\item \textsuperscript{263} See, e.g., \textsc{Howell et al.}, supra note 57.
\item \textsuperscript{264} See SCM Agreement, supra note 81, arts. 1, 3, 8, 27.
\item \textsuperscript{265} For example, for some manufacturing foreign-invested enterprises, beginning from their first profitable fiscal year, the Chinese government offers a statutory two-year income tax holiday and subsequent three-year 50\% income tax exemption. \textit{See} \textsc{Gensler}
never encountered any challenge from other countries before or after its accession to the WTO on the ground of national treatment or MFN. Therefore, if China changes the form of the VAT rebate to its domestic IC fabricators into income tax exemption programs exclusively applicable to them, the legal challenges posed by the United States in this dispute may be rendered moot. For instance, it would be hard to imagine a type of national treatment violation caused by enterprise income tax schemes, as foreign exporters are normally not subject to the income tax jurisdiction of the importing country’s government.266

Another way China could have minimized the risk of violating GATT rules is to have explicitly structured the VAT rebate regime as a type of subsidy.267 This type of subsidy could be based on the preferential treatments for developing countries as sanctioned in Article 27 of the SCM Agreement (regarding special and differential treatment of developing countries), and China could notify the relevant committee in the WTO of its intention to implement such a subsidy.268

Thus, as seen by the alternatives available to the Chinese government, different forms of taxation schemes and methods can lead to different WTO legal implications, although such forms are aimed at similar substantive policy goals. The goal of this Article is to encourage the development of China’s IC industry. Yet, should this kind of “form over substance” ideology find standing and/or ultimately be encouraged under the WTO legal regime? This is a larger question yet to be answered.

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266 See Id., art. 1.

267 In relevant circulars discussed in this Article, the Chinese government does not seem to have expressly featured the VAT rebates concerned as a form of government subsidy program.

268 SCM Agreement, supra note 81, art. 27.