

WORLD TRADE

WT/DS8/AB/R  
WT/DS10/AB/R  
WT/DS11/AB/R  
4 October 1996

ORGANIZATION

(96-3951)

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**Appellate Body**

**Japan - Taxes on Alcoholic Beverages**

AB-1996-2

Report of the Appellate Body

WORLD TRADE ORGANIZATION  
APPELLATE BODY

<i>Japan - Taxes on Alcoholic Beverages</i>	AB-1996-2
Japan, Appellant/Appellee	Present:
United States, Appellant/Appellee	Lacarte-Muró, Presiding Member
Canada, Appellee	Bacchus, Member
European Communities, Appellee	El-Naggar, Member

**A. Introduction**

Japan and the United States appeal from certain issues of law and legal interpretations in the Panel Report, *Japan - Taxes on Alcoholic Beverages*<sup>1</sup> (the "Panel Report"). That Panel (the "Panel") was established to consider complaints by the European Communities, Canada and the United States against Japan relating to the Japanese Liquor Tax Law (Shuzeiho), Law No. 6 of 1953 as amended (the "Liquor Tax Law").<sup>2</sup>

The Panel Report was circulated to the Members of the World Trade Organization (the "WTO") on 11 July 1996. It contains the following conclusions:

- (i) Shochu and vodka are like products and Japan, by taxing the latter in excess of the former, is in violation of its obligation under Article III:2, first sentence, of the General Agreement on Tariffs and Trade 1994.

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<sup>1</sup>WT/DS8/R, WT/DS10/R, WT/DS11/R.

<sup>2</sup>Norway originally reserved its right as a third party to the dispute but subsequently informed the Panel that it was withdrawing its request to participate as a third party.

- (ii) Shochu, whisky, brandy, rum, gin, genever, and liqueurs are "directly competitive or substitutable products" and Japan, by not taxing them similarly, is in violation of its obligation under Article III:2, second sentence, of the General Agreement on Tariffs and Trade 1994.<sup>3</sup>

The Panel made the following recommendations:

- 7.2 The Panel recommends that the Dispute Settlement Body request Japan to bring the Liquor Tax Law into conformity with its obligations under the General Agreement on Tariffs and Trade 1994.<sup>4</sup>

On 8 August 1996, Japan notified the Dispute Settlement Body<sup>5</sup> of the WTO of its decision to appeal certain issues of law covered in the Panel Report and legal interpretations developed by the Panel, pursuant to paragraph 4 of Article 16 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU") and filed a Notice of Appeal with the Appellate Body, pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "Working Procedures").<sup>6</sup> On 19 August 1996, Japan filed an appellant's submission.<sup>7</sup> On 23 August 1996, the United States filed an appellant's submission pursuant to Rule 23(1) of the *Working Procedures*. The European Communities, Canada and the United States submitted appellees' submissions pursuant to Rule 22 of the *Working Procedures*, on 2 September 1996. That same day, Japan submitted an appellee's submission pursuant to Rule 23(3) of the *Working Procedures*.

The oral hearing contemplated by Rule 27 of the *Working Procedures* was held on 9 September 1996. The participants presented their arguments and answered questions from the Division of the Appellate Body hearing the appeal (the "Division"). The participants answered most of these questions orally at the hearing. They answered some in writing.<sup>8</sup> The Division gave each participant an opportunity to respond to the written post-hearing memoranda of the other participants.<sup>9</sup>

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<sup>3</sup>Panel Report, para. 7.1.

<sup>4</sup>Panel Report, para. 7.2.

<sup>5</sup>WT/DS8/9, WT/DS10/9, WT/DS11/6.

<sup>6</sup>WT/AB/WP/1.

<sup>7</sup>Pursuant to Rule 21(1) of the *Working Procedures*.

<sup>8</sup>Pursuant to Rule 28(1) of the *Working Procedures*.

<sup>9</sup>Pursuant to Rule 28(2) of the *Working Procedures*.

## B. Arguments of Participants

### 1. Japan

Japan appeals from the Panel's findings and conclusions, as well as from certain of the legal interpretations developed by the Panel. Japan argues that the Panel erred in its interpretation of Article III:2, first and second sentences of the General Agreement on Tariffs and Trade 1994 (the "GATT 1994"), which is an integral part of the *Marrakesh Agreement Establishing the World Trade Organization* (the "*WTO Agreement*").<sup>10</sup> According to Japan, with respect to both the first and second sentences of Article III:2, the Panel erred in: (1) disregarding the need to determine whether the Liquor Tax Law has the aim of affording protection to domestic production; (2) ignoring whether there is "linkage" between the origin of products and the tax treatment they incur and, in this respect, not comparing the tax treatment of domestic products as a whole and foreign products as a whole; and (3) not giving proper weight to the tax/price ratio as a yardstick to compare the tax burdens.

With respect to the first sentence of Article III:2, Japan argues that the Panel erred by virtually ignoring Article III:1, particularly the phrase "so as to afford protection to domestic production", as part of the context of Article III:2. Japan maintains also that the title of Article III forms part of the context of Article III:2, and that the object and purpose of the GATT 1994 and the *WTO Agreement* as a whole must also be taken into account in interpreting Article III:2. Japan argues that the interpretation of Article III:2, first sentence, in the light of these considerations, requires an examination of both the aim and the effect of the measure in question. Japan also alleges that the Panel erred in placing excessive emphasis on tariff classification in finding that shochu and vodka are "like products" within the meaning of Article III:2, first sentence, arguing that the relevant tariff bindings indicate that these products are not "like".

With respect to the second sentence of Article III:2, Japan asserts that the Panel erred by failing to interpret correctly the principle of Article III:1, in particular, the language "so as to afford protection to domestic production", erroneously placing excessive emphasis on the phrase "not similarly taxed" in the Interpretative Note *Ad* Article III:2. Japan claims further that the Panel erred by failing to examine the issue of *de minimis* differences in the light of the principle of "so as to afford protection to domestic

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<sup>10</sup>Done at Marrakesh, Morocco, 15 April 1994 and entered into effect on 1 January 1995.

production"; the Panel examined the issue of *de minimis* differences only by comparing taxes in terms of taxation per kilolitre of product and taxation per degree of alcohol.

With respect to the points of appeal raised by the United States in its appellant's submission, Japan responds that the arguments advanced by the United States are not based on a correct understanding of the Japanese liquor tax system. Japan argues that the Liquor Tax Law has the legitimate policy purpose of ensuring neutrality and equity, particularly horizontal equity, and that it has neither the aim nor the effect of protecting domestic production. Japan asserts that it is not correct to conclude that all distilled liquors are "like products" under Article III:2, first sentence, or to conclude that the Liquor Tax Law is inconsistent with Article III:2 because it imposes a tax on imported distilled liquors in excess of the tax on like domestic products.

## 2. United States

The United States supports the Panel's overall conclusions, but appeals nonetheless. The United States alleges several errors in the findings of the Panel and the legal interpretations developed by the Panel in reaching its conclusions in the Panel Report. The United States maintains that the Panel erred in its interpretation of Article III:2, first and second sentences, principally as a result of an erroneous understanding of the relationship between Article III:2 and Article III:1. The United States contends that the Panel disregarded Article III:1, which the United States sees as an integral part of the context that must be considered in interpreting Article III:2, and Article III generally. The United States asserts that Article III:1 sets out the object and purpose of Article III and must therefore be considered in any interpretation of the text of Article III:2. The United States argues that the Panel did not look beyond the text of Article III:2 in interpreting Article III:2 and thereby fell into error.

More specifically, with respect to the first sentence of Article III:2, the United States submits that the Panel erred in finding that "likeness" can be determined purely on the basis of physical characteristics, consumer uses and tariff classification without considering also the context and purpose of Article III, as set out in Article III:1, and without considering, in particular, whether regulatory distinctions are made, in the language of Article III:1, "so as to afford protection to domestic production". The United States concludes that the Panel erred in its interpretation of Article III:2, first sentence in: failing to interpret Article III:2, first sentence, in the light of Article III:1, consistently with the

analysis in *United States - Measures Affecting Alcoholic and Malt Beverages* ("*Malt Beverages*");<sup>11</sup> not finding that all distilled spirits constitute "like products" under Article III:2, first sentence; and drawing a connection between national treatment obligations and tariff bindings.

With respect to the second sentence of Article III:2 and the *Ad Article* thereto, the United States argues that the Panel erred with respect to the *Ad Article* to the second sentence in its interpretation of the term "directly competitive or substitutable products" by not considering whether a tax distinction is applied "in a manner contrary to the principles set forth in paragraph 1 of [Article III]", that is, "so as to afford protection to domestic production". The United States also claims that the Panel erred by using cross-price elasticity as the "decisive criterion" for whether products are "directly competitive or substitutable".

The United States contends as well that the Panel erred in not addressing the full scope of the products subject to the dispute and that there is inconsistency between the Panel's conclusions in paragraph 7.1(ii) of the Panel Report and in paragraphs 6.32-6.33 of the Panel Report. The United States further submits that the Panel erred in incorrectly assessing the relationship between Article III:2 and Article III:4 by stating that the product coverage of the two provisions is not identical.

Finally, the United States claims that the Panel erred in incorrectly characterizing adopted panel reports as "subsequent practice" within the meaning of Article 31(3)(b) of the *Vienna Convention on the Law of Treaties* (the "*Vienna Convention*").<sup>12</sup> According to the United States, adopted panel reports serve only to clarify, for the purposes of the particular dispute, the application of the rights and obligations of the parties to that dispute to the precise set of circumstances at that time. The *decision* to adopt a panel report constitutes a "decision" within the meaning of paragraph 1(b)(iv) of the language incorporating the GATT 1994 into the *WTO Agreement*, however, the adopted panel report as such does not constitute a "decision" in this sense.

With respect to the claims of error raised in Japan's appellant's submission, the United States responds that: the national treatment provisions in Article III of GATT 1994 can apply to origin-neutral measures; Japan's taxation under the Liquor Tax Law does have the aim and effect of affording protection

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<sup>11</sup>Panel Report adopted on 19 June 1992, BISD 39S/206.

<sup>12</sup>23 May 1969, 1155 *U.N.T.S.* 331; 8 *International Legal Materials* 679.

to domestic production; and the tax/price ratios cited by Japan are not the appropriate basis for evaluating the consistency of taxation under the Liquor Tax Law with Article III:2.

### 3. European Communities

The European Communities support the Panel's conclusions, and largely agree with the legal interpretations of Article III:2, first and second sentences, employed by the Panel. With respect to Article III:2, first sentence, the European Communities submit that the Panel's reasons for adopting the interpretation in the Panel Report, and thus for rejecting a specific test of "aims and effects", are sound and "in accordance with customary rules of interpretation of public international law", as contemplated by Article 3.2 of the *DSU*.<sup>13</sup> The European Communities contend that the Panel made it clear that the essential criterion for a "like product" determination is similarity of physical characteristics and that tariff nomenclatures may be relevant for a determination of "likeness" because they constitute an objective classification of products according to their physical characteristics. The European Communities maintain that the Panel's decision to identify only vodka and shochu as "like products" for purposes of Article III:2 cannot be regarded as arbitrary or insufficiently motivated. Although not entirely satisfied with the Panel's conclusions on the range of products found to be "like" under Article III:2, first sentence, the European Communities claim that those conclusions primarily involve the assessment of facts and, therefore, are not reviewable by the Appellate Body, which is limited to the consideration of issues of law under Article 17.6 of the *DSU*.<sup>14</sup>

With respect to Article III:2, second sentence, the European Communities argue that the Panel did not rule that cross-price elasticity is the decisive criterion for a determination that two products are directly competitive or substitutable, but rather ruled that such elasticity is only one of the criteria to be considered. The European Communities view the Panel's findings on the issue of the tax/price ratios as factual; however, if the Appellate Body nevertheless considers it necessary to rule on this

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<sup>13</sup>Article 3.2 of the *DSU* states in pertinent part:

...The Members recognize that [the dispute settlement system] serves to preserve the rights and obligations of Members under the covered agreements, and to clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law.

<sup>14</sup>Article 17.6 of the *DSU* states:

An appeal shall be limited to issues of law covered in the panel report and legal interpretations developed by the panel.

issue, the European Communities argue that tax/price ratios are not the most appropriate yardstick for comparing tax burdens imposed by a system of specific taxes. The European Communities submit further that the Panel was correct in ignoring the linkage between differences in taxation and the origin of products. The European Communities assert that Japan's argument that the Liquor Tax Law is not applied "so as to afford protection to domestic production" of shochu because shochu is also produced in other countries and, therefore, is not an "inherently domestic product" rests on two wrong propositions: first, that "domestic production" of shochu is not "protected" if the same tax treatment is accorded to foreign shochu; and, second, that the mere fact that shochu is produced in third countries is sufficient to conclude that foreign shochu may benefit from the lower tax as much as domestic shochu and, consequently, that protection is not afforded only to domestic production. The European Communities further contend that the United States is incorrect to attribute to the Panel the statement that the product coverage of Article III:2 and Article III:4 is not equivalent.

With respect to the status of adopted panel reports, the European Communities conclude that the Panel's characterization of them as "subsequent practice in a specific case" is intrinsically contradictory, since the essence of subsequent practice is that it consists of a large number of legally relevant events and pronouncements. The European Communities' view is that one adopted panel report "would merely constitute part of a wall of the house that constitutes subsequent practice". The European Communities, therefore, ask the Appellate Body to modify the Panel's legal terminology on this issue. The European Communities further consider that the *decision* to adopt a panel report constitutes a "decision" within the meaning of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the *WTO Agreement*, however an adopted panel report is not itself a "decision" in this sense.

#### 4. Canada

Canada confined its submissions and arguments on appeal to Article III:2, second sentence. Canada supports the Panel's legal interpretations of Article III:2, second sentence, as well as the conclusion of the Panel that the Liquor Tax Law is inconsistent with Article III:2, second sentence. Canada claims that the Panel properly found that the phrase "so as to afford protection" in Article III:1 does not require a consideration of both the aim and effect of a measure to determine whether that measure affords protection to domestic production. Canada argues further that: first, the Panel Report did not create a *per se* test in Article III:2, second sentence, and did not equate the reference to "so



as to afford protection to domestic production" with a determination that directly competitive or substitutable products are "not similarly taxed"; second, the Panel had sufficient evidence before it to conclude that differential tax treatment under the Liquor Tax Law favours domestic shochu production; third, the Panel Report considered in detail the issue of the tax/price ratios and assigned them their proper weight in assessing the tax burden on the products in dispute; and, finally, the Panel interpreted the phrase "directly competitive or substitutable" properly and did not identify "cross-price elasticity" as *the* decisive criterion for assessment of whether products are directly competitive or substitutable.

With regard to the status of adopted panel reports, Canada argues that decisions to adopt panel reports under GATT 1947 constitute "decisions" under Article 1(b)(iv) of the GATT 1994.

### **C. Issues Raised in the Appeal**

The appellants, Japan and the United States, have raised the following issues in this appeal:

#### 1. Japan

- (a) whether the Panel erred in failing to interpret Article III:2, first and second sentences, in the light of Article III:1;
- (b) whether the Panel erred in rejecting an "aim-and-effect" test in establishing whether the Liquor Tax Law is applied "so as to afford protection to domestic production";
- (c) whether the Panel erred in failing to examine the effect of affording protection to domestic production from the perspective of the linkage between the origin of products and their treatment under the Liquor Tax Law;
- (d) whether the Panel failed to give proper weight to tax/price ratios as a yardstick for comparing tax burdens under Article III:2, first and second sentences;

- (e) whether the Panel erred in interpreting and applying Article III:2, second sentence, by equating the language "not similarly taxed" in *Ad* Article III:2, second sentence, with "so as to afford protection" in Article III:1; and
- (f) whether the Panel erred in placing excessive emphasis on tariff classification as a criterion for determining "like products".

2. United States

- (a) whether the Panel erred in failing to interpret Article III:2, first and second sentences, in the light of Article III:1;
- (b) whether the Panel erred in failing to find that all distilled spirits are "like products";
- (c) whether the Panel erred in drawing a connection between national treatment obligations and tariff bindings;
- (d) whether the Panel erred in interpreting and applying Article III:2, second sentence, by equating the language "not similarly taxed" in *Ad* Article III:2, second sentence, with "so as to afford protection" in Article III:1;
- (e) whether the Panel erred in its conclusions on "directly competitive or substitutable products" by examining cross-price elasticity as "the decisive criterion";
- (f) whether the Panel erred in failing to maintain consistency between the conclusions in paragraph 7.1(ii) of the Panel Report on "directly competitive or substitutable products" and the conclusions in paragraphs 6.32-6.33 of the Panel Report, and whether the Panel erred in failing to address the full scope of products subject of this dispute;

- (g) whether the Panel erred in finding that the coverage of Article III:2 and Article III:4 are not equivalent; and
- (h) whether the Panel erred in its characterization of panel reports adopted by the GATT CONTRACTING PARTIES and the WTO Dispute Settlement Body as "subsequent practice in a specific case by virtue of the decision to adopt them".

#### **D. Treaty Interpretation**

Article 3.2 of the *DSU* directs the Appellate Body to clarify the provisions of GATT 1994 and the other "covered agreements" of the *WTO Agreement* "in accordance with customary rules of interpretation of public international law". Following this mandate, in *United States - Standards for Reformulated and Conventional Gasoline*,<sup>15</sup> we stressed the need to achieve such clarification by reference to the fundamental rule of treaty interpretation set out in Article 31(1) of the *Vienna Convention*. We stressed there that this general rule of interpretation "has attained the status of a rule of customary or general international law".<sup>16</sup> There can be no doubt that Article 32 of the *Vienna Convention*, dealing with the role of supplementary means of interpretation, has also attained the same status.<sup>17</sup>

Article 31, as a whole, and Article 32 are each highly pertinent to the present appeal. They provide as follows:

#### ARTICLE 31

##### *General rule of interpretation*

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

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<sup>15</sup>Adopted 20 May 1996, WT/DS2/9.

<sup>16</sup>*Ibid.*, at p. 17.

<sup>17</sup>See e.g.: Jiménez de Aréchaga, "International Law in the Past Third of a Century" (1978-I) 159 *Recueil des Cours* p.1 at 42; *Territorial Dispute (Libyan Arab Jamahiriya/Chad)*, Judgment, (1994), *I.C.J. Reports*, p. 6 at 20; *Maritime Delimitation and Territorial Questions between Qatar and Bahrain, Jurisdiction and Admissibility*, Judgment, (1995), *I.C.J.Reports*, p. 6 at 18; *Interpretation of the Convention of 1919 Concerning Employment of Women during the Night* (1932), P.C.I.J., Series A/B, No. 50, p. 365 at 380; cf. the *Serbian and Brazilian Loans Cases* (1929), P.C.I.J., Series A, Nos. 20-21, p. 5 at 30; *Constitution of the Maritime Safety Committee of the IMCO* (1960), *I.C.J. Reports*, p. 150 at 161; *Air Transport Services Agreement Arbitration (United States of America v. France)* (1963), *International Law Reports*, 38, p. 182 at 235-43.

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

## ARTICLE 32

### *Supplementary means of interpretation*

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

- (a) leaves the meaning ambiguous or obscure; or
- (b) leads to a result which is manifestly absurd or unreasonable.

Article 31 of the *Vienna Convention* provides that the words of the treaty form the foundation for the interpretive process: "interpretation must be based above all upon the text of the treaty".<sup>18</sup>

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<sup>18</sup>*Territorial Dispute (Libyan Arab Jamahiriya/Chad)*, Judgment, (1994) I.C.J. Reports, p. 6 at 20; *Maritime Delimitation and Territorial Questions between Qatar and Bahrain, Jurisdiction and Admissibility*, Judgment, (1995) I.C.J. Reports, p. 6 at 18.

The provisions of the treaty are to be given their ordinary meaning in their context.<sup>19</sup> The object and purpose of the treaty are also to be taken into account in determining the meaning of its provisions.<sup>20</sup> A fundamental tenet of treaty interpretation flowing from the general rule of interpretation set out in Article 31 is the principle of effectiveness (*ut res magis valeat quam pereat*).<sup>21</sup> In *United States - Standards for Reformulated and Conventional Gasoline*, we noted that "[o]ne of the corollaries of the 'general rule of interpretation' in the *Vienna Convention* is that interpretation must give meaning and effect to all the terms of the treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility".<sup>22</sup>

#### **E. Status of Adopted Panel Reports**

In this case, the Panel concluded that,

...panel reports adopted by the GATT CONTRACTING PARTIES and the WTO Dispute Settlement Body constitute subsequent practice in a specific case by virtue of the decision to adopt them. Article 1(b)(iv) of GATT 1994 provides institutional recognition that adopted panel reports constitute subsequent practice. Such reports are an integral part of GATT 1994, since they constitute "other decisions of the CONTRACTING PARTIES to GATT 1947".<sup>23</sup>

Article 31(3)(b) of the *Vienna Convention* states that "any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation" is to be "taken into account together with the context" in interpreting the terms of the treaty. Generally, in international

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<sup>19</sup>See, e.g., *Competence of the General Assembly for the Admission of a State to the United Nations (Second Admissions Case)* (1950), I.C.J. Reports, p. 4 at 8, in which the International Court of Justice stated: "The Court considers it necessary to say that the first duty of a tribunal which is called upon to interpret and apply the provisions of a treaty, is to endeavour to give effect to them in their natural and ordinary meaning and in the context in which they occur".

<sup>20</sup>That is, the treaty's "object and purpose" is to be referred to in determining the meaning of the "terms of the treaty" and not as an independent basis for interpretation: Harris, Cases and Materials on International Law (4th ed., 1991) p. 770; Jiménez de Aréchaga, "International Law in the Past Third of a Century" (1978-I) 159 Recueil des Cours p. 1 at 44; Sinclair, *The Vienna Convention and the Law of Treaties* (2nd ed, 1984), p. 130. See e.g. Oppenheims' International Law (9th ed., Jennings and Watts, eds., 1992) Vol. I, p.1273; *Competence of the ILO to Regulate the Personal Work of the Employer* (1926), P.C.I.J., Series B, No. 13, p. 6 at 18; *International Status of South West Africa* (1962), I.C.J. Reports, p. 128 at 336; *Re Competence of Conciliation Commission* (1955), 22 International Law Reports, p. 867 at 871.

<sup>21</sup>See also (1966) Yearbook of the International Law Commission, Vol. II, p. 219: "When a treaty is open to two interpretations one of which does and the other does not enable the treaty to have appropriate effects, good faith and the objects and purposes of the treaty demand that the former interpretation should be adopted."

<sup>22</sup>*United States - Standards for Reformulated and Conventional Gasoline*, WT/DS2/9, adopted 20 May 1996, p. 23.

<sup>23</sup>Panel Report, para. 6.10.

law, the essence of subsequent practice in interpreting a treaty has been recognized as a "concordant, common and consistent" sequence of acts or pronouncements which is sufficient to establish a discernable pattern implying the agreement of the parties regarding its interpretation.<sup>24</sup> An isolated act is generally not sufficient to establish subsequent practice;<sup>25</sup> it is a sequence of acts establishing the agreement of the parties that is relevant.<sup>26</sup>

Although GATT 1947<sup>27</sup> panel reports were adopted by decisions of the CONTRACTING PARTIES<sup>28</sup>, a decision to adopt a panel report did not under GATT 1947 constitute agreement by the CONTRACTING PARTIES on the legal reasoning in that panel report. The generally-accepted view under GATT 1947 was that the conclusions and recommendations in an adopted panel report bound the parties to the dispute in that particular case, but subsequent panels did not feel legally bound by the details and reasoning of a previous panel report.<sup>29</sup>

We do not believe that the CONTRACTING PARTIES, in deciding to adopt a panel report, intended that their decision would constitute a definitive interpretation of the relevant provisions of GATT 1947. Nor do we believe that this is contemplated under GATT 1994. There is specific cause for this conclusion in the *WTO Agreement*. Article IX:2 of the *WTO Agreement* provides: "The Ministerial Conference and the General Council shall have the exclusive authority to adopt interpretations of this Agreement and of the Multilateral Trade Agreements". Article IX:2 provides further that such decisions "shall be taken by a three-fourths majority of the Members". The fact that such an "exclusive authority" in interpreting the treaty has been established so specifically in the *WTO Agreement* is reason enough to conclude that such authority does not exist by implication or by inadvertence elsewhere.

Historically, the decisions to adopt panel reports under Article XXIII of the GATT 1947 were different from joint action by the CONTRACTING PARTIES under Article XXV of the GATT 1947. Today, their nature continues to differ from interpretations of the GATT 1994 and the other Multilateral

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<sup>24</sup>Sinclair, *The Vienna Convention on the Law of Treaties* (2nd ed., 1984), p. 137; Yasseen, "L'interprétation des traités d'après la Convention de Vienne sur le Droit des Traités" (1976-III) 151 *Recueil des Cours* p. 1 at 48.

<sup>25</sup>Sinclair, *supra.*, footnote 24, p. 137.

<sup>26</sup>(1966) *Yearbook of the International Law Commission*, Vol. II, p. 222; Sinclair, *supra.*, footnote 24, p. 138.

<sup>27</sup>By GATT 1947, we refer throughout to the General Agreement on Tariffs and Trade, dated 30 October 1947, annexed to the Final Act Adopted at the Conclusion of the Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment, as subsequently rectified, amended or modified.

<sup>28</sup>By CONTRACTING PARTIES, we refer throughout to the CONTRACTING PARTIES of GATT 1947.

<sup>29</sup>*European Economic Community - Restrictions on Imports of Dessert Apples*, BISD 36S/93, para. 12.1.

Trade Agreements under the *WTO Agreement* by the WTO Ministerial Conference or the General Council. This is clear from a reading of Article 3.9 of the *DSU*, which states:

The provisions of this Understanding are without prejudice to the rights of Members to seek authoritative interpretation of provisions of a covered agreement through decision-making under the *WTO Agreement* or a covered agreement which is a Plurilateral Trade Agreement.

Article XVI:1 of the *WTO Agreement* and paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the *WTO Agreement* bring the legal history and experience under the GATT 1947 into the new realm of the WTO in a way that ensures continuity and consistency in a smooth transition from the GATT 1947 system. This affirms the importance to the Members of the WTO of the experience acquired by the CONTRACTING PARTIES to the GATT 1947 -- and acknowledges the continuing relevance of that experience to the new trading system served by the WTO. Adopted panel reports are an important part of the GATT *acquis*. They are often considered by subsequent panels. They create legitimate expectations among WTO Members, and, therefore, should be taken into account where they are relevant to any dispute. However, they are not binding, except with respect to resolving the particular dispute between the parties to that dispute.<sup>30</sup> In short, their character and their legal status have not been changed by the coming into force of the *WTO Agreement*.

For these reasons, we do not agree with the Panel's conclusion in paragraph 6.10 of the Panel Report that "panel reports adopted by the GATT CONTRACTING PARTIES and the WTO Dispute Settlement Body constitute subsequent practice in a specific case" as the phrase "subsequent practice" is used in Article 31 of the *Vienna Convention*. Further, we do not agree with the Panel's conclusion in the same paragraph of the Panel Report that adopted panel reports in themselves constitute "other decisions of the CONTRACTING PARTIES to GATT 1947" for the purposes of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the *WTO Agreement*.

However, we agree with the Panel's conclusion in that same paragraph of the Panel Report that *unadopted* panel reports "have no legal status in the GATT or WTO system since they have not

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<sup>30</sup>It is worth noting that the Statute of the International Court of Justice has an explicit provision, Article 59, to the same effect. This has not inhibited the development by that Court (and its predecessor) of a body of case law in which considerable reliance on the value of previous decisions is readily discernible.

been endorsed through decisions by the CONTRACTING PARTIES to GATT or WTO Members".<sup>31</sup> Likewise, we agree that "a panel could nevertheless find useful guidance in the reasoning of an unadopted panel report that it considered to be relevant".<sup>32</sup>

## **F. Interpretation of Article III**

The *WTO Agreement* is a treaty -- the international equivalent of a contract. It is self-evident that in an exercise of their sovereignty, and in pursuit of their own respective national interests, the Members of the WTO have made a bargain. In exchange for the benefits they expect to derive as Members of the WTO, they have agreed to exercise their sovereignty according to the commitments they have made in the *WTO Agreement*.

One of those commitments is Article III of the GATT 1994, which is entitled "National Treatment on Internal Taxation and Regulation". For the purpose of this appeal, the relevant parts of Article III read as follows:

### **Article III**

#### *National Treatment on Internal Taxation and Regulation*

1. The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.\*

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

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<sup>31</sup>Panel Report, para. 6.10.

<sup>32</sup>*Ibid.*



### *Ad Article III*

#### *Paragraph 2*

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.

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'".<sup>33</sup> Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products.<sup>34</sup> "[T]he 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".<sup>35</sup> Moreover, it is irrelevant that "the trade effects" of the tax differential between imported and domestic products, as reflected in the volumes of imports, are insignificant or even non-existent; Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products.<sup>36</sup> Members of the WTO are free to pursue their own domestic goals through internal taxation or regulation so long as they do not do so in a way that violates Article III or any of the other commitments they have made in the *WTO Agreement*.

The broad purpose of Article III of avoiding protectionism must be remembered when considering the relationship between Article III and other provisions of the *WTO Agreement*. Although the protection of negotiated tariff concessions is certainly one purpose of Article III,<sup>37</sup> the statement in Paragraph 6.13 of the Panel Report that "one of the main purposes of Article III is to guarantee that WTO Members

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<sup>33</sup>*United States - Section 337 of the Tariff Act of 1930*, BISD 36S/345, para. 5.10.

<sup>34</sup>*United States - Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, para. 5.1.9; *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.5(b).

<sup>35</sup>*Italian Discrimination Against Imported Agricultural Machinery*, BISD 7S/60, para. 11.

<sup>36</sup>*United States - Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, para. 5.1.9.

<sup>37</sup>*Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.5(b); *Canada - Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies*, BISD 39S/27, para. 5.30.

will not undermine through internal measures their commitments under Article II" should not be overemphasized. The sheltering scope of Article III is not limited to products that are the subject of tariff concessions under Article II. The Article III national treatment obligation is a general prohibition on the use of internal taxes and other internal regulatory measures so as to afford protection to domestic production. This obligation clearly extends also to products not bound under Article II.<sup>38</sup> This is confirmed by the negotiating history of Article III.<sup>39</sup>

### G. Article III:1

The terms of Article III must be given their ordinary meaning -- in their context and in the light of the overall object and purpose of the *WTO Agreement*. Thus, the words actually used in the Article provide the basis for an interpretation that must give meaning and effect to all its terms. The proper interpretation of the Article is, first of all, a textual interpretation. Consequently, the Panel

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<sup>38</sup>*Brazilian Internal Taxes*, BISD II/181, para. 4; *United States - Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, para. 5.1.9; *EEC - Regulation on Imports of Parts and Components*, BISD 37S/132, para. 5.4.

<sup>39</sup>At the Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment, held in 1947, delegates in the Tariff Agreement Committee addressed the issue of whether to include the national treatment clause from the draft Charter for an International Trade Organization ("ITO Charter") in the GATT 1947. One delegate noted:

This Article in the Charter had two purposes, as I understand it. The first purpose was to protect the items in the Schedule or any other Schedule concluded as a result of any subsequent negotiations and agreements - that is, to ensure that a country offering a tariff concession could not nullify that tariff concession by imposing an internal tax on the commodity, which had an equivalent effect. If that were the sole purpose and content of this Article, there could really be no objection to its inclusion in the General Agreement. But the Article in the Charter had an additional purpose. That purpose was to prevent the use of internal taxes as a system of protection. It was part of a series of Articles designed to concentrate national protective measures into the forms permitted under the Charter, i.e. subsidies and tariffs, and since we have taken over this Article from the Charter, we are, by including the Article, doing two things: so far as the countries become parties to the Agreement, we are, first of all, ensuring that the tariff concessions they grant one another cannot be nullified by the imposition of corresponding internal taxes; but we are also ensuring that those countries which become parties to the Agreement undertake not to use internal taxes as a system of protection.

This view is reinforced by the following statement of another delegate:

... [Article III] is necessary to protect not only scheduled items in the Agreement, but, indeed, all items for all our exports and the exports of any country. If that is not done, then every item which does not appear in the Schedule would have to be reconsidered and possibly tariff negotiations re-opened if Article III were changed to permit any action on these non-scheduled items.

is correct in seeing a distinction between Article III:1, which "contains general principles", and Article III:2, which "provides for specific obligations regarding internal taxes and internal charges".<sup>40</sup> Article III:1 articulates a general principle that internal measures should not be applied so as to afford protection to domestic production. This general principle informs the rest of Article III. The purpose of Article III:1 is to establish this general principle as a guide to understanding and interpreting the specific obligations contained in Article III:2 and in the other paragraphs of Article III, while respecting, and not diminishing in any way, the meaning of the words actually used in the texts of those other paragraphs. In short, Article III:1 constitutes part of the context of Article III:2, in the same way that it constitutes part of the context of each of the other paragraphs in Article III. Any other reading of Article III would have the effect of rendering the words of Article III:1 meaningless, thereby violating the fundamental principle of effectiveness in treaty interpretation. Consistent with this principle of effectiveness, and with the textual differences in the two sentences, we believe that Article III:1 informs the first sentence and the second sentence of Article III:2 in different ways.

## **H. Article III:2**

### **1. First Sentence**

Article III:1 informs Article III:2, first sentence, by establishing that if imported products are taxed in excess of like domestic products, then that tax measure is inconsistent with Article III. Article III:2, first sentence does not refer specifically to Article III:1. There is no specific invocation in this first sentence of the general principle in Article III:1 that admonishes Members of the WTO not to apply measures "so as to afford protection". This omission must have some meaning. We believe the meaning is simply that the presence of a protective application need not be established separately from the specific requirements that are included in the first sentence in order to show that a tax measure is inconsistent with the general principle set out in the first sentence. However, this does not mean that the general principle of Article III:1 does not apply to this sentence. To the contrary, we believe the first sentence of Article III:2 is, in effect, an application of this general principle. The ordinary meaning of the words of Article III:2, first sentence leads inevitably to this conclusion. Read in their context and in the light of the overall object and purpose of the *WTO Agreement*, the words of the first sentence require an examination of the conformity of an internal tax measure with Article III by determining, first, whether the taxed imported and domestic products are "like" and, second, whether

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<sup>40</sup>Panel Report, para. 6.12.

the taxes applied to the imported products are "in excess of" those applied to the like domestic products. If the imported and domestic products are "like products", and if the taxes applied to the imported products are "in excess of" those applied to the like domestic products, then the measure is inconsistent with Article III:2, first sentence.<sup>41</sup>

This approach to an examination of Article III:2, first sentence, is consistent with past practice under the GATT 1947.<sup>42</sup> Moreover, it is consistent with the object and purpose of Article III:2, which the panel in the predecessor to this case dealing with an earlier version of the Liquor Tax Law, *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages* ("1987 *Japan - Alcohol*"), rightly stated as "promoting non-discriminatory competition among imported and like domestic products [which] could not be achieved if Article III:2 were construed in a manner allowing discriminatory and protective internal taxation of imported products in excess of like domestic products".<sup>43</sup>

(a) "*Like Products*"

Because the second sentence of Article III:2 provides for a separate and distinctive consideration of the protective aspect of a measure in examining its application to a broader category of products that are not "like products" as contemplated by the first sentence, we agree with the Panel that the first sentence of Article III:2 must be construed narrowly so as not to condemn measures that its strict

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<sup>41</sup>In accordance with Article 3.8 of the *DSU*, such a violation is *prima facie* presumed to nullify or impair benefits under Article XXIII of the GATT 1994. Article 3.8 reads as follows:

In cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment. This means that there is normally a presumption that a breach of the rules has an adverse impact on other Members parties to that covered agreement, and in such cases, it shall be up to the Member against whom the complaint has been brought to rebut the charge.

<sup>42</sup>See *Brazilian Internal Taxes*, BISD II/181, para. 14; *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.5(d); *United States - Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, para. 5.1.1; *United States - Measures Affecting the Importation, Internal Sale and Use of Tobacco*, DS44/R, adopted on 4 October 1994.

<sup>43</sup>*Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para 5.5(c).

terms are not meant to condemn. Consequently, we agree with the Panel also that the definition of "like products" in Article III:2, first sentence, should be construed narrowly.<sup>44</sup>

How narrowly is a matter that should be determined separately for each tax measure in each case. We agree with the practice under the GATT 1947 of determining whether imported and domestic products are "like" on a case-by-case basis. The Report of the Working Party on *Border Tax Adjustments*, adopted by the CONTRACTING PARTIES in 1970, set out the basic approach for interpreting "like or similar products" generally in the various provisions of the GATT 1947:

... the interpretation of the term should be examined on a case-by-case basis. This would allow a fair assessment in each case of the different elements that constitute a "similar" product. Some criteria were suggested for determining, on a case-by-case basis, whether a product is "similar": the product's end-uses in a given market; consumers' tastes and habits, which change from country to country; the product's properties, nature and quality.<sup>45</sup>

This approach was followed in almost all adopted panel reports after *Border Tax Adjustments*.<sup>46</sup> This approach should be helpful in identifying on a case-by-case basis the range of "like products" that fall within the narrow limits of Article III:2, first sentence in the GATT 1994. Yet this approach will be most helpful if decision makers keep ever in mind how narrow the range of "like products" in Article III:2, first sentence is meant to be as opposed to the range of "like" products contemplated in some other provisions of the GATT 1994 and other Multilateral Trade Agreements of the *WTO Agreement*. In applying the criteria cited in *Border Tax Adjustments* to the facts of any particular case, and in considering other criteria that may also be relevant in certain cases, panels can only apply their best judgement in determining whether in fact products are "like". This will always involve an

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<sup>44</sup>We note the argument on appeal that the Panel suggested in paragraph 6.20 of the Panel Report that the product coverage of Article III:2 is not identical to the coverage of Article III:4. That is not what the Panel said. The Panel said the following:

*If the coverage of Article III:2 is identical to that of Article III:4, a different interpretation of the term "like product" would be called for in the two paragraphs. Otherwise, if the term "like product" were to be interpreted in an identical way in both instances, the scope of the two paragraphs would be different. (emphasis added)*

This was merely a hypothetical statement.

<sup>45</sup>Report of the Working Party on *Border Tax Adjustments*, BISD 18S/97, para. 18.

<sup>46</sup>*The Australian Subsidy on Ammonium Sulphate*, BISD II/188; *EEC - Measures on Animal Feed Proteins*, BISD 25S/49; *Spain - Tariff Treatment of Unroasted Coffee*, BISD 28S/102; *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83; *United States - Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136. Also see *United States - Standards for Reformulated and Conventional Gasoline*, WT/DS2/9, adopted on 20 May 1996.

unavoidable element of individual, discretionary judgement. We do not agree with the Panel's observation in paragraph 6.22 of the Panel Report that distinguishing between "like products" and "directly competitive or substitutable products" under Article III:2 is "an arbitrary decision". Rather, we think it is a discretionary decision that must be made in considering the various characteristics of products in individual cases.

No one approach to exercising judgement will be appropriate for all cases. The criteria in *Border Tax Adjustments* should be examined, but there can be no one precise and absolute definition of what is "like". The concept of "likeness" is a relative one that evokes the image of an accordion. The accordion of "likeness" stretches and squeezes in different places as different provisions of the *WTO Agreement* are applied. The width of the accordion in any one of those places must be determined by the particular provision in which the term "like" is encountered as well as by the context and the circumstances that prevail in any given case to which that provision may apply. We believe that, in Article III:2, first sentence of the GATT 1994, the accordion of "likeness" is meant to be narrowly squeezed.

The Panel determined in this case that shochu and vodka are "like products" for the purposes of Article III:2, first sentence. We note that the determination of whether vodka is a "like product" to shochu under Article III:2, first sentence, or a "directly competitive or substitutable product" to shochu under Article III:2, second sentence, does not materially affect the outcome of this case.

A uniform tariff classification of products can be relevant in determining what are "like products". If sufficiently detailed, tariff classification can be a helpful sign of product similarity. Tariff classification has been used as a criterion for determining "like products" in several previous adopted panel reports.<sup>47</sup> For example, in the *1987 Japan - Alcohol* Panel Report, the panel examined certain wines and alcoholic

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<sup>47</sup>*EEC - Measures on Animal Feed Proteins*, BISD 25S/49; *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83; *United States - Standards for Reformulated and Conventional Gasoline*, WT/DS2/9, adopted on 20 May 1996.

beverages on a "product-by-product basis" by applying the criteria listed in the Working Party Report on *Border Tax Adjustments*,

... as well as others recognized in previous GATT practice (see BISD 25S/49, 63), such as the Customs Cooperation Council Nomenclature (CCCN) for the classification of goods in customs tariffs which has been accepted by Japan.<sup>48</sup>

Uniform classification in tariff nomenclatures based on the Harmonized System (the "HS") was recognized in GATT 1947 practice as providing a useful basis for confirming "likeness" in products. However, there is a major difference between tariff classification nomenclature and tariff bindings or concessions made by Members of the WTO under Article II of the GATT 1994. There are risks in using tariff bindings that are too broad as a measure of product "likeness". Many of the least-developed country Members of the WTO submitted schedules of concessions and commitments as annexes to the GATT 1994 for the first time as required by Article XI of the *WTO Agreement*. Many of these least-developed countries, as well as other developing countries, have bindings in their schedules which include broad ranges of products that cut across several different HS tariff headings. For example, many of these countries have very broad uniform bindings on non-agricultural products.<sup>49</sup> This does not necessarily indicate similarity of the products covered by a binding. Rather, it represents the results of trade concessions negotiated among Members of the WTO.

It is true that there are numerous tariff bindings which are in fact extremely precise with regard to product description and which, therefore, can provide significant guidance as to the identification of "like products". Clearly enough, these determinations need to be made on a case-by-case basis. However, tariff bindings that include a wide range of products are not a reliable criterion for determining or confirming product "likeness" under Article III:2.<sup>50</sup>

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<sup>48</sup>*Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.6.

<sup>49</sup>For example, Jamaica has bound tariffs on the majority of non-agricultural products at 50%. Trinidad and Tobago have bound tariffs on the majority of products falling within HS Chapters 25-97 at 50%. Peru has bound all non-agricultural products at 30%, and Costa Rica, El Salvador, Guatemala, Morocco, Paraguay, Uruguay and Venezuela have broad uniform bindings on non-agricultural products, with a few listed exceptions.

<sup>50</sup>We believe, therefore, that statements relating to any relationship between tariff bindings and "likeness" must be made cautiously. For example, the Panel stated in paragraph 6.21 of the Panel Report that "... with respect to two products subject to the same tariff binding and therefore to the same maximum border tax, there is no justification, outside of those mentioned in GATT rules, to tax them in a differentiated way through internal taxation". This is incorrect.

With these modifications to the legal reasoning in the Panel Report, we affirm the legal conclusions and the findings of the Panel with respect to "like products" in all other respects.

(b) *"In Excess Of"*

The only remaining issue under Article III:2, first sentence, is whether the taxes on imported products are "in excess of" those on like domestic products. If so, then the Member that has imposed the tax is not in compliance with Article III. Even the smallest amount of "excess" is too much. "The prohibition of discriminatory taxes in Article III:2, first sentence, is not conditional on a 'trade effects test' nor is it qualified by a *de minimis* standard."<sup>51</sup> We agree with the Panel's legal reasoning and with its conclusions on this aspect of the interpretation and application of Article III:2, first sentence.

2. Second Sentence

Article III:1 informs Article III:2, second sentence, through specific reference. Article III:2, second sentence, contains a general prohibition against "internal taxes or other internal charges" applied to "imported or domestic products in a manner contrary to the principles set forth in paragraph 1". As mentioned before, Article III:1 states that internal taxes and other internal charges "should not be applied to imported or domestic products so as to afford protection to domestic production". Again, *Ad* Article III:2 states as follows:

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.

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<sup>51</sup>*United States - Measures Affecting Alcoholic and Malt Beverages*, BISD 39S/206, para 5.6; see also *Brazilian Internal Taxes*, BISD II/181, para. 16; *United States - Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, para. 5.1.9; *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.8.



Article III:2, second sentence, and the accompanying *Ad Article* have equivalent legal status in that both are treaty language which was negotiated and agreed at the same time.<sup>52</sup> The *Ad Article* does not replace or modify the language contained in Article III:2, second sentence, but, in fact, clarifies its meaning. Accordingly, the language of the second sentence and the *Ad Article* must be read together in order to give them their proper meaning.

Unlike that of Article III:2, first sentence, the language of Article III:2, second sentence, specifically invokes Article III:1. The significance of this distinction lies in the fact that whereas Article III:1 acts implicitly in addressing the two issues that must be considered in applying the first sentence, it acts explicitly as an entirely separate issue that must be addressed along with two other issues that are raised in applying the second sentence. Giving full meaning to the text and to its context, three separate issues must be addressed to determine whether an internal tax measure is inconsistent with Article III:2, second sentence. These three issues are whether:

- (1) the imported products and the domestic products *are "directly competitive or substitutable products" which are in competition with each other;*
- (2) the directly competitive or substitutable imported and domestic products *are "not similarly taxed";* and
- (3) the dissimilar taxation of the directly competitive or substitutable imported domestic products *is "applied ... so as to afford protection to domestic production".*

Again, these are three separate issues. Each must be established separately by the complainant for a panel to find that a tax measure imposed by a Member of the WTO is inconsistent with Article III:2, second sentence.

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<sup>52</sup>The negotiating history of Article III:2 confirms that the second sentence and the *Ad Article* were added during the Havana Conference, along with other provisions and interpretative notes concerning Article 18 of the draft ITO Charter. When introducing these amendments to delegates, the relevant Sub-Committee reported that: "The new form of the Article makes clearer than did the Geneva text the intention that internal taxes on goods should not be used as a means of protection. The details have been relegated to interpretative notes so that it would be easier for Members to ascertain the precise scope of their obligations under the Article." E/CONF.2/C.3/59, page 8. Article 18 of the draft ITO Charter subsequently became Article III of the GATT pursuant to the Protocol Modifying Part II and Article XXVI, which entered into force on 14 December 1948.

(a) *"Directly Competitive or Substitutable Products"*

If imported and domestic products are not "like products" for the narrow purposes of Article III:2, first sentence, then they are not subject to the strictures of that sentence and there is no inconsistency with the requirements of that sentence. However, depending on their nature, and depending on the competitive conditions in the relevant market, those same products may well be among the broader category of "directly competitive or substitutable products" that fall within the domain of Article III:2, second sentence. How much broader that category of "directly competitive or substitutable products" may be in any given case is a matter for the panel to determine based on all the relevant facts in that case. As with "like products" under the first sentence, the determination of the appropriate range of "directly competitive or substitutable products" under the second sentence must be made on a case-by-case basis.

In this case, the Panel emphasized the need to look not only at such matters as physical characteristics, common end-uses, and tariff classifications, but also at the "market place".<sup>53</sup> This seems appropriate. The GATT 1994 is a commercial agreement, and the WTO is concerned, after all, with markets. It does not seem inappropriate to look at competition in the relevant markets as one among a number of means of identifying the broader category of products that might be described as "directly competitive or substitutable".

Nor does it seem inappropriate to examine elasticity of substitution as one means of examining those relevant markets. The Panel did not say that cross-price elasticity of demand is "*the* decisive criterion"<sup>54</sup> for determining whether products are "directly competitive or substitutable". The Panel stated the following:

In the Panel's view, the decisive criterion in order to determine whether two products are directly competitive or substitutable is whether they have common end-uses, *inter alia*, as shown by elasticity of substitution.<sup>55</sup>

We agree. And, we find the Panel's legal analysis of whether the products are "directly competitive or substitutable products" in paragraphs 6.28-6.32 of the Panel Report to be correct.

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<sup>53</sup>Panel Report, para. 6.22.

<sup>54</sup>United States Appellant's Submission, dated 23 August 1996, para. 98, p.63. (emphasis added)

<sup>55</sup>Panel Report, para 6.22.

We note that the Panel's conclusions on "like products" and on "directly competitive or substitutable products" contained in paragraphs 7.1(i) and (ii), respectively, of the Panel Report fail to address the full range of alcoholic beverages included in the Panel's Terms of Reference.<sup>56</sup> More specifically, the Panel's conclusions in paragraph 7.1(ii) on "directly competitive or substitutable products" relate only to "shochu, whisky, brandy, rum, gin, genever, and liqueurs," which is narrower than the range of products referred to the Dispute Settlement Body by one of the complainants, the United States, which included in its request for the establishment of a panel "all other distilled spirits and liqueurs falling within HS heading 2208". We consider this failure to incorporate into its conclusions all the products referred to in the Terms of Reference, consistent with the matters referred to the DSB in WT/DS8/5, WT/DS10/5 and WT/DS11/2, to be an error of law by the Panel.

(b) *"Not Similarly Taxed"*

To give due meaning to the distinctions in the wording of Article III:2, first sentence, and Article III:2, second sentence, the phrase "not similarly taxed" in the *Ad Article* to the second sentence must not be construed so as to mean the same thing as the phrase "in excess of" in the first sentence. On its face, the phrase "in excess of" in the first sentence means *any* amount of tax on imported products "in excess of" the tax on domestic "like products". The phrase "not similarly taxed" in the *Ad Article* to the second sentence must therefore mean something else. It requires a different standard, just as "directly competitive or substitutable products" requires a different standard as compared to "like products" for these same interpretive purposes.

Reinforcing this conclusion is the need to give due meaning to the distinction between "like products" in the first sentence and "directly competitive or substitutable products" in the *Ad Article* to the second sentence. If "in excess of" in the first sentence and "not similarly taxed" in the *Ad Article* to the second sentence were construed to mean one and the same thing, then "like products" in the first sentence and "directly competitive or substitutable products" in the *Ad Article* to the second sentence would also mean one and the same thing. This would eviscerate the distinctive meaning that must be respected in the words of the text.

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<sup>56</sup>The Panel's Terms of Reference cite the matters referred to the Dispute Settlement Body by the European Communities, Canada and the United States in WT/DS8/5, WT/DS10/5 and WT/DS11/2, respectively. In WT/DS8/5, the European Communities referred the Dispute Settlement Body to Japan's taxation of shochu, "spirits", "whisky/brandy" and "liqueurs". In WT/DS10/5, Canada referred the Dispute Settlement Body to Japan's taxation of shochu and products falling "within HS 2208.30 ('whiskies'), HS 2208.40 ('rum and tafia'), HS 2208.90 ('other' including fruit brandies, vodka, ouzo, korn, cream liqueurs and 'classic' liqueurs.)" In WT/DS11/2, the United States referred the Dispute Settlement Body to Japan's taxation of shochu and "all other distilled spirits and liqueurs falling within HS heading 2208".

To interpret "in excess of" and "not similarly taxed" identically would deny any distinction between the first and second sentences of Article III:2. Thus, in any given case, there may be some amount of taxation on imported products that may well be "in excess of" the tax on domestic "like products" but may not be so much as to compel a conclusion that "directly competitive or substitutable" imported and domestic products are "not similarly taxed" for the purposes of the *Ad Article* to Article III:2, second sentence. In other words, there may be an amount of excess taxation that may well be more of a burden on imported products than on domestic "directly competitive or substitutable products" but may nevertheless not be enough to justify a conclusion that such products are "not similarly taxed" for the purposes of Article III:2, second sentence. We agree with the Panel that this amount of differential taxation must be more than *de minimis* to be deemed "not similarly taxed" in any given case.<sup>57</sup> And, like the Panel, we believe that whether any particular differential amount of taxation is *de minimis* or is not *de minimis* must, here too, be determined on a case-by-case basis. Thus, to be "not similarly taxed", the tax burden on imported products must be heavier than on "directly competitive or substitutable" domestic products, and that burden must be more than *de minimis* in any given case.

In this case, the Panel applied the correct legal reasoning in determining whether "directly competitive or substitutable" imported and domestic products were "not similarly taxed". However, the Panel erred in blurring the distinction between that issue and the entirely separate issue of whether the tax measure in question was applied "so as to afford protection". Again, these are separate issues that must be addressed individually. If "directly competitive or substitutable products" are *not* "not similarly taxed", then there is neither need nor justification under Article III:2, second sentence, for inquiring further as to whether the tax has been applied "so as to afford protection". But if such products are "not similarly taxed", a further inquiry must necessarily be made.

(c) *"So As To Afford Protection"*

This third inquiry under Article III:2, second sentence, must determine whether "directly competitive or substitutable products" are "not similarly taxed" in a way that affords protection. This is not an issue of intent. It is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish legislative or regulatory intent. If the measure is applied to imported or domestic products so as to afford protection to domestic production, then it does not matter that there may not have been any

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<sup>57</sup>Panel Report, para. 6.33.

desire to engage in protectionism in the minds of the legislators or the regulators who imposed the measure. It is irrelevant that protectionism was not an intended objective if the particular tax measure in question is nevertheless, to echo Article III:1, "*applied* to imported or domestic products so as to afford protection to domestic production".<sup>58</sup> This is an issue of how the measure in question is *applied*.

In the *1987 Japan- Alcohol* case, the panel subsumed its discussion of the issue of "not similarly taxed" within its examination of the separate issue of "so as to afford protection":

... whereas under the first sentence of Article III:2 the tax on the imported product and the tax on the like domestic product had to be equal in effect, Article III:1 and 2, second sentence, prohibited only the application of internal taxes to imported or domestic products in a manner "so as to afford protection to domestic production". The Panel was of the view that also small tax differences could influence the competitive relationship between directly competing distilled liquors, but the existence of protective taxation could be established only in the light of the particular circumstances of each case and there could be a *de minimis* level below which a tax difference ceased to have the protective effect prohibited by Article III:2, second sentence.<sup>59</sup>

To detect whether the taxation was protective, the panel in the 1987 case examined a number of factors that it concluded were "sufficient evidence of fiscal distortions of the competitive relationship between imported distilled liquors and domestic shochu affording protection to the domestic production of shochu". These factors included the considerably lower specific tax rates on shochu than on imported directly competitive or substitutable products; the imposition of high *ad valorem* taxes on imported alcoholic beverages and the absence of *ad valorem* taxes on shochu; the fact that shochu was almost exclusively produced in Japan and that the lower taxation of shochu did "afford protection to domestic production"; and the mutual substitutability of these distilled liquors.<sup>60</sup> The panel in the 1987 case concluded that "the application of considerably lower internal taxes by Japan on shochu than on other directly competitive or substitutable distilled liquors had trade-distorting effects affording protection to domestic production of shochu contrary to Article III:1 and 2, second sentence".<sup>61</sup>

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<sup>58</sup>Emphasis added.

<sup>59</sup>*Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.11.

<sup>60</sup>*Ibid.*

<sup>61</sup>*Ibid.*

As in that case, we believe that an examination in any case of whether dissimilar taxation has been applied so as to afford protection requires a comprehensive and objective analysis of the structure and application of the measure in question on domestic as compared to imported products. We believe it is possible to examine objectively the underlying criteria used in a particular tax measure, its structure, and its overall application to ascertain whether it is applied in a way that affords protection to domestic products.

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. The very magnitude of the dissimilar taxation in a particular case may be evidence of such a protective application, as the Panel rightly concluded in this case. Most often, there will be other factors to be considered as well. In conducting this inquiry, panels should give full consideration to all the relevant facts and all the relevant circumstances in any given case.

In this respect, we note and agree with the panel's acknowledgment in the *1987 Japan - Alcohol* Report:

... that Article III:2 does not prescribe the use of any specific method or system of taxation. ... there could be objective reasons proper to the tax in question which could justify or necessitate differences in the system of taxation for imported and for domestic products. The Panel found that it could also be compatible with Article III:2 to allow two different methods of calculation of price for tax purposes. Since Article III:2 prohibited only discriminatory or protective tax burdens on imported products, what mattered was, in the view of the Panel, whether the application of the different taxation methods actually had a discriminatory or protective effect against imported products.<sup>62</sup>

We have reviewed the Panel's reasoning in this case as well as its conclusions on the issue of "so as to afford protection" in paragraphs 6.33 - 6.35 of the Panel Report. We find cause for thorough examination. The Panel began in paragraph 6.33 by describing its approach as follows:

... if directly competitive or substitutable products are not "similarly taxed", and if it were found that the tax favours domestic products, then protection would be afforded to such products, and Article III:2, second sentence, is violated.

This statement of the reasoning required under Article III:2, second sentence is correct.

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<sup>62</sup>*Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.9(c).

However, the Panel went on to note:

... for it to conclude that dissimilar taxation afforded protection, it would be sufficient for it to find that the dissimilarity in taxation is not *de minimis*. ... the Panel took the view that "similarly taxed" is the appropriate benchmark in order to determine whether a violation of Article III:2, second sentence, has occurred as opposed to "in excess of" that constitutes the appropriate benchmark to determine whether a violation of Article III:2, first sentence, has occurred.<sup>63</sup>

In paragraph 6.34, the Panel added:

(i) The benchmark in Article III:2, second sentence, is whether internal taxes operate "so as to afford protection to domestic production", a term which has been further interpreted in the Interpretative Note ad Article III:2, paragraph 2, to mean dissimilar taxation of domestic and foreign directly competitive or substitutable products.

And, furthermore, in its conclusions, in paragraph 7.1(ii), the Panel concluded that:

(ii) Shochu, whisky, brandy, rum, gin, genever, and liqueurs are "directly competitive or substitutable products" and Japan, by not taxing them similarly, is in violation of its obligation under Article III:2, second sentence, of the General Agreement on Tariffs and Trade 1994.

Thus, having stated the correct legal approach to apply with respect to Article III:2, second sentence, the Panel then equated dissimilar taxation above a *de minimis* level with the separate and distinct requirement of demonstrating that the tax measure "affords protection to domestic production". As previously stated, a finding that "directly competitive or substitutable products" are "not similarly taxed" is necessary to find a violation of Article III:2, second sentence. Yet this is not enough. The dissimilar taxation must be more than *de minimis*. It may be so much more that it will be clear from that very differential that the dissimilar taxation was applied "so as to afford protection". In some cases, that may be enough to show a violation. In this case, the Panel concluded that it was enough. Yet in other cases, there may be other factors that will be just as relevant or more relevant to demonstrating that the dissimilar taxation at issue was applied "so as to afford protection". In any case, the three issues that must be addressed in determining whether there is such a violation must be addressed clearly and separately in each case and on a case-by-case basis. And, in every case, a careful, objective analysis, must be done of each and all relevant facts and all the relevant circumstances

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<sup>63</sup>Panel Report, para 6.33.

in order to determine "the existence of protective taxation".<sup>64</sup> Although the Panel blurred its legal reasoning in this respect, nevertheless we conclude that it reasoned correctly that in this case, the Liquor Tax Law is not in compliance with Article III:2. As the Panel did, we note that:

... the combination of customs duties and internal taxation in Japan has the following impact: on the 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 shochu or any other of the mentioned white and brown spirits.<sup>65</sup>

Our interpretation of Article III is faithful to the "customary rules of interpretation of public international law".<sup>66</sup> WTO rules are reliable, comprehensible and enforceable. WTO rules are not so rigid or so inflexible as not to leave room for reasoned judgements in confronting the endless and ever-changing ebb and flow of real facts in real cases in the real world. They will serve the multilateral trading system best if they are interpreted with that in mind. In that way, we will achieve the "security and predictability" sought for the multilateral trading system by the Members of the WTO through the establishment of the dispute settlement system.<sup>67</sup>

## **I. Conclusions and Recommendations**

For the reasons set out in the preceding sections of this report, the Appellate Body has reached the following conclusions:

- (a) the Panel erred in law in its conclusion that "panel reports adopted by the GATT CONTRACTING PARTIES and the WTO Dispute Settlement Body constitute subsequent practice in a specific case by virtue of the decision to adopt them";

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<sup>64</sup>*Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.11.

<sup>65</sup>Panel Report, para. 6.35.

<sup>66</sup>Article 3.2 of the *DSU*.

<sup>67</sup>*Ibid.*



- (b) the Panel erred in law in failing to take into account Article III:1 in interpreting Article III:2, first and second sentences;
- (c) the Panel erred in law in limiting its conclusions in paragraph 7.1(ii) on "directly competitive or substitutable products" to "shochu, whisky, brandy, rum, gin, genever, and liqueurs", which is not consistent with the Panel's Terms of Reference; and
- (d) the Panel erred in law in failing to examine "so as to afford protection" in Article III:1 as a separate inquiry from "not similarly taxed" in the *Ad Article* to Article III:2, second sentence.

With the modifications to the Panel's legal findings and conclusions set out in this report, the Appellate Body affirms the Panel's conclusions that shochu and vodka are like products and that Japan, by taxing imported products in excess of like domestic products, is in violation of its obligations under Article III:2, first sentence, of the General Agreement on Tariffs and Trade 1994. Moreover, the Appellate Body concludes that shochu and other distilled spirits and liqueurs listed in HS 2208, except for vodka, are "directly competitive or substitutable products", and that Japan, in the application of the Liquor Tax Law, does not similarly tax imported and directly competitive or substitutable domestic products and affords protection to domestic production in violation of Article III:2, second sentence, of the General Agreement on Tariffs and Trade 1994.

The Appellate Body *recommends* that the Dispute Settlement Body request Japan to bring the Liquor Tax Law into conformity with its obligations under the General Agreement on Tariffs and Trade 1994.

Signed in the original at Geneva this 25th day of September 1996 by:

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Julio Lacarte-Muró  
Presiding Member

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James Bacchus  
Member

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Said El-Naggar  
Member