

**FURTHER SUBMISSION ON WHEN AND HOW
TO ALLOCATE SUBSIDY BENEFITS OVER TIME**

Paper from the United States

The following communication, dated 27 May 2005, is being circulated at the request of the Delegation of the United States.

The submitting delegations has requested that this paper, which was submitted to the Rules Negotiating Group as an informal document (JOB(05)/87), also be circulated as a formal document.

The United States previously submitted papers for informal discussion on the questions of when and how to allocate subsidy benefits over time in the context of both multilateral subsidy disciplines and remedies as well as countervailing duties. One paper examined how to distinguish between subsidies whose benefits are fully realized ("expensed") in a single year and subsidies whose benefits are "allocated" over more than one year.¹ Another paper continued the discussion by considering how to determine an appropriate allocation period over which allocable subsidy benefits should be distributed.² A third paper presented one possible model for calculating the benefit from an allocable subsidy in any given year.³ This paper reviews and further elaborates on these concepts. The United States reserves the right to submit further elaboration on the concepts and suggested changes contained in these papers.

DISCUSSION

The United States has previously noted that, although it is generally accepted that the benefit from certain types of subsidies should be spread over time, the Agreement on Subsidies and Countervailing Measures (Subsidies Agreement) is silent concerning when or how this should be done. Alternative approaches to these questions can result in extreme differences in the calculated subsidy benefit allocated to a given year, thereby making it imperative that the Rules Group clarify and improve the rules in this area. Some efforts have been made by Members, over the decades since the inception of the GATT, to develop more specific guidelines for allocating subsidy benefits.⁴ The most recent, concerted effort in this regard was by the Informal Group of Experts to the Committee on Subsidies and Countervailing Measures (IGE), which issued a list of recommendations regarding,

¹ TN/RL/GEN/17, 15 September 2004.

² TN/RL/GEN/12, 14 July 2004.

³ TN/RL/GEN/4, 14 July 2004.

⁴ TN/RL/GEN/12, 14 July 2004, at 1-2.

inter alia, when and how to allocate subsidy benefits over time.⁵ Much of what the United States has proposed to date, and further elaborates below, on this topic builds on or is consistent with the general recommendations of the IGE.⁶

Before providing the specifics of a possible approach to this issue, we would like to recall three points we have suggested that Members keep in mind when taking up this topic. These are: (1) any methodology for determining which subsidy benefits should be allocated, and how such allocation should be performed, must strike a reasonable balance among the goals of predictability, accuracy, transparency, and administrability; (2) any subsidy allocation period is only an approximation of the actual duration of the subsidy benefit; and (3) it can not be determined in advance whether a particular approach taken in determining the duration of a subsidy benefit will be more advantageous to the complainant or the respondent in the context of a potential countervailing duty or dispute settlement proceeding; therefore, the issue should be addressed purely on a technical basis.⁷ Moreover, we would like to reiterate the point that the questions of when and how to allocate subsidy benefits over time are more than minor, technical calculation issues relating only to countervailing duty remedies; rather, in our view, these issues have possible broader implications for WTO subsidy disciplines and dispute settlement including, as most recently noted by one Member, the remedy of subsidy withdrawal.⁸

We suggest that the first step in determining the amount of a subsidy benefit in any given year would be to categorize the subsidy as either "non-recurring" or "recurring", where non-recurring subsidy benefits are allocated over more than one year and recurring subsidy benefits are deemed to benefit the recipient solely in the year of receipt.⁹ This would be done for both theoretical and practical reasons. The theory behind distinguishing and allocating non-recurring subsidies is that these types of subsidies, by their nature, generally are infrequent, exceptional and linked more directly to the longer-term financial structure (*i.e.*, debt and equity) and fixed assets (*e.g.*, plant and equipment) of the firm and, therefore, continue to benefit the firm beyond the year of receipt. For example, where the government provides a grant to purchase machinery and equipment, the firm will continue to benefit from the use of this equipment throughout that asset's useful life.¹⁰ Recurring subsidy benefits, on the other hand, are normally related to or consumed in a firm's regular/ongoing production and sales activity. Ongoing corporate income tax exemptions, for example, mainly have an impact on annual after-tax profits and are not a primary factor in the firm's longer-term productive capability.

From a practical point of view, since non-recurring subsidies are generally (though not necessarily) larger in size than recurring subsidies, it may be inappropriate to concentrate the entire amount of the subsidy benefit in just one year. Furthermore, expensing small, recurring subsidies in the year of receipt reduces the burden on subsidy recipients involved in countervailing duty proceedings, for example, in that they do not have to track and report numerous small, ongoing subsidies dating several years prior to the period being investigated.

⁵ G/SCM/W/415/Rev.2, 15 May 1998 ("IGE Report"). All WTO Members were invited to nominate representatives to the IGE. Experts, serving in their personal capacities, from Australia, Brazil, Canada, Japan, Korea, Mexico, the European Communities and the United States participated. Although the mandate of the IGE was to develop recommendations for clarifying certain provisions under Annex IV, the recommendations ultimately developed are also relevant to other provisions of the Subsidies Agreement.

⁶ We also note that other Members have pointed to the IGE report as a starting point for consideration of further development of subsidy benefit calculation rules. See, for example, TN/RL/W/85, 30 April 2003.

⁷ For example, in the countervailing duty context, longer allocation periods do not, *per se*, necessarily benefit one party over another.

⁸ TN/RL/GEN/35, 23 March 2005.

⁹ IGE Report, at 3.

¹⁰ See also, TN/RL/W/19, 7 October 2002.

To facilitate consistency and predictability in dispute settlement proceedings or in the administration of countervailing duty proceedings, and consistent with the IGE recommendations, this Group should consider adopting illustrative lists of types of subsidies that, normally, would be considered to be recurring or non-recurring.¹¹ It has been the United States' experience, for example, that the following subsidies normally provide benefits that are best characterized as recurring: direct tax exemptions and deductions; exemptions from and excessive rebates of indirect taxes or import duties; provision of goods and services for less than adequate remuneration; price support payments; discounts on electricity, water, and other utilities; freight subsidies; export promotion assistance; early retirement payments; worker assistance; worker training; wage subsidies; and upstream subsidies. Subsidies that have normally provided non-recurring benefits include: equity infusions, grants, plant closure assistance, debt forgiveness, coverage for an operating loss, debt-to-equity conversions, provision of non-general infrastructure, and provision of plant and equipment.

Although such lists normally would be practical as well as accurate, they should remain illustrative only. Parties to a subsidy-related dispute should be able to make arguments based on the unique factual circumstances of a particular case. Any ultimate finding of whether a particular subsidy is appropriately characterized as recurring or non-recurring could be made with reference to the following three criteria, reflecting the theoretical and practical considerations noted above: (1) whether the subsidy is exceptional in the sense that the recipient cannot expect to receive additional subsidies under the same programme on an ongoing basis from year to year; (2) whether the subsidy required or received the government's express authorization or approval (*i.e.*, receipt of benefits is not automatic); or (3) whether the subsidy was provided for, or linked to, the capital structure or capital assets of the firm.

Once an allocable (non-recurring) subsidy has been identified, the logical next step in determining the subsidy benefit in a given year would be to decide upon the number of years over which the subsidy benefit should be spread. Consistent with the IGE recommendations, we believe that this period should be based on the average of the useful lives (AUL) of all the depreciable, physical assets of the subsidy recipient.¹² Such a period is a reasonable approximation of the duration of the benefit that a subsidy recipient enjoys, and is the most practical approach in terms of application.¹³ For example, if a government provides a grant to a chair manufacturer to purchase electric saws and wood-carving equipment, it is reasonable to assume that the chair producer continues to benefit from that subsidy throughout the life of the equipment.

However, the AUL of all a subsidy recipient's depreciable, physical assets is not necessarily a readily identifiable number, and calculating such a figure can be complex and controversial given that the different depreciation periods of numerous assets generally must be taken into account. This leads to the threshold question of whether such an AUL should be based on the actual (and, therefore, ever-fluctuating) financial position of the individual subsidy recipient, or instead on some other objective measurement or standard. Although the use of company-specific AUL data might appear preferable in terms of accuracy, there are common instances where this may not be the case and, in fact, there can be a considerable downside to relying on company-specific data.

One very common situation where individual company-specific data may not be an appropriate basis for determining the AUL of assets is where a company bases its asset depreciation schedules on estimated asset lives that are based on other financial considerations and not on the actual expected operating life of the asset. Similarly, it could be problematic to use company-specific

¹¹ Such lists are only relevant to those government actions that meet the definition of a subsidy under Article 1 and are specific under Article 2 of the Subsidies Agreement.

¹² IGE Report, at 5.

¹³ An exception should be made for subsidized long-term loans, where the benefit could be allocated over the life of the loan given that the duration of the loan (and its benefit) is a fixed and known period.

data where the company's depreciation expenses are based on an accelerated depreciation methodology,¹⁴ or when a company has written down its assets. Calculating a company-specific AUL can also prove unduly burdensome, often requiring the subsidy recipient to perform an analysis and provide documentation at a level of detail that may be difficult, costly and time consuming. Generally, the United States has found that calculating company-specific AULs can very often produce inconsistent, unpredictable results.

Given the theoretical preference for relying on company-specific data, but the practical problems that such data can entail, we would suggest a flexible approach with regard to selection of AULs that allows for the possibility of basing the determination on either the company-specific data or an industry standard value, depending on the facts of a particular situation. We think the best approach would be to start with an initial presumption that the allocation period for a subsidy benefit is the AUL of depreciable physical assets for the industry concerned.¹⁵

Any industry standard value used should reasonably reflect the actual AUL of the industry. Specifically, it should be the product of a system that was set up to determine the actual AUL of industries in the country, that is based on reliable surveys and/or studies used to gather information from companies on their AULs, and that ensures the accuracy of any reported information and of any calculations performed.

However, if it is clear in the context of a given WTO subsidies dispute or countervailing duty proceeding that the presumed industry AUL does not reasonably reflect the actual AUL of the particular assets of the subsidy recipient, the actual company-specific AUL could be used as the basis for allocating subsidy benefits. This situation, in turn, raises additional complexities. Because firms often do not calculate the "actual" AUL for all assets in the normal course of business, this Group should give consideration to developing a straightforward, practical approach to calculating company-specific AULs based on information generally contained in a company's regular accounting records.¹⁶

The allocation period (*i.e.*, length of the benefit stream), once identified, logically becomes a key variable in any model for determining the benefit in a given year of an allocable (non-recurring) subsidy. A second key variable is the interest or discount rate used to take into account the time value of money (discussed in further detail below). Under the US allocation methodology, for example, the values for these two variables, along with the face value of the subsidy, are entered into an established subsidy allocation formula that calculates the amount of benefit allocable to any given year within the allocation period. As this formula was discussed in detail in TN/RL/GEN/4 (14 July 2004), and is fairly complex, we will not reproduce it here. However, we would like to reiterate some basic points about the mechanics of subsidy allocation generally, and possible formulas, in particular.

¹⁴ As discussed in greater detail in document TN/RL/GEN/12 (14 July 2004), averaging the expected useful lives of all a firm's depreciable physical assets involves a calculation that takes into account total annual depreciation charges. A company's annual total depreciation expense can be significantly affected (and distorted) by the choice of depreciation methodology (*e.g.*, accelerated versus straight line depreciation).

¹⁵ This immediately raises the question of which industry AULs should be used: those of the investigating Member in a countervailing duty investigation (or the complaining Member in a multilateral dispute) or, rather, those of the opposing Member? There may be good arguments on both sides.

¹⁶ One such approach could be as follows. First, the annual average gross book value of the firm's depreciable renewable physical assets (which is usually based on historical cost) would be cumulated over an appropriate period of historical data (*e.g.*, 10 years). The average gross book value for a given year can be determined by adding the gross book value in the beginning of the year and the gross book value at the end of the year, and then dividing the sum by two. Next, the firm's annual charges to accumulated depreciation for the same time period would be summed. Finally, the sum of the annual average gross book values would be divided by the sum of annual depreciation charges, resulting in an AUL for the company's stock of all physical assets during the historical period.

In structuring a methodology, it may be helpful to visualize the allocation of subsidy benefits as a line on a graph. The x-axis of the graph represents each year within the allocation period and the y-axis represents the corresponding annual allocated benefits. Any method of allocating benefits over time essentially has three facets: the shape of the benefit stream, the length of the benefit stream (already discussed in detail above), and the discount rate.

The shape of the benefit stream, *i.e.*, the slope of the line in the visualized graph, can be flat, upward sloping, or downward sloping. A flat line implies that the subsidy recipient benefits in equal annual increments over time. An upward sloping line indicates that the recipient receives greater benefit from the subsidy in the later years of the allocation period. A downward sloping line suggests that the level of annual benefit declines over time. Different arguments can be made as to what the correct shape or slope of the benefit line is, and it may not be necessary for this Group to adopt a rigid rule one way or the other. That said, we note that the US model assumes that the subsidy recipient receives greater benefits in the early years and thus has a downward sloping line.

The effect of the discount rate is to set the height of the flat benefit stream or the slope of the slanted stream of benefits. Once it is accepted that the benefit from a subsidy should be allocated over time, use of a discount rate is necessary to account for the time value of money.¹⁷ More precisely, the incorporation of a discount rate ensures that the net present value of the annual benefits spread over time is equal to the face value of the subsidy provided in the year of bestowal. The result is that the real benefit provided by the original subsidy is determined, in constant grant-year dollars, regardless of the period over which the benefit is allocated. We believe that the appropriate discount rate to use in most cases would be the subsidy recipient's long-term cost of funds.

SUMMARY OF SUGGESTED CHANGES

Ideally, this Group would reach a consensus on a single methodology or set of guidelines, to be employed by all Members and dispute settlement panels, for determining when and how subsidy benefits should be expensed or allocated. We have provided concrete, specific suggestions above for how such a methodology or guidelines could be structured. At a minimum, however, any new rules in this regard should recognize the following general principles:

- (1) *"Recurring" subsidies (e.g., those that are not exceptional, or linked to the capital assets or capital structure of the recipient firm) only benefit the subsidy recipient in the year of receipt. "Non-recurring" subsidies benefit the subsidy recipient throughout the allocation period.*
- (2) *The allocation period for non-recurring subsidies should normally be based on the AUL of depreciable, physical assets for the relevant industry or firm.*
- (3) *Any method for allocating subsidy benefits over time must reflect the time value of money.*
- (4) *Members shall notify the particular subsidy allocation methodology they follow in countervailing duty proceedings and explain the rationale for any subsequent deviation from that methodology.*

¹⁷ A fundamental principle of finance is that \$1,000 received today, for example, is worth more than \$1,000 received one year from today, even though the face values of the payments are the same. We firmly believe that this basic, well-recognized principle of the time value of money must be incorporated into any method of subsidy allocation in order for the measurement of subsidy benefits to be meaningful.

We also note that one additional, practical question that arises in considering this issue is how (and where) any such new rules or guidelines would be incorporated into the Subsidies Agreement. One logical place in which to add such rules is Article 14, which provides guidelines for calculating the subsidy benefit to the recipient. Although Article 14 only pertains to countervailing duty remedies, several dispute settlement reports have applied the principles of Article 14 to dispute settlement proceedings under Parts II and III of the Subsidies Agreement.¹⁸ This raises the broader issue of whether specific subsidy calculation rules should be applicable to dispute settlement proceedings under Parts II and III of the Subsidies Agreement. The United States believes that much, if not all of Article 14 should also be relevant to Parts II and III of the Subsidies Agreement, but recognizes that this is an issue worthy of further deliberation and discussion.

¹⁸ See, e.g., Appellate Body Report, *Canada - Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R; Panel Report, *Korea - Measures Affecting Trade in Commercial Vessels*, WT/DS273/R, para. 7.420.