

**EXPENSING VERSUS ALLOCATING SUBSIDY BENEFITS**

Communication from the United States

Revision

The following communication, dated 20 September 2004, is being circulated at the request of the Delegation of the United States.

The submitting delegation has requested that this paper, which was submitted to the Rules Negotiating Group as an informal document (JOB(04)/122/Rev.1), also be circulated as a formal document.

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**ISSUE**

As the United States has previously noted, although it is generally accepted that the benefit from certain types of subsidies should be allocated over time, the Agreement on Subsidies and Countervailing Measures (SCM Agreement) does not specify how or when such allocation should occur. It is important for the Rules Negotiating Group to clarify and improve the multilateral rules in this area and, ideally, reach consensus on a common methodology, given that different methodologies can result in significant differences in the subsidy benefit attributable to a particular year.<sup>1</sup>

In our first paper on subsidy allocation, we explored some of the issues relating to how to allocate subsidy benefits over time and reviewed the US approach for calculating the amount of subsidy benefit allocable to a particular year.<sup>2</sup> In a subsequent paper, we considered how to determine an appropriate allocation period, *viz.*, the period over which the benefit of an allocable subsidy should be spread.<sup>3</sup> In this paper, we will address the threshold matter of when such a methodology should be invoked, by distinguishing between subsidies that should be “allocated” (*i.e.*, spread over a period of several years according to a commonly accepted standard, such as the average useful life of the assets) and subsidies that should be “expensed” (*i.e.*, attributed entirely to a single year). As in the case of the previously discussed allocation issues, the United States has a well-developed practice in the context of conducting countervailing duty investigations, which is described below and which we believe can serve as a good basis for discussion.

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<sup>1</sup> The United States initially raised the issue of how and when to allocate subsidy benefits over time in TN/RL/W/78, *Subsidies Disciplines Requiring Clarification and Improvement*, 19 March 2003, page 6. Other Members have also raised this as an issue for consideration by this Group, *e.g.* TN/RL/W/19, 7 October 2002.

<sup>2</sup> TN/RL/W/148, 22 April 2004.

<sup>3</sup> TN/RL/W/157, 4 June 2004.

## DISCUSSION

We begin by recalling three overarching principles discussed in our previous paper on average useful life (AUL) of assets that are also relevant here. These are: (1) the allocation period for a subsidy is only an approximation of the actual duration of the subsidy benefit; (2) any allocation methodology must strike a practical and reasonable balance among the goals of consistency, predictability, accuracy, transparency, and administrability; and (3) determining the duration of a subsidy benefit is purely a technical matter, with no particular approach being inherently more or less advantageous to a party in the context of a countervailing duty proceeding or dispute settlement proceeding.

Following the entry into force of the SCM Agreement, the Committee on Subsidies and Countervailing Measures established an Informal Group of Experts (IGE) to develop recommendations for clarifying the provisions of Annex IV to the Agreement. Among other issues, the IGE considered the question of “allocating versus expensing” subsidy benefits.<sup>4</sup> Although Annex IV, and therefore the IGE’s work, specifically related to the valuation of subsidies under the now lapsed Article 6.1(a) provision based on a cost-to-government approach, many of the key conclusions and recommendations of the IGE are instructive for purposes of this discussion. Among those conclusions are: (1) that not all subsidies should be allocated over time (*viz.*, certain subsidies should be expensed)<sup>5</sup>; (2) whether a subsidy should be allocated or expensed may depend on the particular circumstances of the subsidy, including its type (*i.e.*, form), size, frequency, purpose, and the manner in which it is recorded; and (3) that it may be helpful to develop an illustrative list of those subsidies that would usually be allocated or expensed.

The United States’ methodology for distinguishing between allocable and expensable subsidies in the context of conducting countervailing duty investigations is similar in many fundamental respects to the general approach recommended by the Informal Group.<sup>6</sup> Central to our methodology is a distinction between “recurring” and “non-recurring” subsidies<sup>7</sup>, where non-recurring subsidies are allocated over the AUL of the firm’s assets and recurring subsidies are expensed in full in the year of receipt.<sup>8</sup> We do this 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. Recurring subsidy benefits, on the other hand, are normally related to or consumed in a firm’s regular/ongoing production and sales activity. 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. In contrast,

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<sup>4</sup> See G/SCM/W/415/Rev.2, 15 May 1998, page 3.

<sup>5</sup> This point is also at least implicitly recognized in the April 1985 report of the GATT Committee on Subsidies and Countervailing Measures entitled, *Guidelines on Amortization and Depreciation* (SCM/64; BISD 32S/154), which began with the statement, “*Certain subsidies exist which should be spread over time.*” (Emphasis added).

<sup>6</sup> The US methodology is detailed in full in the following *Federal Register* notice: *Countervailing Duties; Final Rule*, 63 Fed. Reg. 65348, 65392 (November 25, 1998), available on the US Department of Commerce web site at <http://www.ia.ita.doc.gov/regs/index.html>.

<sup>7</sup> The distinction between recurring and non-recurring subsidies has also been recognized under WTO jurisprudence. See, *e.g.*, Appellate Body Report, *United States – Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom*, WT/DS138/AB/R, adopted June 2000, para. 62; Appellate Body Report, *United States – Countervailing Measures Concerning Certain Products from the European Communities*, WT/DS212/AB/R, paras. 84, 158.

<sup>8</sup> An exception to this rule is that we will expense in the year of receipt non-recurring subsidies whose value is less than 0.5 per cent of the firm’s sales.

ongoing corporate income tax exemptions mainly impact 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 countervailable subsidy in just one year. Furthermore, expensing small, recurring subsidies reduces the burden on subsidy recipients involved in countervailing duty proceedings in that they do not have to track and report numerous small, ongoing subsidies dating several years prior to the period being investigated.

To facilitate consistency and predictability in the administration of countervailing duty proceedings, the United States has adopted *illustrative* lists of types of subsidies that, based on our past experience, should generally be characterized as recurring or non-recurring. In our experience, subsidies that would normally be considered as providing recurring benefits include: 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 we would normally consider as providing non-recurring benefits include: equity infusions, grants, plant closure assistance, debt forgiveness, coverage for operating losses, debt-to-equity conversions, provision of non-general infrastructure, and provision of plant and equipment.

Although we have found these lists generally to be useful and accurate, they remain illustrative only. Parties to a US countervailing duty proceeding can demonstrate that the unique factual circumstances of a particular case indicate that a program of a type that is normally considered to be recurring should be found to be nonrecurring, or *vice versa*. When considering parties' arguments in this regard, we make our ultimate determination of whether a particular subsidy is appropriately classified as recurring or non-recurring 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 program 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 tied to, the capital structure or capital assets of the firm.

The aforementioned criteria and their theoretical underpinnings notwithstanding, in applying our methodology, we are careful not to place too much emphasis or reliance on determining whether or not a subsidy is "tied" to capital assets. When taken to an extreme, such a rule can result in the need to trace precisely how a subsidy was used, which in many instances is difficult, if not impossible. With this in mind, the US approach for distinguishing recurring from non-recurring subsidies is best viewed as a straightforward rule of reason, whose primary purpose is to foster consistency, predictability, transparency, and administrability while also reflecting an overall theoretical coherence.

## CONCLUSION

We recognize that our approach for distinguishing between subsidies that should be allocated versus expensed may not be the only reasonable one. However, as we have previously noted, the continued absence of rules in this area will result in disparate treatment of similarly situated exporters. Preferably, the Group would reach a consensus on a single methodology or set of guidelines for dispute settlement panels and Members to use in determining both how and when to allocate subsidies. Devising an illustrative list -- such as the one recommended by the IGE or used by the United States -- may also be helpful in this regard. At a minimum, Members should be required to notify the methodology they use in countervailing duty proceedings and, if the notified methodology is not used in a particular case, the Member should be obligated to explain the methodology it used and the

reason for doing so, including an explanation of the facts and reasoning that led it to conclude that the normal methodology was not appropriate.

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