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Panel Proceedings

BRAZIL – CERTAIN MEASURES CONCERNING TAXATION AND CHARGES

(DS472)

Second Written Submission
by the European Union

Geneva, 15 April 2016
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1. **INTRODUCTION**

1. In this second written submission, the European Union will address and rebut Brazil's defence in the present case as outlined in Brazil's first written submission as well as in Brazil's oral statements at the first meeting with the Panel and Brazil's responses to the Questions posed by the Panel and the European Union. First, the European Union will examine some common features of Brazil's arguments. Then, the European Union will address the various programmes at issue, starting with the INOVAR-AUTO programme, then continuing with the ICT-related programmes and concluding with the export programmes, RECAP and PEC.

2. As will be elaborated below, the European Union stands by its claims that the programmes at issue are contrary to the GATT 1994, the TRIMs Agreement and the SCM Agreement.

2. **GENERAL ISSUES**

3. In its opening oral statement at the first meeting with the Panel, the European Union already addressed some of the horizontal issues raised by Brazil in its first written submission. In this respect, the European Union recalls that in the present case the European Union is not putting into question Brazil's taxation system as such; nor the European Union is asking the Panel to preserve any status quo between developed and developing countries. Rather, the European Union takes issue with the discriminatory elements enshrined in the programmes at issue, primarily by means of local content requirements that run afoul of Brazil's WTO commitments.

4. In an attempt to deviate the discussion towards other issues which do not arise in this case, Brazil wrongly asserts that the European Union considers that even requirements for firms to improve social outcomes, such as requirements for a specified level of local employment (or management) or requirements to train local employees or capacity-building of suppliers, may also be considered "local content requirements". Brazil's quotation is taken out of context. As the European Union noted in its first written submission, requirements for regulated firms to improve social outcomes such as requirements for a specified level of local employment (or

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1 Brazil's first written submission, footnote 37, referring to EU's first written submission, footnote 48.
management), and requirements to train local employees or build capacity in suppliers "may also be seen as local content requirements in a wider sense", and there is some literature on this respect. Since there is no clear definition of what local content requirements mean (and there are a wide variety of similar terms employed in the literature such as performance requirements, investment requirements, etc), the European Union chose to define the terms "local content requirement" in its first written submission as follows: "those requirements that include a certain content of local elements, be it the manufacturing or sourcing of products from one country or conducting certain value-added activities linked to a product (such as R&D, technological development, manufacturing or assembling activities) in one country". Such a formula addresses the various requirements contained in the programmes at issue in this dispute. The Panel should thus read those terms as defined by the European Union, not in isolation from the specific context of this dispute. Importantly, in the European Union's view, the Panel should limit its assessment to the facts of the present case, as evidenced by the European Union, and make findings and recommendations with respect to the specific requirements imposed by Brazil pursuant to the seven programmes challenged in this case. Thus, the Panel should not, as Brazil, posits,\(^2\) endeavour to determine whether an undefined category labelled as "local content requirements" is inconsistent with the covered agreements; rather, the Panel should examine whether the specific measures at issue in this case are inconsistent with the GATT 1994, the TRIMs Agreement and the SCM Agreement.

5. That being said, from a legal viewpoint, in a nutshell Brazil's defence in this case revolves around the following issues.

6. With respect to the EU's claims under Article III of the GATT 1994 (and mutatis mutandi under the TRIMs Agreement), Brazil argues that the measures at issue concern obligations regarding "production" and investment in R&D by producers, that is, they do not deal with or affect "products" and cannot be considered as such, as they are "pre-market" requirements. According to Brazil, only measures affecting products in the market fall under the scope of Article III and measures regarding production, research, development and design are outside the scope of

\(^2\) Brazil's first written submission, paras 80 and 88.
Article III. Moreover, Brazil maintains that the advantages granted pursuant to the various programmes are not based on the origin of the products, since they are related to production and development requirements imposed on accredited producers. Finally, Brazil considers that to the extent that the measures are subsidies, they would be carved out by Article III:8(b) of the GATT 1994.

7. Brazil further argues that any inconsistency with Article III of the GATT 1994 with respect to the PATVD and INOVAR-AUTO programmes would be justified under Article XX of the GATT 1994.

8. With respect to the EU's claims under the SCM Agreement, Brazil considers that there is no subsidy in this case and that, in any event, the programmes would not be prohibited under Articles 3.1(a) and 3.1(b) of the SCM Agreement.

9. Finally, Brazil puts emphasis on the lack of trade effects of the measure.

10. Before entering into Brazil's arguments with respect to each programme, the European Union will address below these horizontal arguments raised by Brazil in order to show that they are without merit.

2.1.1. Article III of the GATT 1994 applies to the INOVAR-AUTO and the ICT-related programmes

11. As will be explained below, contrary to what Brazil asserts, the European Union considers that the obligations contained in Articles III:2, III:4 and III:5 of the GATT 1994 fully apply to the INOVAR-AUTO and the ICT-related programmes.

2.1.1.1 Article III includes discrimination through internal taxes directly or indirectly affecting imported products when compared to domestic like products

12. The European Union disagrees with Brazil that the programmes at issue escape the disciplines of Article III. The text of Article III as well as the relevant case-law confirms that Article III applies to products (including through pre-market or production requirements) when they affect the equality of competitive conditions

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3 See e.g. Brazil's first written submission, paras 179 – 185.
4 Brazil's first written submission, para. 200.
5 Brazil confirms that its defence under Article XX of the GATT 1994 also applies with respect to the EU's claims under the TRIMs Agreement. On the other hand, Brazil does not make an Article XX defence with regard to the SCM Agreement (see Brazil's response to the EU's Question no. 2).
for imported products in the market. As a matter of fact, Article III:1 refers explicitly also to "regulations requiring the mixture processing or use of products" and Article III:5 contains similar language. Moreover, the illustrative list of TRIMs that are inconsistent with Article III:4 contained in the Annex to the TRIMs Agreement refers explicitly to measures which require the purchase or use of products of domestic origin or from any domestic source specified in terms of a proportion of volume or value of a company local production. Thus, by its plain terms, Article III also covers measures that concerns the production or processing of products.

13. In the specific context of Article III of the GATT 1994, the key element in order to establish whether measures requiring a particular behaviour or conduct from economic operators are caught by its provisions is how those measures alter the competitive conditions with respect to domestic vis-à-vis imported like products in the market of the Member in question.6 Brazil's approach that the programmes are addressed to "producers" as opposed to products and that they concern "pre-market" stages is thus extremely formalistic. First and foremost, the terms "pre-market" do not appear in the covered agreements. They are thus a terminology used by Brazil in this case for the purpose of artificially isolate the measures at issue from the non-discrimination obligations under the GATT 1994. Moreover, accepting Brazil's views would open a loophole in the non-discrimination obligations under the GATT 1994, allowing Members to introduce measures which alter the conditions of competition to the detriment of imports, just because "formally" they are addressed to producers. The European Union considers that the Panel should reject Brazil's approach outright. Measures should be examined by having regard to their design, structure and (expected) operation.

14. Moreover, as explained in the EU's first written submission, there is ample case-law supporting the view that measures affecting the equality of the conditions of competition between domestic and imported products cannot be limited to measures directly regulating products or imposing market requirements.

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6 See e.g. Appellate Body Report, Japan – Alcoholic Beverages II, para. 109 (and all the cases cited therein); and more recently Appellate Body Report, EC – Seal Products, para. 5.105.
15. For instance, in *Thailand – Cigarettes (Philippines)*, Thailand's measure subjected resellers of imported cigarettes to VAT when they did not satisfy prescribed conditions for obtaining input tax credits necessary to achieve zero VAT liability. The Appellate Body found that "[w]hether such conditions are satisfied thus has a direct consequence for the amount of tax liability imposed on imported cigarettes".7

16. In *Indonesia – Autos*, the panel noted that "[u]nder the Indonesian car programmes the distinction between the products for tax purposes is based on such factors as the nationalitiy of the producer or the origin of the parts and components contained in the product". Thus, imposing certain requirements on those car manufacturers fell under Article III:2 of the GATT 1994 because of the discriminatory effect on the products. Similarly, the panel in *India – Autos* found that an indigenisation requirement imposed by the Indian Government on car manufacturers modified the conditions of competition in the Indian market to the detriment of imported products and was, therefore, in violation of Article III:4 of the GATT 1994.8

17. In *Argentina — Hides and Leather*, the panel addressed Argentina's tax collection mechanism which required the pre-payment of taxes only with respect to internal sales made by certain taxable persons, so-called *agentes de percepción*, whilst in respect of import transactions, a pre-payment obligation would arise without regard to who made them. The panel found that by requiring the pre-payment of the IVA (an indirect tax, VAT) on imports by non-registered taxable persons when no pre-payment of the IVA or additional IVA payment of equal amount is required on internal sales to non-registered taxable persons, Argentina acted contrary to Article III:2, first sentence.9 In other words, even if the requirements were imposed on taxable persons, their effects were felt at the level of products.

18. Consequently, measures affecting the conditions of competition between domestic and imported products are covered by Article III, regardless of whether they are formally designed to impose so-called "pre-market" conditions upon producers.

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Even assuming that such a category exists (i.e. pre-market) for the purpose of the GATT 1994, *quod non*, the European Union considers that pre-market requirements affecting the competitive conditions in the marketplace would fall under the non-discrimination obligations.

19. It cannot be disputed that the programmes at issue are designed, structured and operate in order to alter the competitive conditions between Brazilian products incentivised pursuant to those programmes and imported like products. Indeed, the benefit arising from compliance with the requirements provided for by the relevant programmes consists precisely in a decrease of the fiscal charge that is applicable to each individual product produced by the accredited company when that product is put on the Brazilian market. Thus, the programmes at issue modify the conditions of competition between products produced in accordance with the requirements under those programmes in Brazil and imported like products.

20. Finally, of note, Brazil argues that the programmes at issue incentivise the *production* of products, as opposed to the *selling* of products.\(^\text{10}\) Quite tellingly, Brazil acknowledges that the programmes relates to "products". The European Union disagrees that the programmes do not incentivise the selling of products. In view of the mechanism chosen by Brazil (i.e. benefits through indirect taxation on the sale of products in Brazil), it is difficult to obviate that the aim of those programmes is to allow for import substitution in Brazil, both at the level of inputs (i.e. favouring the use of local products) and final products (i.e. favouring the selling of local products).

2.1.1.2 The programmes at issue apply on the basis of an origin distinction

21. The European Union maintains that the programmes at issue apply on the basis of an origin distinction. In other words, they discriminate not on the basis of factors affecting the properties, nature, qualities or end-use of the products, but on origin-related criteria.

22. To put it simple, if in producing a given product a company decides to take certain development or production steps in a country different from Brazil, the resulting

\(^{10}\) See Brazil's closing oral statement at the first meeting with the Panel, para. 11.
product can never benefit from the advantageous tax treatment provided by the challenged programmes when sold in Brazil. Likewise, by providing tax benefits for products when certain manufacturing steps of parts and components of those products are carried out in Brazil (such as in the PPBs), the programmes incentivise the purchase and use of products made in Brazil as inputs into the production process. Participation in the programmes by an accredited company thus necessarily implies that the products made by that company benefitting from the tax reduction or exemption (and some of its components as the case may be) must be produced in Brazil (including in some cases they must be developed in Brazil). Therefore, the programmes at issue draw an origin-based distinction in respect of the fiscal advantages that discriminate against like imported products.

2.1.1.3 Article III:8(b) of the GATT 1994 does not apply in this case

23. Brazil argues that the programmes at issue fall under Article III:8(b) of the GATT 1994 since they provide subsidies exclusively to domestic producers. The European Union disagrees that Article III:8(b) applies in the present case.

24. First, as clarified by previous case-law, Article III:8(b) applies only to the payment of subsidies which involve the "expenditure of revenue by a government", and not to subsidies in the form of exemption or reduction of internal taxes. The 1992 GATT Panel Report in United States - Measures Affecting Alcoholic and Malt Beverages already noted that "[t]he words 'payment of subsidies' refer only to direct subsidies involving a payment, not to other subsidies such as tax credits or tax reductions". The GATT Panel noted that "[a]s any fiscal burden imposed by discriminatory internal taxes on imported goods is likely to entail a trade-distorting advantage for import-competing domestic producers, the prohibition of discriminatory internal taxes in Article III:2 would be ineffective if discriminatory internal taxes on imported products could be generally justified as subsidies for competing domestic producers in terms of Article III:8(b)".

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11 See e.g. Brazil's first written submission, paras 187 – 199.
13 Id. para. 5.9.
25. The Appellate Body also made this clear in Canada – Periodicals, finding that reduced postal rates applied by Canada Post to Canadian-owned and Canadian-controlled periodicals did not fall under Article III:8(b). The Appellate Body explained:

A proper interpretation of Article III:8(b) must be made on the basis of a careful examination of the text, context and object and purpose of that provision. In examining the text of Article III:8(b), we believe that the phrase, “including payments to domestic producers derived from the proceeds of internal taxes or charges applied consistently with the provisions of this Article and subsidies effected through governmental purchases of domestic products” helps to elucidate the types of subsidies covered by Article III:8(b) of the GATT 1994. It is not an exhaustive list of the kinds of programmes that would qualify as “the payment of subsidies exclusively to domestic producers,” but those words exemplify the kinds of programmes which are exempted from the obligations of Articles III:2 and III:4 of the GATT 1994.

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

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

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

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15 Appellate Body Report, Canada – Periodicals, pp. 33-34 (emphasis added).
26. The Appellate Body further explained the rationale underlying the above interpretation of Article III:8(b) by citing the panel report (under GATT 1947) in United States – Malt Beverages, which states:

   Article III:8(b) limits, therefore, the permissible producer subsidies to “payments” after taxes have been collected or payments otherwise consistent with Article III. This separation of tax rules, e.g. on tax exemptions or reductions, and subsidy rules makes sense economically and politically. Even if the proceeds from non-discriminatory product taxes may be used for subsequent subsidies, the domestic producer, like his foreign competitors, must pay the product taxes due. The separation of tax and subsidy rules contributes to greater transparency. It also may render abuses of tax policies for protectionist purposes more difficult, as in the case where producer aids require additional legislative or governmental decisions in which the different interests involved can be balanced.\footnote{GATT Panel Report, US – Malt Beverages, para. 5.10. See also Panel Report, United States - Measures Affecting the Importation, Internal Sale and Use of Tobacco, para. 109 (“The Panel was cognizant of the fact that a remission of a tax on a product and the payment of a producer subsidy out of the proceeds of such a tax could have the same economic effects. However, the Panel noted that the distinction in Article III:8(b) is a formal one, not one related to the economic impact of a measure”).}

27. When arguing the opposite, Brazil misreads a statement of the panel in EC – Vessels in an attempt to unduly expand the scope of Article III:8(b). In particular, Brazil cites EC – Vessels to argue that a regulatory measure that does not “involve an actual outlay of funds” could nevertheless fall under the scope of the provision.\footnote{Brazil's first written submission, para. 188.} However, the panel in that dispute stated that “[w]hat matters in the Panel’s view is not whether [a regulatory measure] itself involves outlays of funds by governments, but rather that the measures provided for under [the regulatory measure], state aids, are outlays of funds by governments”.\footnote{Panel Report, EC – Commercial Vessels, para. 7.71.} In no way did that panel depart from the Appellate Body’s ruling that “only the payment of subsidies which involves the expenditure of revenue by a government” can fall under Article III:8(b). It merely made clear that “outlays of funds by governments” subject to Article III:8(b) can be either the function of a regulatory measure itself, or that of a measure provided for under such regulatory measure. Brazil’s citation appears to
be rather to the argument developed by Korea and with which the Panel explicitly disagreed.\textsuperscript{19}

28. In this case, the programmes at issue do not involve the expenditure of revenue by Brazil, but rather the exemption of domestic products from internal taxes imposed on like imported products or the remission of such taxes. Thus, pursuant to the well-established principles, Brazil’s measures do not fall within the scope of Article III:8(b).

29. \textit{Second}, the panel in Indonesia – Autos found that "the purpose of Article III:8(b) is to confirm that subsidies to producers do not violate Article III, so long as they do not have any component that introduces discrimination between imported and domestic products".\textsuperscript{20} Thus, Article III:8(b) exempts payments to domestic producers from the national treatment obligation, but only to the extent that those payments do not discriminate between domestic and imported goods. Brazil contends that tax benefits granted pursuant to the programmes at issue are "payments of subsidies exclusively to domestic producers" that do not pass through to the final products and do not affect the conditions of competition in the market, because these benefits are offset by the costs of complying with the requirements under the relevant programme, such as R&D investment and production-step requirements.\textsuperscript{21}

30. However, as further explained below, if all benefits under the programmes were offset by the costs of complying with the requirements, the programmes would fail to have any incentivising effect. Simply put, companies would have no interest in becoming accredited and reduce their freedom to organise their operations as they wish if no advantage would be granted by participating in the programmes. It is evident from the structure and design of the measures that, by exempting or reducing indirect taxes or contributions, they seek to have a direct impact on the price of products (which structurally bear a lower tax burden when compared to imported like products) and, thus, affect the conditions of competition of such products in the market. Brazil presents no evidence in support of its contention,

\textsuperscript{19} See in particular Panel Report, \textit{EC – Commercial Vessels}, footnote 205.


\textsuperscript{21} Brazil's first written submission, paras 189, 192, 195-197, 551.
failing to rebut the \textit{prima facie} case made by the European Union in this respect. Brazil does not demonstrate that tax benefits accorded by these programmes do not translate into product price reductions, or do not affect the competitive opportunities for imported products. Brazil thus fails to substantiate its assertion that the measures “do not discriminate between domestic and imported goods”. Those programmes discriminate between imported and domestic products and, therefore, do not fall within the scope of Article III:8(b).

31. Further support to this conclusion can be found when examining Article III:8(a) of the GATT 1994, as immediate context. In \textit{Canada – Feed-in-Tariff Program} the Appellate Body examined whether requirements imposed by the Province of Ontario when procuring electricity from renewable sources (wind and solar) fell under Article III:8(a) of the GATT 1994. In particular, the Appellate Body examined whether imposing certain local content requirements with respect to the generators of that electricity would also be covered by the carve-out under Article III:8(a). The Appellate Body noted in this respect the following:

\begin{quote}
We have found above that the conditions for derogation under Article III:8(a) must be understood in relation to the obligations stipulated in the other paragraphs of Article III. This means that the product of foreign origin allegedly being discriminated against must be in a competitive relationship with the product purchased. In the case before us, the product being procured is electricity, whereas the product discriminated against for reason of its origin is generation equipment. These two products are not in a competitive relationship. None of the participants has suggested otherwise, much less offered evidence to substantiate such proposition. Accordingly, the discrimination relating to generation equipment contained in the FIT Programme and Contracts is not covered by the derogation of Article III:8(a) of the GATT 1994.\footnote{Appellate Body Reports, \textit{Canada – Renewable Energy / Canada – Feed-in Tariff Program}, para. 5.79.}
\end{quote}

32. Thus, under Article III:8(a) it is not possible to discriminate between products which are not in a competitive relationship when the government procures those products (i.e. a government may decide to purchase electricity generated by the sun or by the wind; however, it cannot require that the generators of such electricity be made locally as the generators are not in a competitive relationship with the electricity). Thus, the Article III:8(a) carve-out has been interpreted
narrowly not to cover discrimination at a level different from the product procured by the government.

33. Similarly, the European Union considers that a subsidy could incentivise the local production in general terms; and that a subsidy can be granted to domestic producers only (as opposed to also foreign producers) without falling under Article III of the GATT 1994. But when the general production subsidy to product X or the subsidy to domestic producers imposes conditions to use domestic over imported goods which are not in a competitive relationship with X (for instance, the requirement to use tyres made locally as opposed to imported tyres for the granting of a subsidy to make bicycles in the territory of the granting authority), such a contingency would make the subsidy fall under the provisions of Article III of the GATT 1994. The carve-outs in Article III:8 of the GATT 1994 should thus be interpreted harmoniously.

34. Thirdly, Brazil wrongly asserts that the tax reductions in question do not have any adverse consequences and that it is for the European Union to show this. In this connection it is useful to recall that when there is tax discrimination between imported and domestic product, there is no need to show any impact of such different taxation on the market to demonstrate a violation of Article III:2 of the GATT 1994. 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 so even the smallest amount of "excess" is too much. In this respect, the purpose of Article III:2, first sentence, is to ensure "equality of competitive conditions between imported and like domestic products". Thus, the European Union (as it did in its first written submission) is only called to show that domestic products pursuant to the programmes at issue are subject to a lower tax burden when compared to imported products.

35. Finally, Brazil wrongly asserts that the subsidies in question are paid to producers. The fact that e.g. producers have to invest on R&D in Brazil does not mean that

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23 Brazil's first written submission para. 192.
the subsidy is granted to the producer. Obviously any tax is ultimately to be paid by a legal or physical person, and accordingly any tax advantage is to benefit the legal or physical person liable to pay that tax. However, there is a difference between a tax advantage granted directly to the producer, such as a corporate tax reduction, that does not necessarily distort the conditions of competition between domestic and imported products, on the one hand, and the tax advantages bestowed pursuant to the challenged programmes, on the other. The programmes at issue rely on a reduction of indirect taxation as the tool to benefit certain domestic products in the market. In other words, each individual product incentivised according to the programmes when it is placed on the Brazilian market carries a tax burden, which is designed to be lower than the tax burden imposed on the like imported product. The higher is the number of the incentivised products which are put on the market, the higher is the tax advantage that the producer will obtain and the greater will be the negative impact on the competitive position of the like imported products. Even if the producer would have had to pay those taxes to the treasury "but for" the programmes, this does not meant that the subsidy is granted to producers (as e.g. direct taxation) within the meaning of Article III:8(b) of the GATT 1994.

2.1.1.4 Conclusion

36. The measures are therefore not excluded from the scope of application of the non-discrimination obligations in Article III of the GATT 1994. Thus, the European Union considers that Article III of the GATT 1994 fully applies in the case at hand.

2.1.2. Brazil fails to justify certain national treatment violations under Article XX of the GATT 1994

37. In this section the European Union discusses certain common aspects with regard to Article XX of the GATT 1994. First, the European Union refers to the similarities in the legal tests under different provisions in Article XX. Then, the European Union will distinguish between the different stages of analysis: design of the measure and protected values, the necessity analysis and the chapeau test.

38. While the language in paragraphs (a) to (j) of Article XX may differ (e.g. some measures need to be "necessary", while other measures need to "relate to"), the
legal tests under different subparagraphs of Article XX of the GATT 1994 are in practice very similar. Indeed, the "necessity" test in Articles XX(a) and (b) and the "relate to" test in Article XX(g) seek in essence to establish whether the measures at issue are "rational and reasonable" in their design, while the chapeau addresses in principle their application.

39. For instance, in the framework of the necessity test, the Appellate Body explained in Brazil – Retreaded Tyres that a measure contributes to the achievement of the objective when there is "a genuine relationship of ends and means between the objective pursued and the measure at issue".  

26 Similarly, the Appellate Body has found that, for a measure to "relate to" conservation in the sense of Article XX(g), there must be "a close and genuine relationship of ends and means".  

27 The conclusion of similar tests in practice finds further support in the idea that Members should not be encouraged to arbitrarily shield a measure under one or another exception, solely on the consideration that different intensity tests apply.

40. Thus, for a measure to be justified under Article XX of the GATT 1994, the panel's analysis boils down to determining whether the measure is rational and reasonable both in its design and in its application.  

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41. With regard to the different stages of analysis of a justification under one of the exceptions in Article XX, the European Union acknowledges that certain overlaps may occur, in the sense that similar evidence may be analysed at different stages. However, such overlaps should not lead to the blurring of the demarcation lines between different stages or to "overloading" the first stage of the analysis and "migrating" elements of the analysis from later stages to prior stages.

42. The first stage of analysis concerns the value protected and the objective of the measure at issue. It is required that a sufficient nexus exists between the objective protected and the measure at issue. When the measure at issue is manifestly not designed to serve the alleged objectives, it may be appropriate for a panel to conduct a similar analysis both with regard to the design of the measure at issue in

26 Appellate Body Report, Brazil – Retreaded Tyres, para. 145.
the light of the value addressed, and with regard to the contribution of the measure to the value protected under the necessity test.

44. The second stage of the analysis consists of a test which seeks to ascertain if the measure at issue is "necessary", within the meaning of Articles XX(a) and (b), or "relates to", within the meaning of Article XX(g). In both cases the tests require a genuine relationship of ends and means between the objective pursued and the measure at issue. Not any contribution would fulfill the respective standards in Article XX, as the type of contribution required is a material contribution. It is at this stage that less trade restrictive reasonably available alternatives capable of making an equivalent contribution are taken into account.

45. Finally, the last stage of the analysis is the chapeau, which acts as a safety net, ensuring that measures which arbitrarily or unjustifiably discriminate between like products from countries in which the same conditions prevail cannot be validly enacted by Members. While it addresses the application of the measure, it may also require an analysis of its design and structure.

46. As a general comment, the European Union highlights the manifest disconnect between the measures at issue and the attempted justifications in the present case. General exceptions have been invoked by Members in some 40 cases so far, ranging from cases when they were quickly dismissed by panels as an attempt to post-rationalise (protectionist) measures to cases when Members proved genuine concerns of the type the general exceptions were designed for (i.e. EC - Asbestos).

47. The European Union recalls that the Appellate Body explained that "the aspects of a measure to be justified under the subparagraphs of Article XX are those that give rise to the finding of inconsistency under the GATT 1994." Brazil failed to establish that the discriminatory features of the INOVAR-AUTO and the PATVD programmes, as challenged by the European Union, can be justified under Article XX of the GATT 1994.

48. The present case is a classic case when a Member attempts to defend clearly protectionist measures by recourse to general exceptions. Thus, the Panel may easily conclude from the first stages of its analysis (i.e. even without the need to

29 Appellate Body Report, EC – Seal Products, para.5.185.
examine the measures under the *chapeau*) that the INOVAR-AUTO programme and the PATVD programme do not meet the conditions in Articles XX(b) and (g) of the GATT 1994, and in Article XX(a) of the GATT 1994, respectively. Indeed, the local content requirements suffer from the same structural problem from the point of view of their justification: why are they necessary to achieve the objectives invoked under the letters of Article XX? In virtually all cases, the European Union considers that providing for freedom as to the source of products as well as with respect to the organisation of manufacturing activities would better allow to achieve the objectives under Article XX than imposing the restrictions embedded under the local content requirements.

2.1.3. The programmes at issue confer a subsidy within the meaning of Article 1.1 of the SCM Agreement

49. Brazil does not dispute that the programmes at issue mainly provide subsidies to the beneficiaries, i.e. the accredited companies of the products incentivised by the discriminatory tax advantages. However, Brazil argues that, with respect to inputs, suspensions and exemptions of non-cumulative valued added taxes along the production chain do not constitute a subsidy within the meaning of Article 1 of the SCM Agreement, since these tax measures are "neutral" in terms of revenue collection and thus are not deemed to be a "financial contribution" by the government, according to the general rule in the Brazilian tax system. Brazil argues that the tax authorities collect the same amount of taxes in the end, "albeit at a different stage of the production and marketing cycle of the product". Brazil further maintains that "economically, there is not an advantage for the company that has had the tax suspended". As already stated before, the European Union disagrees.

50. The Appellate Body has clarified that there must be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised "otherwise". In this respect, the Appellate Body has noted that "it is important to ensure that the examination under

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30 Brazil's first written submission, para. 98.
31 Brazil's first written submission, para. 99.
32 Brazil's first written submission, para. 100.
Article 1.1(a)(1)(ii) involves a comparison of the fiscal treatment of the relevant income for taxpayers in comparable situations. Moreover, the basis of comparison must be the "prevailing domestic standard" established by the tax rules applied by the Member in question, because "[w]hat is 'otherwise due' … depends on the rules of taxation that each Member, by its own choice, establishes for itself". The Appellate Body highlighted that, because Members, in principle, have the sovereign authority to determine their own rules of taxation, the comparison under Article 1.1(a)(1)(ii) must necessarily be between the rules of taxation contained in the challenged measure and other rules of taxation of the Member concerned. As the Appellate Body explained, such a comparison enables panels and the Appellate Body "to reach an objective conclusion, on the basis of the rules of taxation established by a Member". The Appellate Body further recognised that it may be sometimes difficult to identify the appropriate benchmark for comparison under Article 1.1(a)(1)(ii), because domestic rules of taxation are varied and complex. The Appellate Body stated that, "[i]n identifying the appropriate benchmark for comparison, panels must obviously ensure that they identify and examine fiscal situations which it is legitimate to compare", and that this will be the case when there is "a rational basis for comparing the fiscal treatment of the income subject to the contested measure and the fiscal treatment of certain other income". The Appellate Body added that, in general terms, "like will be compared with like", and that it is important to ensure that the examination under Article 1.1(a)(1)(ii) "involves a comparison of the fiscal treatment of the relevant income for taxpayers in comparable situations".

51. In sum, the following steps should be followed: (1) identify the tax treatment that applies to the income of the alleged recipients; Identifying such tax treatment will entail consideration of the objective reasons behind that treatment and, where it involves a change in a Member's tax rules, an assessment of the reasons underlying

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that change; (2) identify a benchmark for comparison—that is, the tax treatment of comparable income of comparably situated taxpayers: identifying a benchmark involves an examination of the structure of the domestic tax regime and its organising principles. In some cases, these principles will be those that are well recognised in the tax regimes of other Members; in other cases, they will be unique to the particular domestic regime. It may be that disparate tax measures, implemented over time, do not easily offer a coherent picture serving as a benchmark. In any event, an understanding of the tax structure and principles should be developed that best explains that Member's tax regime, in order to provide a reasoned basis for identifying what constitutes comparable income of comparably situated taxpayers. Evidence relied upon in such an analysis must be located in the rules of taxation that each Member, by its own choice, establishes for itself. In doing so, a Member will be held to account for the tax structure and principles that it itself employs; and (3) compare the reasons for the challenged tax treatment with the benchmark tax treatment identified after scrutinizing a Member's tax regime: such a comparison show whether, in the light of the treatment of the comparable income of comparably situated taxpayers, the government is foregoing revenue that is otherwise due in relation to the income of the alleged recipients.  

52. The tax treatment that applies to the recipients is the one foreseen by each programme. In some cases, Brazil acknowledges that the programme grants a subsidy to the final producer. In other cases, however, Brazil argues that the reason for not collecting duties e.g. on inputs or capital goods when purchased by accredited companies under the programmes is to avoid the accumulation of tax credits by those companies with low or no taxation regarding their final products. The European Union respectfully disagrees.

53. First, Brazil has failed to show that the suspension/exemption of otherwise revenue collected at the time of the purchases by accredited companies is the "prevailing domestic standard" established by the tax rules in Brazil. Other than a selection of other support programmes which also provide for a similar suspension of taxes and contributions, Brazil has failed to meet its burden of showing that

there is a prevailing rule in the Brazilian tax system whereby companies subject to low or no taxation on their products are also exempted from paying certain taxes or contributions on their inputs in order to avoid the accumulation of tax credits. Brazil is not consistent with the alleged general rule. Indeed, the suspension of IPI for certain goods does not imply the suspension of other similar contributions imposed on the same transactions, such as PIS/PASEP and COFINS. Even within the IPI tax, a quick glance at the TIPI shows that Brazil is not consistent with the sectors/chapters for which there is a rule to, allegedly, avoid the accumulation of tax credits. For example, parts of water gas generators are subject to 5% IPI tax rate. Water gas generators are subject to IPI 0% tax rate. Arguably, producer of water gas generators would also tend to accumulate IPI credits; however, they are not subject to any IPI suspension. 

54. Brazil has also failed to explain how or why a general rule of taxation would require companies to be accredited under the relevant programmes. By definition, the accreditation process aims at reducing the universe of eligible companies, thereby making it narrower than a hypothetical rule, which is always applicable to all tax payers that are found to be in the factual situation contemplated in general terms by that rule.

55. Rather, in the European Union's view, the general principle of taxation in Brazil is that tax credits earned are kept and can be offset with other tax liabilities even when the inputs are used in the manufacturing of goods benefiting from exempted, suspended, or zero rated outbound transactions.

56. Second, it should not be disputed that tax deferrals amount to "government revenue that is otherwise due is foregone or not collected" in the sense of Article 1.1(a)(1)(ii) of the SCM Agreement.

57. Without the suspension or exemption of the tax on the inputs, a company has to pay an amount of tax when purchasing products (e.g. $100) and this generates a tax credit that the company can offset with future liabilities. The company

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38 See also the EU’s response to the Panel's question to the Parties no. 41.
39 See e.g. Article 11 of Law 9,779/1999.
40 See e.g. Panel Report, US – FSC, para. 7.98.
effectively pays first to the seller (who acts as a collector on behalf of the government) and, on that basis, the government recognises a credit to the company. The company bears the financial costs of having to pay an amount of tax upfront, even though it may be offset later in time (i.e. when the company sells its own output, charges tax, and uses the tax credit to decrease the amount of money to be transferred to the government). In other words, the company bears the "cost of money" and thereby forfeits the possibility of freely employing those financial resources (e.g. for investments, such as buying low risk government bonds and thus gaining interests). That costs for the company continues to arise for as long as it has offset the sums anticipated by using the tax credit later in time against new tax liabilities and in proportion to the sums still outstanding (i.e. the amount still to be offset). On the other hand, if, in turn, the purchase of the inputs by the company is not subject to tax, but later on the company must transfer to the government the full amount of tax it charges on the sale of its final products (whose price will include the price of the inputs the company purchased), nominally the government could end up collecting the same amount as if the system of tax credits were to operate; however, in its undisputed that the government would collect the money later. In that case, it is the government that bears the "cost of money" in that it loses the possibility of having available financial resources at an earlier stage. The positive effects for the company in its cash flow and operations is clear: rather than paying upfront and getting a tax credit, the company does not need to advance money and only pays later in time and in accordance with its own sales.

58. In this connection, it should be observed that Brazil admits that the same nominal amount of money has a different value over time.\textsuperscript{41} It explains indeed that when the minimum fixed R&D investment is not met, the accredited company must spend the outstanding value in the Support Programme for the Development of the IT sector, \textit{monetarily updated plus 12\%}.\textsuperscript{42} Thus, Brazil contention that there is no advantage in the suspension of the IPI tax on inputs because the State cashes in the same amount of money at a later stage when the final products are subject to the IPI tax is contradicted by the very Brazilian law, which provides for an

\textsuperscript{41} Brazil's first written submission, para. 120.
\textsuperscript{42} See Article 9 of Law 8,248 of 23 October 1991 (Informatics Law – Exhibit EU/JE-1) and Article 35 of Decree 5,906/2006 (Exhibit EU/JE-7).
automatic revaluation of sums when they are paid later than the moment they are normally due.

59. Moreover, the time-value of money assumes particular relevance in times of high inflation. Currently, Brazil's inflation rate is around 10% a year. That means for example, that a company that pays the same nominal amount of IPI six months after the purchase of the input in reality pays a sum which is worth 5% less (and one year later is 10% less). This simple observation shows that the suspension or exemption of the tax on the inputs is in reality a significant advantage for a company and, accordingly, it represents an important cost for the government.

60. Finally on this point, in addition to the temporal aspect of the revenue foregone or not collected when the suspension is applied, the European Union further considers that Brazil is sacrificing public revenue when suspending those taxes. Normally, the company subject to a transaction with e.g. IPI will take into account as a cost the time lagging between having to pay the IPI tax on the inputs and the moment it charges the IPI tax when selling its products. Assuming that such a company acts as a rational market operator, it will pass that cost into its price (market conditions so permitting). This results in a higher IPI tax base and, thus, higher IPI tax being collected by the Brazilian authorities when compared to a situation when the same IPI tax on the input was suspended. Indeed, in that situation, there is no extra "cost of money" for the company at issue and, therefore, it can charge a lower price, resulting in less revenue being collected.

61. In sum, no matter how the Panel may approach this issue, there is revenue foregone or not collected in the sense of Article 1.1(a)(1)(ii) of the SCM Agreement.

62. With respect to the existence of benefit, Brazil maintains that the tax measures challenged in this case do not provide any advantage or alter the conditions of competition between domestic and imported products because they are used to offset the costs in fulfilling specific policy requirements under those programmes. In this respect, the European Union recalls that the panel in EC and certain Member States – Large Civil Aircraft rejected a similar argument:

43 See e.g. Brazil's first written submission, paras 97 and 102.
The extent to which the cost of public policy obligations should be taken into account when identifying a market interest rate benchmark for the purpose of determining whether a loan granted by a public entity amounts to a subsidy under the SCM Agreement is a matter that merits serious reflection. This is particularly so in the case of public policy obligations connected with the establishment or continuation of economic activity that impacts international trade. In our view, subsidies containing public policy obligations of this kind may be precisely the types of measures that the adverse effects provisions of the SCM Agreement are intended to address. Thus, to take such "public policy costs" into account when establishing the existence of a subsidy would seem to be incompatible with the objectives of Part III of the SCM Agreement.  

63. Like in that case, at the very least Brazil would have to (i) demonstrate that the measures at issue pursue the specific policy objectives, (ii) quantify precisely the alleged "additional costs" an accredited company bears specifically in order to comply with those requirements, and (iii) show that the benefits granted do not go beyond the compensation of those additional costs. Needless to say, Brazil does not even attempt to do so realistically. The European Union has only identified in this respect the tables in paragraph 120 of Brazil's first written submission in DS497.

64. Those tables are used by Brazil to illustrate that the tax incentives under the programmes do not translate into price reductions, because the costs of complying with the programmes requirements are greater than the value of the tax exemption or reduction. Those tables were provided by the MDIC and ABINEE, which are entities that have a clear interest in the outcome of this dispute, and do not specify the methodology employed to come to those calculation. In addition, those tables purport to show that the programmes impose a net cost to the companies, and this goes against Brazil's statements that those programmes provide for incentives and that they amount to subsidies to producers. Moreover, it is manifest that they provide a biased picture. For instance, they do not even mention (let alone try to quantify) the advantages that the accredited companies derive in terms of technological improvements of their products, intellectual property rights and know-how as a result of the R&D investment requirements that are imposed by those programmes.

44 Panel Report, *EC and certain Member States – Large Civil Aircraft*, footnote 2743.
65. In summary, relying on those calculations implies necessarily the proposition that all the companies that ask for accreditation under the challenged programmes are irrational economic operators that ask the Brazilian government to be made subject to costs that are greater than the advantages they may derive from those programmes. The European Union, on the contrary trusts that companies in general pursue their economic interest and if they ask a government to be accredited under a given fiscal scheme it is because they consider that to be economically advantageous. In conclusion, the European Union considers that Brazil has failed to substantiate its argument that the requirements under the programme offset any advantages granted pursuant to those programmes.

66. Indeed, the ICT sector is notoriously very R&D intensive. Every company that is active in this market must invest a sizeable amount of resources in R&D if it wishes to keep up with constant market developments. Thus, R&D expenditure is a normal business costs for any company active in ICT. The effect of the fiscal incentives is not to push the company to carry out R&D (which it will have to do anyway) but rather to carry it out in Brazil and not elsewhere, in order to cash in the fiscal advantage. Hence, that fiscal advantage is essentially a windfall profit for the company. During the first meeting with the parties on 23 February 2016, Brazil confirmed that any company accredited under PADIS is required by the conditions for accreditation to make R&D investment that are important for the company itself. Brazil added however, that companies that want to stay in that market segment (semiconductors and displays) have to make important investments in R&D to keep up with constant technological developments.

67. In fact, Brazil itself shows how complying with e.g. the R&D requirement under the Informatics programme provides an advantage to accredited companies. Indeed, in its first written submission, Brazil explains that thanks to the Informatics programme many companies "have set up their own research institute in Brazil in order to optimize the resources invested in R&D". Those centres

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45 Brazil's first written submission paras 122 – 127.

46 See also Exhibit BRA-24 (“Large international companies realized they could use, in an efficient manner, the resources mobilized by the Informatics Law. They understood that such resources could provide them significant benefits (...) Such companies found out that developments here may leverage issues not only in Brazil but abroad as well (...) Many of the developments we made were inserted in the corporate R&D program of such companies”).

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count among the institutions accredited with the executive branch and which are the beneficiaries of a portion of resources that accredited companies have to invest in R&D in Brazil. In practice, Brazil undermines its own argument that the R&D investment requirement is an additional cost imposed on accredited companies which the tax incentives under the Informatics Programme aim to compensate. ICT producers in Brazil benefit from those R&D investments, not only indirectly through a development of the general technological environment but also directly because they can invest in R&D activities in-house or set up their own research institute in which they can invest their own resources.

Brazils equally fails to demonstrate any proportionality between the alleged disadvantage caused to any accredited company by the R&D investment requirement and the advantages procured by the Informatics programme. Since Brazil argues that the fiscal incentives aim to compensate for that disadvantage it should have proven that there is somehow some proportionality between the two. Brazil merely asserts that the measures "stipulate onerous conditions that nullify any financial gain that might be generated by [them]". Thus, Brazil's argument should be rejected.

In any event, more generally, the European Union considers that taking into account the alleged costs to comply with the policy requirement for determining whether there is a subsidy (in the context of the SCM Agreement) or, more generally, whether the conditions of competition are distorted by the measures at issue (in the GATT context), would not be appropriate. As a general rule no government grants subsidies to any company without any condition being attached to it. "Subsidy" is not synonymous of "gratuitous present" or "gift". Most of the time those conditions have the purpose of ensuring that the subsidy allows the company to pursue its economic interests at the same time as the public interests underlying the granting of public resources. For instance, a subsidy given to a company in order to make an investment in a depressed region allows the company to finance some of its investment costs and at the same time to develop that region. A subsidy for R&D activities allows the company to finance some of its R&D

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47 Brazil's first written submission para. 117.
48 Brazil's first written submission, para. 103.
costs and improve its products, and at the same time to improve the technological base of the industry in general by various means (e.g. human capital, knowledge sharing and other positive spillover effects). If the existence of any condition imposed by the government in order to grant a subsidy would be enough for it not to be considered a subsidy under the SCM Agreement, the scope of that agreement would be reduced almost to nil.

70. Finally, the European Union notes that, if companies do not obtain anything out of participating in those programmes, as Brazil alleges, they would not bother in becoming accredited companies. Naturally, companies comply with certain requirements in order to get "positive" advantages from government resources (as opposed to just "neutral" or negative, as Brazil posits). Why would a company producing e.g. intermediate ICT products undergo the hassles of getting accredited under the Informatics, PADIS and PATVD, bear the costs of the R&D requirements if at the end neither its products nor the producer itself would be better off? Why would the accredited producers of final ICT products receive a subsidy to compensate the alleged costs they have to bear for the R&D requirements, whilst the accredited producers of intermediate ICT products would support those costs for no advantage in return? In any event, Brazil recognises that accredited companies benefit from those programmes in the sense that the lower taxation translates into greater technological and manufacturing capabilities.

71. In sum, the European Union fails to see how the programmes at issue do not confer a benefit in the sense of Article 1.1(b) of the SCM Agreement.

2.1.4. The programmes at issue are prohibited subsidies

72. Brazil also fails to rebut the EU's argument with respect to the INOVAR-AUTO and the ICT-related programmes as subsidies contingent upon the use of domestic over imported products in the sense of Article 3.1(b) of the SCM Agreement. Brazil appears to reject the argument that the term "domestic" in Article 3.1(b) of the SCM Agreement should be juxtaposed with the term "imported", and argues

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49 See e.g. Brazil's response to the Panel's question to the Parties no. 2(i).

50 Brazil's first written submission, para. 197.
that "domestic" in that provision should be understood as "making economic sense".  

73. No matter how the Panel approaches this issue, it is uncontested that in this case imported products (including both inputs and final products) cannot benefit from the advantages granted through the programmes. They cannot be used to satisfy the manufacturing requirements provided by those programmes. For example, an accredited company purchasing Brazilian engines is entitled to claim the IPI presumed tax credits under the category of "strategic inputs", to the extent that such engines are used in the manufacture of and physically incorporated into the motor vehicles which are then sold in Brazil. Similarly, the PPBs require that specific degrees of physical transformation and value added take place in Brazil, and also that certain intermediate inputs, parts and components incorporated into the product the company is accredited for be assembled or produced in Brazil in accordance with their own PPB. For example, the PPB for "Tablet PCs" requires accredited companies to use parts and components (e.g. motherboards, batteries) that are produced locally (in Brazil) under the terms of their respective PPB following certain time schedules, where the minimum annual quotas of those local parts and components increase over time. Accordingly, for manufacturers of Tablet PCs, the IPI tax reduction available under the Informatics programme requires them to use domestic rather than imported motherboards, batteries, and other parts and components.

74. Brazil wrongly argues that a mere requirement to attach the imported wheels to the imported structure using the imported fasteners would not make the resulting bicycle "domestic" for the purpose of Article 3.1(b) of the SCM Agreement as the percentage of value-added in the territory would be virtually zero. Brazil conveniently switches to an example which does not show the need to use

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51 See e.g. Brazil's response to the EU's question no. 6.
52 For the sake of completeness, the European Union recalls that under the INOVAR-AUTO programme, imported motor vehicles may benefit from the presumed credits under certain limited conditions.
53 Article 1 of Portaria 257/2014 (Exhibit EU/JE-158).
54 Article 1 §4 of Portaria 111/2014 (Exhibit EU/JE-33).
55 See e.g. Brazil's closing statement at the first meeting with the Panel, para. 5.
domestic bicycles part over imported parts. The point is thus not whether the resulting bicycle is "domestic" or not. In contrast, what Brazil requires in the programmes at issue is that the frame, wheels and fasteners (i.e. the intermediate products are each made in Brazil in order for the resulting bicycle to benefit from the advantage (by e.g. requiring that the spikes, tyres, etc are put together in Brazil to make a bicycle wheel). Thus, whether the resulting bicycle is "domestic" or not is irrelevant from the point of view of an Article 3.1(b) claim; rather, what matters is whether in order to make such an incentivised bicycle, the programme required the use of domestic over imported parts (e.g. tyres, seats, frames, etc) either directly (e.g. the company must source tyres locally and cannot use imported tyres) or indirectly (e.g. the company must manufacture the wheels, i.e. put together the spikes, the tyres, etc and incorporate it into the incentivised bicycle).

75. Likewise, the evidence put forward by Brazil alleging that a high percentage of components under products produced in accordance with PPBs are imported should be rejected.\(^56\) Brazil appears to consider that e.g. when a PPB requires to assemble a printed circuit board with electrical components (such as transistors) in order to make the motherboard, the fact that the printed circuit board and the electrical components can be imported should be taken into account to measure the amount if imported components included in the final product. Brazil misses the point entirely. The European Union considers that, in such example, the motherboard has to be made in Brazil for the final product to qualify from the tax advantages. In other words, an imported motherboard using the same imported printed circuit and electrical components but made somewhere else, if used in the final product, would disqualify such final product from the programmes. Moreover, to the extent that Brazil considers such motherboard assembled in Brazil as imported, the European Union disagrees. Such motherboard made in accordance with the required production steps in Brazil would allow the producer to benefit from the programmes whereas an identical motherboard made elsewhere and imported in Brazil would not. In the European Union's view, this type of import substitution is covered by the language "use of domestic over imported goods" in Article 3.1(b) of the SCM Agreement.

\(^{56}\) See e.g. Brazil's first written submission, para. 244.
76. Thus, a company using imported inputs instead of domestic ones will not benefit from the relevant tax advantages. Accordingly, the local content requirements make the subsidies conferred by the relevant programmes contingent upon the use of domestic over imported goods.

77. In this respect, the European Union would like to clarify that it is not arguing that all production subsidies are contingent upon the use of domestic over imported goods in the sense of Article 3.1(b) of the SCM Agreement. In other words, the fact that the manufacturer of product is required to make such a product in the facility installed in the country granting the subsidy as a condition to receive a given subsidy from the government would not be covered by this provision. Many governments employ those subsidies as a tool to promote the development of certain industries and regions and, as such, they should be examined under Part III of the SCM Agreement, not as prohibited subsidies.

78. Nevertheless, the present case is different from subsidies promoting certain activities in one country. Brazil grants subsidies contingent upon certain production steps being taken in Brazil. Even if some inputs can be imported, the resulting intermediary products (as well as the final products) necessarily are made in Brazil. And of note, the instrument chosen to provide a benefit to the resulting products is a reduction on indirect taxation, i.e. an advantage that materialises at the time those products are sold in the Brazilian market in competition with like imported products. Thus, the distortion occurs directly at the level of the product and on the choice of sourcing or supply of inputs and intermediary products by the manufacturer when making the final product.

79. To take an example, an accredited company under the INOVAR-AUTO programme must make the engine or the gearbox in Brazil in order to benefit from the IPI presumed credit when selling the motor vehicle incorporating that engine and gearbox. If the producer uses imported engines or gearboxes, the resulting vehicle will not qualify for the tax reduction. Likewise, the presumed IPI credit on strategic inputs and tools is granted when they are sourced locally.

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57 Canada's third party written submission, para. 4.
80. Thus, the European Union is not saying that any subsidy which requires manufacturing or assembling a product (being intermediary or not) in a country is contingent upon the use of domestic over imported products. In contrast, if the resulting final product can only be subsidised if inputs or intermediate products were sourced locally or made by the recipient itself, that is, "domestic" goods, then the subsidy would be contingent upon the use of domestic over imported products.

81. Finally, Brazil does not seriously dispute that the programmes for predominantly exporting companies (i.e. RECAP and the programme of fiscal incentives with respect to raw materials, intermediate goods and packaging materials) are contingent upon export performance in the sense of Article 3.1(a) of the SCM Agreement. Brazil merely attempts to justify the chosen export thresholds in order to benefit from the programmes. Whether the export threshold is set on the basis of the level of credit accumulation by certain companies or because of any other reason, this does not put into question the fact that the subsidies are granted only if certain export conditions are met. This is an explicit condition contained in the relevant programmes. Thus, the two programmes for predominantly exporting companies are contrary to Articles 3.1(a) and 3.2 of the SCM Agreement.

2.1.5. Brazil's argument about the lack of trade effects of the measures is inapposite

82. Brazil puts emphasis on the lack of trade effects of the measures in order to support its argument that the programmes at issue do not achieve import substitution. The European Union fails to see the relevance of Brazil's argument. As noted by the Appellate Body, a panel is not required to focus its examination primarily on numerical or statistical data regarding the effects of the measure in practice. As explained before, the programmes at issue are designed to promote the development of the domestic industry in Brazil. Whether Brazil's programmes have achieved total or partial import substitution is irrelevant. As a matter of fact,
Brazil has not shown any figures indicating what level of imports would have been reached but for the incentivising programmes. In the European Union's views, it is clear that, absent the programmes at issue, Brazil's imports of the incentivised products would have higher (or at the very least, they would have competed on an equal basis with Brazilian like products).

2.1.6. Final remarks

83. As noted in the EU's responses to the Panel's questions to the Parties, the European Union disagrees with Brazil that the changes made by Law 13,137/2015 as well as Portaria 257/2014 are outside the Panel's terms of reference. Furthermore, since Brazil acknowledges that the PIS/PASEP-Importação and the COFINS-Importação amount to indirect taxes, and absent any further reaction by Brazil during the first meeting with the Panel, the European Union considers it unnecessary to further develop its alternative claim under Article II:1(b) of the GATT 1994 in the context of the ICT-related programmes.

84. In the next part of this submission, the European Union will provide specific comments on Brazil's arguments with respect to the various measures challenged by the EU, starting with the INOVAR-AUTO programme, following with the ICT programmes and concluding with some reactions on the export-related programmes.

3. MEASURES IN THE AUTOMOTIVE SECTOR: INOVAR-AUTO PROGRAMME

85. The INOVAR-AUTO programme is one of the flagship programmes through which Brazil decided to incentivise local production, discriminate against imported products and thus operate import substitution. The European Union will first briefly recall the main claims it raises with respect to this programme and then summarize Brazil's assertions. The European Union will then rebut Brazil's assertions and comments on Brazil's responses to the Panel's questions.

3.1. EU'S CLAIMS

86. The European Union explained in detail in its first written submission that the INOVAR-AUTO programme violates Articles III:2, III:4 and III:5 of the GATT

60 See e.g. Brazil's first written submission, paras 323 and 794.
1994. Similarly, the European Union also showed that the INOVAR-AUTO programme is inconsistent with the TRIMs Agreement and the SCM Agreement.

87. First, the INOVAR-AUTO programme is inconsistent with Article III:2 of the GATT 1994, because motor vehicles of the European Union imported into Brazil are subject to an IPI tax burden in excess of that borne by like domestic products.

88. At the same time, the measure at issue contravenes Article III:4 of the GATT 1994, because motor vehicles, automotive components and tools originating in the European Union and imported into Brazil are accorded less favourable treatment than that accorded to like products of Brazilian origin, as a result of the conditions for accreditation to the programme and the rules on the earning and use of the presumed IPI tax credits.

89. Third, certain requirements under the INOVAR-AUTO programme violate the provisions of Article III:5 of the GATT 1994, on the one hand, because conditions relating to the minimum number of manufacturing activities which manufacturers of motor vehicles need to perform in Brazil amount to an internal quantitative regulation relating to the processing of products and such conditions require a specified proportion of the final product from domestic sources; and, on the other hand, because the conditions relating to the minimum number of manufacturing activities in Brazil, coupled with the conditions on the calculation of the tax credits, also amount to an internal quantitative regulation that is applied so as to afford protection to domestic production.

90. Fourth, the European Union also argues that the INOVAR-AUTO programme amounts to a trade-related investment measure that is inconsistent with Article 2.1 of the TRIMs Agreement, in conjunction with Article 2.2 and with paragraph 1(a) of the Agreement’s Illustrative List. Indeed, the requirement related to the purchase or use of inputs and manufacturing equipment, as well as laboratory equipment, of Brazilian origin in order to benefit from the IPI reductions, squarely falls under the list of examples under paragraph 1(a) of the Annex to the TRIMs Agreement of measures that are inconsistent with Article III:4 of the GATT 1994.

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Finally, the European Union claims that several aspects of the INOVAR-AUTO programme amount to subsidies prohibited under Articles 3.1(b) and 3.2 of the SCM Agreement. Indeed, the presumed IPI credit on strategic inputs and tools is granted when they are sourced locally. A traceability system is put in place and the national nature of a product is established on the basis of the proportion of domestic content. Furthermore, in order to benefit from the INOVAR-AUTO programme, accredited domestic vehicle producers must conduct a minimum number of manufacturing and engineering infrastructure activities. Depending on the type of vehicle, for example, companies may need to produce engines and gearboxes in Brazil, or to assemble transmissions, steering and suspensions systems, in order to benefit from the programme. The European Union has also explained how, if an accredited company chooses to comply with the R&D and technology investment requirements through the setting up or refurbishing of testing laboratories, it should rely on national equipment and spare parts.62

In sum, in the European Union's view, the Panel should follow this suggested order of analysis in finding that the INOVAR-AUTO programme, as well as certain specific aspects under that programme, are inconsistent with the national treatment principle as enshrined in various provisions on the covered agreements.

3.2. **Brazil's arguments**

3.2.1. Factual arguments related to vehicle energy efficiency

Brazil devotes considerable space in its first written submission to explaining the history of energy efficiency concerns and measures related to the automotive sector. In particular, Brazil points to the Motor Vehicle Air Pollution Control Program (PROCONVE), created in 1986.63 The European Union understands that Brazil claims that the INOVAR-AUTO programme complements PROCONVE, as PROCONVE does not cover CO2 emissions, but other types of pollutants.64

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62 EU's first written submission, paras 462 and 463.
63 Brazil's first written submission, paras 505-512.
64 Brazil's first written submission, para. 511.
94. Then Brazil continues with describing how vehicle energy efficiency is part of the INOVAR-AUTO programme. Brazil further refers to these factual assertions in the context of its Article XX defences.

95. The European Union does not take issue with such aspects in general (*bien au contraire*) and does not contest the fact that a country may have as a legitimate objective the achievement of vehicle energy efficiency, translated into less pollution and less environmental damage. However, there are at least three highly problematic issues with Brazil's attempted reasoning, which will be explained by the European Union in the next section.

3.2.2. Brazil's alleged non-violation of its national treatment obligations

96. Brazil attempts to explain that it does not draw origin-based distinctions between like domestic and imported products. In essence Brazil presents three main types of arguments with respect to the alleged non-violation of its national treatment obligations. The European Union has already explained that these contentions are not particular to the INOVAR-AUTO programme, but are rather common defence strategies used across most of the programmes.

97. First, Brazil maintains that the requirements to perform certain manufacturing steps in Brazil, to invest in R&D and in engineering in Brazil in order to benefit from the tax advantages under the INOVAR-AUTO programme are not local content requirements relating to products and, thus, fall outside of the scope of Article III. In essence, Brazil treats separately the "production and technology requirements", the investment requirements and the production steps requirements (including the manufacture of engine, gearbox and transmission), claiming that they are "pre-market requirements" and production stages which do not affect the products at issue.

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65 Brazil's first written submission, paras 516–527.
66 Brazil's first written submission, para. 547.
98. Second, Brazil argues that the INOVAR-AUTO programme amounts to a subsidy paid exclusively to domestic producers, thus falling under the carve-out of Article III:8(b) of the GATT 1994.  

99. Finally, Brazil considers that some specific conditions of the legal tests in the relevant provisions at issue are not met. However, this third type of arguments is also closely connected to the previous ones. For instance, Brazil contends that the European Union has not discharged its burden to prove that the products at issue are like products, relying again on the distinction between requirements concerning production and requirements concerning products.

3.2.3. Brazil's attempted defences under Articles XX(b) and (g) of the GATT 1994

100. Brazil alleges that if a prima facie case of violation of the various provisions in Article III is made, the measure at issue is nevertheless justified under Articles XX(b) and (g) of the GATT 1994.

101. In that regard, Brazil alleges that the INOVAR-AUTO programme is part of a comprehensive set of policies to improve vehicle safety and reduce CO2 emissions, thus falling within the range of policies designed to protect human, animal, plant life or health or the environment. Brazil considers that the measure at issue is necessary for the protection of the stated values and that it meets the chapeau test in Article XX.

102. Brazil also maintains that the INOVAR-AUTO programme relates to the conservation of petroleum and its derivatives, including gasoline, thus falling within the range of measures related to the conservation of exhaustible natural resources, and that the measure fulfils all the conditions in Article XX(g).

3.2.4. TRIMs claims

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67 Brazil's first written submission, paras 549 – 552.
68 Brazil's first written submission, para. 584.
69 Brazil's first written submission, paras 605-617.
70 Brazil's first written submission, paras 618-648 and 675-693.
71 Brazil's first written submission, pars 649-674.
103. Brazil agrees that the INOVAR-AUTO programme is an investment measure. However, it considers that the programme is not a trade-related investment measure within the meaning of the TRIMs Agreement, because it deals with research, development and production, not trade in goods. To this end, Brazil reiterates its theory with regard to pre-market requirements. Brazil further considers that were the Panel to find that the INOVAR-AUTO programme does \textit{prima facie} violate Brazil's obligations under Article III, it may be justified under Articles XX(b) and (g) and as a consequence there would be no violation of the TRIMs Agreement.  

\textbf{3.2.5. SCM claims}

104. Brazil does not dispute that the INOVAR-AUTO programme qualifies as a production subsidy, but it alleges that it is accorded in conformity with the requirements of the SCM Agreement, because the INOVAR-AUTO programme is not a subsidy contingent upon the use of domestic over imported goods.  

\textbf{3.2.6. Brazil's invocation of the Enabling Clause}

105. Brazil does not dispute that the measure at issue violates the provisions of Article I:1 of the GATT 1994 and rather concedes this point, by relying directly on paragraph 2(b) of the Enabling Clause. Brazil also notes that LAIA was notified under paragraph 2(c) of the Enabling Clause.  

\textbf{3.3. EU’s Rebuttal}

106. The European Union starts by exposing several inconsistencies with respect to Brazil's allegations regarding its vehicle energy efficiency policy. Then the European Union recalls the main features of the INOVAR-AUTO programme which applies on the basis of origin distinctions between like imported and domestic products, continuing with a brief rebuttal of Brazil's contentions that the INOVAR-AUTO programme does not establish local content requirements and that it amounts to a subsidy exclusively paid to domestic producers within the

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\textsuperscript{72} Brazil's first written submission, paras 743-745.  
\textsuperscript{73} Brazil's first written submission, paras 746-756.  
\textsuperscript{74} Brazil's first written submission, paras 708-742.
meaning of Article III:8(b) of the GATT 1994 and recalling the inconsistencies with different provisions in Article III. Then the European Union will explain that Brazil's invocation of the exceptions in Articles XX(b) and (g) of the GATT 1994 does not fulfill the specific conditions of those exceptions, as they are not genuinely designed and applied for the protection of the alleged values. Finally, the European Union will recall the reasons for which Brazil manifestly cannot rely on the provisions of the Enabling Clause in order to justify the MFN violations.

3.3.1. Factual arguments related to vehicle energy efficiency

107. As already anticipated in the previous section (summarising Brazil's arguments), there are at least three highly problematic issues with Brazil's attempted reasoning.

108. First, Brazil links energy efficiency exclusively to domestic products and local content requirements, while discriminating like imported products. The products at issue from the European Union are capable of achieving similar vehicle energy efficiency. Brazil itself states that "[i]f all qualified companies in the INOVAR-AUTO programme achieve the goal of 1.68 MJ/km (equivalent to the IPI bonus of 2 percentage points) by 2017, the energy efficiency of the vehicles marketed in Brazil will be close to the energy efficiency of the European vehicles."\(^{75}\)

109. Attempting to justify the discriminatory aspects of the INOVAR-AUTO programme (differential tax burden and local content requirements) under the guise of environmental protection (and road safety) lacks any scientific substantiation.

110. Brazil is not prevented from but encouraged by WTO rules to work towards the "increase[ing] of the Brazilian vehicle fleet efficiency and allow[ing] the national automotive industry to meet the current production standards of the international automotive industry",\(^{76}\) however, this should be achieved only in a way consistent with the fundamental principles of non-discrimination. The European Union will analyse in more detail these aspects in the section on Brazil's failed justifications under Article XX of the GATT 1994.

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\(^{75}\) Brazil's first written submission, para. 524.

\(^{76}\) Brazil's first written submission, para. 607, citing the Explanatory Memorandum of the Provisional Measure 563/2012, para. 45 (Exhibit BRA-51).
111. Second, energy efficiency and road safety concerns seem relevant to Brazil in the context of the INOVAR-AUTO programme but only insofar as they boost the competitiveness of the domestic auto industry and not as aims in themselves. The aim of the programme is definitely the protection and development of the domestic industry,\(^{77}\) as it results very clearly from the explanatory memorandum which Brazil itself quotes in its first written submission.\(^{78}\)

112. Interestingly, after the European Union demonstrated how the explanatory memorandum to the INOVAR-AUTO programme in fact contradicted Brazil’s assertions, Brazil tried to dismiss the importance of the explanatory memoranda in general (after Brazil itself quoted such memoranda in support of its assertions in its first written submission).\(^{79}\)

113. Third, as already stated several times in its submissions, the European Union does not understand (and Brazil has failed to offer any explanation so far), why 30 out of the 52 product codes covered by the INOVAR-AUTO programme are exempted from the energy efficiency requirements.\(^{80}\)

3.3.2. The INOVAR-AUTO programme is inconsistent with Brazil’s national treatment obligations

3.3.2.1. The INOVAR-AUTO programme draws origin-based distinctions between like imported and domestic products

114. The European Union explained in its first written submission the origin-based distinctions incorporated in the INOVAR-AUTO programme, which satisfy the like products element of the tests under Articles III:2 and III:4 of the GATT 1994.\(^{81}\) In such a situation, a panel does not need to conduct any further inquiry into the likeness of foreign and domestic products that are subjected to a different

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\(^{77}\) EU’s opening oral statement, paras 71-72.

\(^{78}\) Brazil’s first written submission, para. 607; see also the section on Article XX.

\(^{79}\) Brazil’s response to the Panel’s question to the Parties no. 12.

\(^{80}\) EU’s first written submission, para. 216.

\(^{81}\) Panel Report, Indonesia – Autos, para. 14.112 (“The distinction between the products, which results in different levels of taxation, is not based on the products per se, but rather on such factors as the nationality of the producer or the origin of the parts and components contained in the product. As such, an imported product identical in all aspects to a domestic product, except for its origin or the origin of its parts and components or other factors not related to the product itself, would be subject to a different level of taxation”).
treatment. The same reasoning with respect to likeliness applies *mutatis mutandis* in the context of Article I:1 of the GATT 1994.\(^{82}\)

115. The INOVAR-AUTO programme draws origin-based distinctions (both explicitly, and by its design and structure) between domestic and imported motor vehicles with respect to all three steps necessary for benefiting from the IPI tax reduction through the use of IPI tax credits:

- the conditions for accreditation to participate in the INOVAR-AUTO programme;
- the manner in which IPI tax credits are calculated; and
- the conditions for using such credits.\(^{83}\)

116. Brazil attempts to rebut the European Union's arguments only with regard to certain points. Since Brazil does not present arguments with regard to the conditions for using the IPI tax credits, it follows that it concedes this point.

   \[a. \text{The accreditation conditions draw distinctions between like imported and domestic motor vehicles}\]

117. INOVAR-AUTO's accreditation conditions draw origin-based distinctions between foreign and domestic manufacturers, including newcomers. Because the accreditation conditions require manufacturing activities in Brazil, as well as certain domestic spending in R&D and/or engineering, foreign manufacturers are put in a less favorable situation than domestic manufacturers and newcomers.

118. To recall, Article 2 of Decree 7,819/2012 establishes three categories of companies that can become accredited under the INOVAR-AUTO programme: (i) domestic manufacturers; (ii) domestic distributors; and (iii) newcomers.\(^{84}\) Each of the particular modes of accreditation draws an origin-based distinction.

119. With respect to domestic manufacturers, such companies by definition satisfy the requirement to "manufacture, in Brazil" under Article 2(i) of Decree 7,819/2012. By contrast, no analogous provision exists for manufacturers of foreign motor vehicles. In addition, manufacturers of domestic motor vehicles by definition carry

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\(^{83}\) EU’s first written submission, paras 329-333.

\(^{84}\) EU’s first written submission, paras 221- 232.
out at least some production steps in Brazil, which, in order to lead to accreditation, should satisfy a *minimum* number of production steps requirement under Article 7(i). By contrast, carrying out manufacturing steps abroad never contributes to satisfying such a requirement.

120. With respect to domestic distributors, while Article 2(ii) offers an avenue for foreign manufacturers to participate in the programme, it does not provide a mode of accreditation equivalent to the treatment accorded to Brazilian domestic manufacturers. Qualifying as a domestic distributor is still burdensome for foreign manufacturers.

121. In contrast to the domestic manufacturers' accreditation mode, when two out of three conditions should be satisfied,\(^ {85} \) under the domestic marketing mode of accreditation, the manufacturer of an imported motor vehicle needs to meet all three conditions, regardless of the number of production steps performed (which occur outside Brazil). Not only all three conditions should be met, but it is logical that a foreign manufacturer will not normally spend on R&D and engineering in Brazil, while its production takes place elsewhere.\(^ {86} \) Thus, the presence of Article 2(ii) does not mitigate the discrimination against imported motor vehicles under Article 2(i).

122. With regard to newcomers, Article 2(iii) further discriminates against imported motor vehicles by its very terms. Under this provision, a company's commitment to establish facilities for the manufacture of motor vehicles in Brazil can result in accreditation, whereas there is no corresponding accreditation for new manufacturers of motor vehicles in a different country.

123. Thus, the three modes of accreditation, either individually or collectively, draw explicit origin-based distinctions between domestic and imported motor vehicles.

\textit{b. The manner in which IPI tax credits are calculated draws distinctions between like imported and domestic motor vehicles}

\(^{85}\) Article 7(ii)-(iv) of Decree 7,819/2012.

\(^{86}\) Article 6 of Decree 7,819/2012 (Exhibit EU/JE-132), as amended by Decree 8,015/2013 (Exhibit EU/JE-133).
124. Brazil presents a summary rebuttal of the European Union's arguments with regard to the origin-based distinctions drawn by the method of calculating the IPI tax credits. Brazil maintains that the method of calculation is not related to the origin of the goods, but rather "to the level of contribution of each specific expenditure undertaken by the accredited companies to the broad objectives" of the INOVAR-AUTO programme. In particular, Brazil refers to the greater contribution of expenditures on strategic inputs and tools to the objectives of the programme. However, Brazil fails to discuss the European Union's arguments with regard to the deductible portion and the traceability system in its first written submission. Its responses to Panel's questions 11 and 13 basically confirm the European Union's explanations, as further elaborated below in the section on Brazil's responses to the Panel's questions.

125. The INOVAR-AUTO programme draws discriminatory distinctions between imported and domestic like products through the manner in which IPI tax credits are calculated and accrued.

126. In particular, the INOVAR-AUTO programme sets conditions for earning IPI tax credits that distinguish between foreign and domestic motor vehicles, both in terms of the ability to earn credits and with regard to the overall amount of IPI credits to be earned. These distinctions clearly put imported goods at a competitive disadvantage.

127. As already explained in the first written submission, there are two basic categories of expenditures that can result in the accrual of IPI tax credits:

- expenditures on strategic inputs and tools; and

- expenditures on R&D, as well as expenditures on engineering and basic industrial technology.

128. The first category is by far the most important and it translates into up to 30 percentage points of IPI tax credits, effectively offsetting the elevated tax rates that would otherwise apply under Annex VIII of Decree 7,819/2012 as a consequence

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87 Brazil's first written submission, para. 562.
88 Article 12, items (i) and (ii) of Decree 7,819.
89 Article 12, items (iii)-(viii) of Decree 7,819.
of the IPI increase in 2011 and maintained under the INOVAR-AUTO 2012 programme.

129. By contrast, the value of expenditures under the second category is capped at only 4 percentage points of the company's gross revenue, which translates to a credit that can reduce applicable IPI taxes by approximately 2 percentage points (i.e. because such expenditures are discounted by 50% to determine the value of the IPI tax credit basis).90

130. Contrary to what Brazil argues in its first written submission, the European Union does not take issue only with the difference in the tax burden between imported and domestic like products as a result of offsetting credits obtained under the first category, but with any differences in the tax burden under the INOVAR-AUTO programme, comprising differences resulting from the offsetting of tax credits earned in connection with the second category of expenditures.91

131. Both categories of expenditures must occur "in the Country" in order to result in the accrual of IPI tax credits.92 Thus, expenditures on strategic inputs and tools must be made in Brazil, while similar expenditures outside Brazil can never yield IPI tax credits. It is logical that only companies that manufacture domestic motor vehicles in Brazil would make expenditures on strategic inputs and/or tooling in the country, because such expenditures are related to manufacturing operations. In light of the above, it is not practically possible for a manufacturer of foreign motor vehicles (that does not engage in manufacturing activities in Brazil) to earn IPI tax credits through such expenditures.

132. In order to ensure that strategic inputs and tools actually originate "in the Country", Brazil designed a calculation system where the "deductible portion", discussed in detail in the first written submission, ensures that the value of the IPI credit resulting from expenditures on strategic inputs and tools is reduced to the extent that such goods incorporate content manufactured outside Brazil.93

90 See Article 12 §§ 9, 10 of Decree 7,819/2012 (Exhibit EU/JE-132).
91 Brazil's first written submission, para. 559.
92 Article 41 of Law 12,715/2012.
93 EU's first written submission, section 5.1.5.1.
133. This local content requirement is monitored through a traceability system, so as to ensure that only satisfying levels of domestic content incorporated into the products at issue attract tax credits. The manufacturers of imported vehicles are logically less likely to use strategic inputs and tooling of Brazilian origin than the manufacturers of domestic vehicles. Accordingly, only a limited amount of IPI tax credits may accrue with respect to imported motor vehicles in comparison to domestic motor vehicles.

134. With respect to the second category of expenditures, the "in the Country" requirement translates into the fact that the other means of earning IPI credits under the INOVAR-AUTO programme (expenditures on R&D, payments to the FNDCT, expenditures on engineering and basic industrial technology) are also required to be made in Brazil. Obviously, manufacturers of imported motor vehicles are less likely to earn such IPI credits, since imported motor vehicles are produced outside Brazil and the manufacturers have no commercial reasons to make such expenditures in Brazil. Therefore, imported motor vehicles have lesser opportunities than like domestic products to benefit from such IPI tax credits.

135. In light of the above, the combined effect of the "in the Country" requirement and the local content requirement through the "deductible portion" (and traceability system) draw origin-based distinctions among motor vehicles (as well as their parts and components, and equipment). Foreign manufacturers would have no reasons to make expenditures on strategic inputs and tools in Brazil or expenditures on R&D and engineering in Brazil. Thus, they will not be in the same position with regard to earning IPI tax credits as domestic manufacturers. The resulted tax burden on imported vehicles is in excess of the tax burden on like domestic products. By its very design, structure and operation the measure at issue draws an origin-based distinction between imported and domestic like products.

c. The conditions for using IPI tax credits draw distinctions between like imported and domestic motor vehicles

136. Brazil does not address the European Union's arguments with regard to the fact that the conditions for using IPI tax credits draw distinctions between like
imported and domestic motor vehicles. Accordingly, the European Union considers that Brazil concedes this point.

137. As already explained, the INOVAR-AUTO programme draws origin-based distinctions among imported and domestic motor vehicles also through the rules on the use of the IPI credits earned. Decree 7,819/2012 provides explicitly that IPI credits must be used on domestic vehicles first, and only if such credits remain unused, they may be used on imported vehicles. Furthermore, such "residual" credits can be used only with regard to a limited number of imported vehicles (no more than 4,800 vehicles per year). These conditions constitute additional origin-based distinctions, confirming that domestic and imported motor vehicles subject to the INOVAR-AUTO programme are "like" products within the meaning of Articles III:2 and III:4 of the GATT 1994.

138. Thus, INOVAR-AUTO draws origin-based distinctions with respect to the use of the IPI credits.

d. Other instances of special tax treatment

139. The European Union also recalls that Annex IX of Decree 7,819/2012 includes two provisions reducing the IPI rates applicable to certain motor vehicles, provided that they are domestically produced:

Additional Note NC (87-5) to the Table of Incidence of Tax on Industrialised Products (TIPI)

From 1 January 2013 to 31 December 2017:
NC (87-5). Tax rates shall be reduced to 45% for vehicles manufactured nationally with manual transmission, transfer case, chassis independent from the bodywork, minimum clear height from the ground of the front or rear axles of 200 mm, minimum clear height from the ground between the axles of 300 mm, minimum approach angle of 35º, minimum departure angle of 24º, minimum ramp angle of 28º, resurfacing capacity from 500 mm, combined total gross weight from 3 000 kg, maximum weight in running order of up to 2 100 kg, designed for military use or agro-industrial work, classified under codes 8703.32.10 and 8703.33.10.

From 1 January 2018:
NC (87-5). Tax rates shall be reduced to 15% for vehicles manufactured nationally with manual transmission, transfer case,

95 Article 14 § 2(ii) of Decree 7,819/2012.
chassis independent from the bodywork, minimum clear height from the ground of the front or rear axles of 200 mm, minimum clear height from the ground between the axles of 300 mm, minimum approach angle of 35°, minimum departure angle of 24°, minimum ramp angle of 28°, resurfacing capacity from 500 mm, combined total gross weight from 3 000 kg, maximum weight in running order of up to 2 100 kg, designed for military use or agro-industrial work, classified under codes 8703.32.10 and 8703.33.10. (emphasis added)

140. Thus, the INOVAR-AUTO programme draws origin-based distinctions with respect to particular categories of motor-vehicles when manufactured nationally.

3.3.2.2. The INOVAR-AUTO programme contains local content requirements and is not a subsidy to domestic producers under Article III:8(b) of the GATT 1994

141. As explained before, the European Union disagrees that the clear local content requirements embodied in the INOVAR-AUTO programme are only "pre-market requirements" and production stages which do not affect the products at issue. Requirements like a minimum number of manufacturing steps to be performed in Brazil, including engine, gearbox, transmission, steering and suspension system manufacture cannot be characterised as merely production stages, especially as such requirements are coupled with rules on a deductible part and a traceability system which seek to ensure that only products incorporating a certain level of domestic content may benefit of the programme.

142. The European Union explained that the provisions of Article III:8(b) of the GATT 1994 cover only payments to domestic producers stricto sensu, and cannot be broadly construed so as to include government revenue that is otherwise due which is foregone or not collected.96

143. As clarified by previous case-law, Article III:8(b) applies only to the payment of subsidies which involve the "expenditure of revenue by a government", and not to subsidies in the form of exemption or reduction of internal taxes, like in the present case.97 Moreover, Article III:8(b) exempts payments to domestic producers from

96 EU’s opening oral statement, para. 23.
97 Appellate Body Report, Canada – Periodicals, pp. 33-34.
the national treatment obligation only to the extent that those payments do not discriminate between domestic and imported goods.\textsuperscript{98}

144. The system of tax credits instituted by the INOVAR-AUTO programme is a classic example of government revenue that is otherwise due which is foregone or not collected within the meaning of the SCM Agreement.

\begin{quotation}
\textbf{3.3.2.3. The INOVAR-AUTO programme is inconsistent with Articles III:2, III:4 and III:5 of the GATT 1994}
\end{quotation}

145. Brazil failed to rebut the European Union's \textit{prima facie} case with regard to the national treatment violations. As already demonstrated, the INOVAR-AUTO programme is inconsistent with Article III:2 of the GATT 1994. Under this claim the Panel should examine the discriminatory aspects with regard to the imported final products (motor vehicles), which are subject to an IPI tax burden in excess of that borne by like motor vehicles. All different sets of conditions (accreditation, calculation of tax credits and their use) confirm an origin-based distinction between domestic and imported goods.

146. At the same time, the INOVAR-AUTO programme is inconsistent with Article III:4 of the GATT 1994, with respect to motor vehicles, as well as automotive components and tools originating in the European Union and imported into Brazil, which are accorded less favourable treatment than that accorded to like products of Brazilian origin. The less favourable treatment results from the conditions for accreditation to the programme, as well as from the rules on the calculation and use of the presumed IPI tax credits.

147. Finally, certain requirements of the INOVAR-AUTO programme more specifically violate the provisions of Article III:5 of the GATT 1994, because they refer to conditions relating to the minimum number of manufacturing steps, together with the calculation of the tax credits, which manufacturers of motor vehicles need to perform in Brazil, which amount to an internal quantitative regulation relating to the processing of products, as such conditions require a specified proportion of the final product from domestic sources. At the same time, the conditions relating to the minimum number of manufacturing activities in Brazil, coupled with the rules

\begin{footnotesize}
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on the calculation of the tax credits, also amount to an internal quantitative regulation that is applied so as to afford protection to domestic production.

3.3.3. The discriminatory aspects of the INOVAR-AUTO programme are not justified under Articles XX(b) and (g) of the GATT 1994

148. The European Union first notes that in its response to the questions from the complainant Brazil confirmed that in the present case it does not raise an Article XX defence with regard to the SCM Agreement. With respect to the claims raised by the European Union under the TRIMS Agreement, Brazil understands that a measure which violates prima facie Article III:4, but is then justified under the general exceptions in Article XX of the GATT 1994 does not violate Article 2.1 of the TRIMs Agreement. Finally, Brazil confirms that it attempts to shelter the MFN violations only under the Enabling Clause.99

149. Accordingly, Brazil invokes the exceptions in Articles XX(b) and (g) of the GATT 1994 only with respect to the violations of its national treatment obligations.

150. The European Union has already described certain general features of Brazil’s defences under Article XX in the general section above and concluded that in practice the test under Articles XX(b) and XX(g) of the GATT 1994 is similar. The European Union will focus now on certain specific aspects related to each of the defences raised by Brazil.

3.3.3.1 Article XX(b) of the GATT 1994

151. With regard to the Article XX(b) defence invoked by Brazil, the European Union submits that first Brazil has not shown that the discriminatory aspects of the INOVAR-AUTO programme, including the local content requirements, have been adopted or enforced, or are designed, to protect human, animal or plant life or health. Second, the discriminatory aspects of the INOVAR-AUTO programme are clearly not necessary to protect human, animal or plant life or health. Third, there are other alternatives reasonably available to Brazil, capable of making (at least) an equivalent contribution to the objectives allegedly pursued. Finally, the measure at

99 Brazil's response to the EU's question to Brazil no. 2.
issue does not comply with the conditions of the *chapeau* of Article XX of the GATT 1994.

152. First, Brazil has not shown that the discriminatory aspects of the INOVAR-AUTO programme have been adopted or enforced, or are designed, to protect human, animal or plant life or health. There is a manifest disconnection between the objectives allegedly pursued by Brazil and the discriminatory elements in the programme.

153. In the European Union's opinion, it is not required that, in order to be justified under Article XX(b), a measure must include an express reference to the protection of human, animal or plant life or health. However, it is relevant if such a reference is made. Nevertheless, a panel should not be bound by such a characterisation and should rather make an objective assessment on the basis of the design, the architecture, and the revealing structure of the measure at issue.

154. The fact that the Decree 7,819/2012 states that it seeks "to support technological development, innovation, safety, environmental protection, energy efficiency and the quality of vehicles and vehicle parts" should not be the end of the Panel's analysis. In this respect, it is worth noting as useful context to understand the objectives sought under the INOVAR-AUTO programme that the Explanatory Memorandum of the Provisional Measure 563/2012, which then was turned into Decree 7,819/2012, refers to the "worrying loss of competitiveness currently experienced by the domestic auto industry", and states that:

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100 Appellate Body Report, *EC – Seal Products*, para.5.185.

101 Article 1 of Decree 7,819/2012 (Exhibit EU/JE-132)
The proposed measure aims to strengthen the national automotive industry and create impulses for an improvement of the technological content of the vehicles produced in the country. The global competition in this industry proves to be each day more conditioned to technological advances, and productive efficiency. (...) In view this context, as well as the intensification of global competition in this industry, action in order to favour technological development, innovation, safety and environmental protection in the automotive industry is urgent. The worrying loss of competitiveness currently experienced by the domestic automotive industry [as well as the valuation of our currency] are factors that justify this urgency.102

155. It follows clearly from this that energy efficiency and vehicle safety were rather seen as elements of boosting competitiveness of the domestic auto industry and not as aims in themselves. The aim of the programme is definitely the protection and development of the domestic industry.

156. When the measure at issue is manifestly not designed to serve the alleged objectives, like in the present case, it may be appropriate for a panel to conduct a similar analysis both with regard to the design of the measure at issue in the light of the value addressed, and with regard to the contribution of the measure to the value protected under the necessity test. Thus, since the discriminatory elements in the INOVAR-AUTO programme do not address the objectives alleged by Brazil, the Panel may well find that they are not designed to achieve those objectives, thereby also failing to meet the necessity test.

157. Second, the discriminatory aspects of the INOVAR-AUTO programme are clearly not necessary to protect human, animal or plant life or health. While the European Union recognises that in abstracto energy efficiency and road safety are the kind of policies which may fall under the purview of Article XX(b) of the GATT 1994, the discriminatory aspects of the INOVAR-AUTO programme are clearly not making the required contribution as there is no "genuine relationship of ends and means" between the objective pursued and the measure at issue.103

158. Furthermore, the European Union would like to draw the Panel's attention to the apparent contradiction between the overall alleged objective of energy efficiency

102 Explanatory Memorandum of the Provisional Measure 563/2012, paras 44 and 46 (Exhibit BRA-51).
103 Appellate Body Report, Brazil – Retreaded Tyres, para. 145.
of the INOVAR-AUTO programme and the fact that the energy efficiency requirement does not apply to accredited companies that only produce or market in Brazil the types of vehicles listed in Annex IV of Decree 7,819/2012. These exemptions concern 30 product codes out of the 52 codes covered by the INOVAR-AUTO programme, including road tractors, motor vehicles for the transport of ten or more passengers and passenger cars.\textsuperscript{104} Accordingly, the contribution made by the INOVAR-AUTO programme to the protection of the alleged objectives is definitely \textit{not a material} contribution.

159. Third, there are other alternatives reasonably available to Brazil, capable of making (at least) an equivalent contribution to the objectives allegedly pursued.\textsuperscript{105} Indeed, such reasonably available alternatives could be:

- that Brazil provides tax exemptions for sales of all the products at issue which comply with Brazil's energy efficiency and road safety standards, regardless of whether they are imported or domestically produced;

- the elimination or the substantial reduction of customs duties on the products at issue which comply with Brazil's energy efficiency and road safety requirements;

160. It is the complaining Member which bears the burden of identifying possible alternatives that the responding Member could have taken.\textsuperscript{106} Once the complainant succeeds in identifying an alternative measure which, in its view, the respondent could have taken and which provides an equivalent contribution to the achievement of the objective pursued, the respondent may seek to show that the proposed measure does not allow it to achieve the level of protection it has chosen or may seek to demonstrate why the proposed alternative is not, in fact, "reasonably available".\textsuperscript{107}

161. Accordingly, the Appellate Body has accepted as a fundamental principle that WTO Members have the right to determine the level of protection that they

\textsuperscript{104} Article 4(ii)(2) and Annex IV of Decree 7,819/2012 (Exhibit EU/JE-132), see EU's first written submission, para. 216.

\textsuperscript{105} EU's responses to the Panel's questions to the Parties, paras 61-76.

\textsuperscript{106} Appellate Body Reports, \textit{US – Gambling}, para. 309; \textit{Brazil – Retreaded Tyres}, para. 156.

\textsuperscript{107} Appellate Body Report, \textit{Brazil – Retreaded Tyres}, para. 156.
consider appropriate in each particular situation, so that an alternative measure must be a measure that would preserve for the responding Member its right to achieve its desired level of protection with respect to the objective pursued.

162. However, according to the Appellate Body:

   An alternative measure may be found not to be 'reasonably available' … where it is merely theoretical in nature, for instance, where the responding Member is not capable of taking it, or where the measure imposes an undue burden on that Member, such as prohibitive costs or substantial technical difficulties.

163. In EC – Asbestos, the Appellate Body considered that, in order for a panel to determine whether a suggested alternative measure is "reasonably available", besides the difficulty of implementation the following elements should be taken into account:

   (i) whether the measure proposed is WTO-consistent or less inconsistent than the measure challenged;

   (ii) the extent to which the alternative measure contributes to the realization of the end pursued; and

   (iii) whether the measure proposed is less trade-restrictive than the measure challenged.

164. Once the European Union has made a prima facie case with regard to the available alternatives, then the burden shifts on Brazil to explain why such measures would not be reasonably available.

165. With regard to the car fuel efficiency and road safety objectives, the first reasonably available alternative identified by the European Union is that Brazil provides tax exemptions for sales of all the products at issue which comply with Brazil's energy efficiency and road safety standards, regardless of whether they are

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108 Appellate Body Report, Korea – Various Measures on Beef, para. 176; Appellate Body Report, Brazil – Retreaded Tyres, para. 210. Similarly, the SPS Agreement, elaborating especially on the provisions of Article XX(b) of the GATT 1994, and the corresponding case law recognize that each WTO Member may establish the level of protection it deems appropriate (Appellate Body Report, EC – Hormones, para. 124).


imported or domestically produced.\textsuperscript{111} Thus, origin-neutral tax exemptions accorded to users and not to producers may make at least an equivalent contribution (actually a more important contribution) to the objective sought, while being less trade restrictive.

166. This alternative measure passes with flying colours the test established by the Appellate Body in EC-Asbestos. First, the proposed measure is WTO-consistent, as it is origin neutral and incentivizes the sales of cars satisfying the fuel efficiency and road safety requirements. This is in stark contrast to the measure challenged, which is WTO-inconsistent because it discriminates solely on the basis of the origin of the products.

167. Second, the extent to which the alternative measure contributes to the realization of the end pursued is even higher than that of the challenged measure. Indeed, incentivizing sales of all fuel efficient and road safety compliant cars provides consumers with enhanced access to a wider range of quality goods. The European Union recalls that 30 product codes incentivised under the INOVAR-AUTO programme are exempted from the fuel efficiency requirements.\textsuperscript{112}

168. Third, the measure proposed is less trade-restrictive than the measure challenged, because it provides the same (preferential) treatment to the like imported automotive products as to the domestic products.

169. The alternative proposed by the European Union does not entail difficulties of implementation. In any event, the burden shifts to Brazil to demonstrate why in fact it is not capable of taking this alternative, or why it imposes an undue burden on Brazil, such as prohibitive costs or substantial technical difficulties.\textsuperscript{113}

170. Furthermore, the European Union considers that another reasonably available alternative could be the elimination or the substantial reduction of customs duties on the products at issue which comply with Brazil's energy efficiency and road safety requirements.

\textsuperscript{111} This is the model embraced for instance by several EU Member States for their car fleet renewal.

\textsuperscript{112} Article 4(ii)(2) and Annex IV of Decree 7,819/2012 (Exhibit EU/JE-132); see EU’s opening oral statement, para. 75, and EU’s first written submission, para. 216.

171. The European Union notes that Brazil maintains for the majority of the products at issue\textsuperscript{114} applied duties of 35\% \textit{ad valorem}.\textsuperscript{115} Eliminating or significantly reducing customs duties on the products at issue which comply with the energy efficiency and road safety standards fulfils all the conditions indicated by the Appellate Body in \textit{EC-Asbestos}.

172. First, the proposed measure is WTO-consistent, as a WTO Member is free to lower its customs duties as much as it desires below the bound level of duties. This is in stark contrast to the measure challenged, which is WTO-inconsistent because it discriminates solely on the basis of the origin of the products. Under the measure at issue imported products are taxed in excess of the like domestic products (up to 30 percentage points), on top of the 35\% customs duties collected.

173. Second, the extent to which the alternative measure contributes to the realization of the end pursued is even higher than that of the challenged measure. Indeed, allowing imports at zero or very low duties of all fuel efficient and road safety compliant cars provides consumers with enhanced access to a wider range of quality goods. The European Union reminds the Panel that the majority of the product codes incentivized under the INOVAR-AUTO programme are exempted from the fuel efficiency requirements.\textsuperscript{116}

174. Third, the proposed alternative is clearly less trade-restrictive than the measure challenged. Instead of discriminatory taxation based on the origin of the goods the proposed alternative allows duty free or low customs duties access to the imported automotive products satisfying Brazil’s energy efficiency and road safety requirements.

175. Similarly to the first alternative proposed by the European Union, this alternative does not entail difficulties of implementation. As already explained, the burden

\textsuperscript{114}EU’s first written submission, para. 204. See Annex I of Decree 7,819/2012 (Exhibit EU/JE-132) and the TIPI Chapter 87 products description (Exhibit EU/JE-194).

\textsuperscript{115}See Resolution no. 98 of 8 December 2011, available at http://www.desenvolvimento.gov.br/portalmdic/arquivos/dwnl_1323716926.pdf. It appears that Brazil has either unbound some of the products at issue or set a bound level of customs duties of 35\% \textit{ad valorem} (see Brazil’s Goods schedules and tariff data, available at: https://www.wto.org/english/thewto_e/countries_e/brazil_e.htm).

\textsuperscript{116}Article 4(ii)(2) and Annex IV of Decree 7,819/2012 (Exhibit EU/JE-132); see EU’s opening oral statement, para. 75, and EU’s first written submission, para. 216.
shifts to Brazil to demonstrate why in fact it is not capable of taking this alternative, or why it imposes an undue burden on Brazil, such as prohibitive costs or substantial technical difficulties.\textsuperscript{117}

176. Finally, the measure at issue does not comply with the conditions of the \textit{chapeau} of Article XX of the GATT 1994. The INOVAR-AUTO programme unjustifiably discriminates between countries where the same conditions prevail and the incentives accorded to domestic producers result in a disguised restriction on international trade. Differently to the case of the PATVD programme, where Brazil attempts to argue that different conditions prevail in the respective countries, in the framework of the INOVAR-AUTO programme Brazil does not raise this point and thus concedes it with regard to its defence.

177. The European Union notes that the Appellate Body stated that "arbitrary discrimination", "unjustifiable discrimination", and "disguised restriction on international trade" impart meaning to one another.\textsuperscript{118} The Appellate Body further considered that "'disguised restriction', whatever else it covers, may properly be read as embracing restrictions amounting to arbitrary or unjustifiable discrimination in international trade taken under the guise of a measure formally within the terms of an exception listed in Article XX".\textsuperscript{119}

178. There is no link between the discriminatory treatment and the alleged energy efficiency and road safety objectives of the INOVAR-AUTO programme. Like products at issue from the European Union meet at least similar levels of energy efficiency\textsuperscript{120} and road safety,\textsuperscript{121} as Brazil itself indirectly admits when it takes as a reference point relevant European standards. The discrimination between domestic and imported products is arbitrary and unjustifiable, and amounts to a disguised restriction on international trade.


\textsuperscript{120} Brazil's first written submission, para. 524.

\textsuperscript{121} Brazil's first written submission, para. 612.
179. It follows from the above that the INOVAR-AUTO programme is not reasonable and rational both in its very design and in its application and, thus, does not fall under Article XX(b) of the GATT 1994.

3.3.3.2 Article XX(g) of the GATT 1994

180. With regard to the Article XX(g) defence invoked by Brazil, the European Union does not dispute the fact that petroleum and its derivatives, including gasoline, are "exhaustible natural resources". However, Brazil has not shown that the discriminatory aspects of the INOVAR-AUTO programme have been adopted or enforced, or are designed, for the conservation of exhaustible natural resources.

181. Second, the discriminatory aspects of the INOVAR-AUTO programme clearly do not "relate to" the conservation of exhaustible natural resources. Brazil has not demonstrated that there is "a close and genuine relationship of ends and means" between the measure at issue and the conservation of exhaustible natural resources. 122

182. Third, the measure at issue is not even-handed, as it is not made effective in conjunction with restrictions on domestic production or consumption. The European Union has already explained that energy efficiency requirements are not applied in practice for 30 product codes out of the 52 codes covered by the INOVAR-AUTO programme.

183. Finally, as already explained, the measure at issue does not comply with the conditions of the chapeau of Article XX of the GATT 1994. The INOVAR-AUTO programme unjustifiably discriminates between countries where the same conditions prevail and the incentives accorded to domestic producers (and others, such as distributors of domestic products) result in a disguised restriction on international trade.

184. It follows from the above that the INOVAR-AUTO programme is not reasonable and rational both in its very design and in its application and thus it does not fulfil the requirements of Article XX(g) of the GATT 1994. Thus, like Brazil's defence under Article XX(b), Brazil's alleged justification under Article XX(g) must fail.

3.3.4. TRIMs claims

185. The European Union notes that Brazil agrees that the INOVAR-AUTO programme is an invested measure. Furthermore, as already explained in the first written submission, the programme is a trade-related invested measure and its specific requirements clearly fall under the list of examples in paragraph 1(a) of the Annex to the TRIMs Agreement.123

186. As already explained, requirements such as those related to the purchase or use of inputs and manufacturing equipment, as well as laboratory equipment, of Brazilian origin, in order to benefit from the IPI reductions cannot be characterised as pre-market requirements.

3.3.5. SCM claims

187. The European Union clearly disagrees with Brazil's assertion according to which the INOVAR-AUTO programme is not a subsidy contingent upon the use of domestic over imported goods.

188. To the contrary, the very essence of the programme is import substitution and credits are conditioned upon, calculated (deductible portion, traceability) and used in such a way as to guarantee the use of domestic over imported goods.124

189. Brazil's alleges that domestic transactions cannot be considered a "use" in the sense of Article 3 of the SCM Agreement. The European Union recalls that tax credits do not simply accrue from expenditures on strategic inputs and tools, as Brazil maintains, but the rules on calculation make sure that only goods produced with a sufficient proportion of domestic content may attract IPI tax credits.

190. Finally, Brazil invokes trade data which demonstrates an increase rather than a decrease of imports of inputs after the establishment of the INOVAR-AUTO programme. The European Union recalls that there is abundant case law clarifying that an inconsistency with certain provisions such as Articles III:2, III:4 and I:1 of

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123 EU's first written submission, paras 435-444.
124 EU's first written submission, paras 462 and 463.
the GATT 1994 is not contingent upon the actual trade effects of a measure.\textsuperscript{125} A similar reasoning applies with regard to an inconsistency with Articles 3.1(b) and 3.2 of the SCM Agreement.

3.3.6. The advantages accorded to Argentina, Mexico and Uruguay violate Brazil's MFN obligations and are not justified under the Enabling Clause

191. As the European Union has already explained, the advantages accorded to Argentina, Mexico and Uruguay violate Brazil's MFN obligations and are not justified under the Enabling Clause.\textsuperscript{126}

192. Brazil incorrectly alleges that the INOVAR-AUTO programme falls outside the scope of Article III of the GATT 1994 and consequently also outside the scope of Article I:1 of the GATT 1994. Brazil does not analyse the requirements in Article I:1. Brazil also fails to explain why a measure not falling under Article III of the GATT 1994 would also escape from the application of Article I.\textsuperscript{127} Thus, Brazil does not rebut the European Union's claim under Article I:1 of the GATT 1994. Instead, Brazil concedes that, by relying directly on the Enabling Clause.

193. In the light of Appellate Body's guidance in \textit{EC - Tariff Preferences}, the Panel should first analyse the EU’s claims under Article I:1 of the GATT 1994 and only then Brazil's attempted defence under the Enabling Clause.\textsuperscript{128} Since Brazil's measures at issue are manifestly not within the purview of the Enabling Clause, there is no legal obligation on the complainant with respect to mentioning the Enabling Clause as part of the burden of proof under Article I:1 of the GATT 1994.\textsuperscript{129}

194. The European Union will recall why the Enabling Clause is not applicable to the measures at issue in the section on Brazil's responses to the Panel's questions. The


\textsuperscript{126} EU’s opening oral statement, paras 84-97, EU’s responses to the Panel's questions to the Parties, paras 43-57.

\textsuperscript{127} Brazil's first written submission, para. 701.


\textsuperscript{129} See also Panel's question to the Parties no. 4.
European Union notes already at this stage that the sole explanation Brazil offers with respect to how the INOVAR-AUTO programme is that the programme comprises non-tariff measures relating to the integration of Latin America. As such, Brazil considers, the measures at issue are covered by the Enabling Clause.\(^{130}\)

3.4. **EU’s comments on Brazil’s responses to the Panel’s questions**

195. With respect to Brazil’s response to the Panel’s question to the Parties no. 4, the European Union has already explained that the advantages accorded to Argentina, Mexico and Uruguay violate Brazil's MFN obligations and are not justified under the Enabling Clause. Since Brazil's measures at issue are manifestly not within the purview of the Enabling Clause, there is no legal obligation on the complainants with respect to identifying any specific provisions of the Enabling Clause alongside Article I:1 of the GATT 1994.\(^{131}\)

196. First, as a general comment, there is no clear link between LAIA, ECAs, the INOVAR-AUTO programme and the relevant provisions of the Enabling Clause relied on by Brazil. Besides the notification of LAIA under paragraph 2(c) of the Enabling Clause, there is no further link between the measures at issue, the ECAs and the Enabling Clause.\(^{132}\) While Brazil maintains that ECAs were notified by LAIA to the WTO,\(^{133}\) it fails to explain the link between the INOVAR-AUTO programme and the ECAs, as well as how the transparency requirements were met by Brazil with respect to the INOVAR-AUTO programme. Indeed, Brazil has never notified the INOVAR-AUTO programme as required by paragraph 4 of the Enabling Clause or by the specific provisions of the transparency mechanisms for RTAs (with respect to paragraph 2(c)) and for PTAs (with respect to paragraph 2(b)). The Treaty of Montevideo does not contain provisions about the preferential tax treatment provided by Decree 7,819/2012.

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130 Brazil’s response to the EU’s question to Brazil no. 3.
131 EU’s opening oral statement, paras 84-97, EU’s responses to the Panel questions to the Parties, paras 43-57.
132 See also Japan’s third party written submission, para. 126.
133 Brazil’s response to the Panel’s question to the Parties no. 34.
197. The European Union further notes that it would be for Brazil to demonstrate that LAIA is a regional arrangement within the meaning of paragraph 2(c) of the Enabling Clause.

198. Second, both the "umbrella treaty" of Montevideo establishing the Latin-American Integration Association (LAIA) and the subsequent Economic Complementation Agreements (ECAs) concluded between Brazil and other LAIA members do not cover internal taxation. The mentioned treaties refer to the elimination of tariffs (customs duties) among the members in certain circumstances. The European Union welcomes any clarifications from Brazil as to how measures concerning domestic taxation like the INOVAR-AUTO programme form an integral part of the ECAs and LAIA architecture.

199. Third, the European Union does not understand how Brazil can link the ECAs and LAIA arrangements to the requirements in paragraph 2(b) of the Enabling Clause. Indeed, it is significant that in analysing the requirements in paragraph 2(b) Brazil never refers to "measures governed by the provisions of instruments multilaterally negotiated under the auspices of the GATT". Instead, Brazil limits itself to analysing the meaning of "non-tariff measures".

200. The European Union submits that the ECAs and LAIA are obviously not "multilateral instruments negotiated under the auspices of the GATT". Both ECAs and LAIA are regional instruments. In addition, the European Union is also not able to identify any multilateral instrument negotiated under the auspices of the GATT which would cover matters of internal taxation of the kind of those at issue in the present case.

201. Fourth, the European Union submits that, at the present stage of evolution of the WTO law, paragraph 2(c) of the Enabling Clause is not available as a justification for non-tariff measures. As already explained by the European Union before the panel in Brazil-Retreaded Tyres, paragraph 2(c) of the Enabling Clause covers only regional arrangements entered into amongst less-developed WTO Members "for the mutual reduction or elimination of tariffs and, in accordance with criteria or conditions which may be prescribed by the [Ministerial Conference], for the

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mutual reduction or elimination of non-tariff measures”. At this point, WTO Members have not established the criteria and conditions applicable to the elimination of non-tariff measures. Accordingly, paragraph 2(c) of the Enabling Clause can be invoked only to justify the reduction or elimination of tariffs, not the reduction or elimination of non-tariff measures.

In the present case, internal taxation measures are clearly not tariff measures and thus cannot be subject to preferential arrangements under paragraph 2(c) of the Enabling Clause before the necessary criteria are established by the WTO Members. Brazil also explains that the measure at issue concerns tax credits, thus non-tariff measures in the broad sense.\footnote{See e.g. Brazil's first written submission, paras 708 – 728.}

Similarly, as already explained, the Panel does not need to explore the meaning of "non-tariff measures" in paragraph 2(b) as long as the qualifying condition regarding multilateral instruments is not met.

In sum, paragraph 2(b) of the Enabling Clause allows developing countries to deviate from the MFN obligation with respect to non-tariff measures, but only in the qualifying context of instruments multilaterally negotiated under the auspices of the GATT. The present case does not qualify under paragraph 2(b) of the Enabling Clause. Moreover, at this stage of development of the WTO law, paragraph 2(c) of the Enabling Clause does not allow developing countries to deviate from the MFN obligation with respect to non-tariff measures.

In light of the above, the European Union submits that Brazil's response to Panel question 4 should be considered in the particular circumstances of this case. Paragraphs 2(b) and 2(c) were manifestly not available to Brazil in the present case and thus the complainants were not required to point out to any specific provisions of the Enabling Clause in conjunction with their MFN claims.

With respect to Brazil's response to the Panel's question to the Parties no. 11, the European Union notes that Brazil confirms that the goal of the traceability system is to properly evaluate the INOVAR-AUTO programme's objectives, namely production "in the country" (Brazil), using a majority of local content.
207. As already explained, Brazil's objectives of producing safe and environmentally friendlier vehicles are not aims in themselves, but rather requirements to be met in order to boost the competitiveness of the Brazilian products on the national and international market.136

208. With respect to Brazil's response to the Panel's question to the Parties no. 12, the European Union finds interesting the fact that Brazil attempts to downplay ("limited relevance") the importance of the explanatory memoranda for understanding the objectives of the different measures at issue, including the INOVAR-AUTO programme, after the European Union demonstrated how the explanatory memorandum of the INOVAR-AUTO programme in fact contradicted Brazil's assertions.137

209. In this respect, the European Union recalls that Brazil itself quoted such memoranda in its first written submission, for instance when referring to the INOVAR-AUTO programme's declared desiderates of "increase[ing] of the Brazilian vehicle fleet efficiency and allow[ing] the national automotive industry to meet the current production standards of the international automotive industry".138

210. The European Union understands that explanatory memoranda are used in Brazil as a legislative technique which "compensates" the fact that certain legal acts, including those containing the measures at issue, do not contain a preamble which may serve a similar purpose. While such documents are not a source of legal rights and obligations in themselves, they are useful tools for interpretative purposes, in a similar way other complementing distinct documents or inbuilt preambles may shed light on the interpretation of certain legal acts in other legal systems.

211. With regard to Brazil's response to the Panel's question to the Parties no. 13, the European Union begins by recalling that it has explained in detail why Portaria 257/2014 is within the scope of the present dispute.139

136 EU’s opening oral statement, para. 31.
137 EU’s opening oral statement, para. 71.
138 Brazil's first written submission, para. 607, citing The Explanatory Memorandum of the INOVAR-AUTO programme, para. 45 (Exhibit BRA-51).
139 EU’s responses to the Panel's questions to the Parties, paras 139-147.
212. Otherwise Brazil's response confirms the European Union's understanding of the deductible part and the traceability system, as Brazil acknowledges that the Fiscal Notes issued by companies that supply strategic inputs and tools are used for monitoring purposes and that similarly the references to the Tax Situation Code, the CFOP and the ICMS Convention allow for a better implementation of the INOVAR-AUTO programme.

213. With respect to Brazil's response to the Panel's question to the Parties no. 14 there is not much to say. Brazil's argument according to which tax credits granted under the INOVAR-AUTO programme serve as compensation for the investments made in Brazil by the accredited companies cannot justify the discriminatory treatment towards like imported products and does not explain why like products from certain third countries enjoy preferential treatment.

214. Brazil also confirms that tax credits accorded pursuant to the INOVAR-AUTO programme amount to subsidies. However, as already explained in detail, these are not subsidies within the meaning of Article III:8(b) of the GATT 1994, as they do not involve a payment to domestic producers. These subsidies are a classic example of government revenue otherwise due which is foregone or not collected, being contingent upon the use of domestic over imported goods.

215. The European Union disagrees with Brazil's response to the Panel's question to the Parties no. 15, according to which there is no relationship between the 2011 measure and the 2012 measure.

216. Brazil attempts to distinguish between what the European Union has called for the easiness of reference the INOVAR-AUTO 2011 and INOVAR-AUTO 2012 programmes. The former is an incipient program described as "a temporary emergency action to forestall the effects of the international economic crisis of 2007-2009", while the latter is "a totally different measure directed to promote fundamental changes in the automotive industry".

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140 EU's opening oral statement, para. 23.
141 Brazil's first written submission, para. 502.
142 Brazil's first written submission, para. 502.
217. While the European Union agrees that the two programmes were enacted through distinct legal instruments, they share a series of common features. First, INOVAR-AUTO 2011 increased the IPI for the products at issue with 30 percentage points, increase which was later on maintained by INOVAR-AUTO 2012. Second, both the INOVAR-AUTO 2011 and the INOVAR-AUTO 2012 programmes provide for a system of tax credits with may offset up to 30 percentage points (IPI), neutralizing the tax increase for the participating companies. Third, both programmes provide for manufacturing activities taking part in Brazil and require a certain proportion of domestic content in the final products. In sum, INOVAR-AUTO 2012 can be seen as a more elaborated, matured form of the 2011 measure, based on the experience accumulated under the first measure.143

218. Another assertion made by Brazil is that the INOVAR-AUTO programme does not impose, as a first step, an increase of 30% of the IPI, as IPI rates are set in the IPI table and determined independently from the programme.144 The European Union disagrees. As explained in its first written submission,145 INOVAR-AUTO 2011 introduced an increase of the IPI rates by 30 percentage points,146 increase which was maintained afterwards and it is currently applicable.

219. Paraphrasing the Appellate Body in a different context, the Brazilian measures at issue in the present proceedings are "evidently not a model of clarity in drafting and communication".147 However, it seems to the European Union that Decree 7,819/2012 contains itself references to the tax treatment of the different products covered.148 The European Union has summarized in the first written submission the tax treatment of the products covered by the INOVAR-AUTO programme on the basis of the 2012 TIPI table.149

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143 For more details see EU's first written submission, paras 189-200.
144 Brazil's responses to the Panel's questions, p. 12.
145 EU's first written submission, paras 189, 204, 205.
146 Article 10 of Decree 7,567/2011 (Exhibit EU/JE-127).
148 Article 25 states that the Additional Notes of TIPI CN (87-2), CN (87-4), CN (87-5) and CN (87-7) shall apply as worded in Annex IX.
149 Exhibit EU/JE-194.
Finally, with regard to the provisions of INOVAR-AUTO 2011, the European Union explained that it still produces certain effects.\textsuperscript{150}

3.5. **CONCLUSIONS**

For the reasons explained in detail above, Brazil's invocation of the general exceptions in defence of its national treatment violations and of the Enabling Clause with respect to the MFN violations must clearly fail. Brazil failed to provide any convincing arguments in order to rebut the European Union's *prima facie* cases with regard to the mentioned violations of several key provisions in the WTO agreements.

4. **MEASURES RELATING TO ICT, AUTOMATION AND RELATED GOODS**

In this section the European Union will recall the legal claims that it has put forward with regard to the four programmes concerning ICT products challenged in the present dispute. The European Union will recall the main defences raised by Brazil, as well as the rebuttals of those defensive arguments already advanced in the EU’s opening oral statement and in the responses to the Panel’s questions. Where appropriate, the European Union will comment on Brazil’s responses to the Panel’s questions.

In reply to the legal claims raised by the European Union against the Informatics programme, Brazil has formulated a number of defensive arguments. With regard to the PADIS, PATVD and Digital Inclusion programmes, beside some precisions on factual aspects, Brazil has essentially made reference to the defensive arguments elaborated with regard to the Informatics programme. On the other hand, Brazil has invoked Article XX(a) of the GATT 1994 to justify the PATVD programme, whereas this defence has not been put forward in connection with the other programmes concerning ICT products.

For the sake of simplicity, the European Union will follow the same structure. It will discuss some factual aspects of the Informatics programme and then focus on each legal claim. The discussion of those claims applies *mutatis mutandis* to the parallel legal claim raised against the PADIS, PATVD and Digital Inclusion programmes.

\textsuperscript{150} EU’s first written submission, paras 193-194 and footnote 176.
programmes. Therefore, when discussing the PADIS, PATVD and Digital Inclusion programmes the European Union will essentially add some precisions on factual aspects of those programmes, without repeating the discussion of the above legal claims. With regard to the PATVD programme, the European Union will explain why the Article XX(a) defence raised by Brazil must fail.

4.1. **INFORMATICS PROGRAMME**

4.1.1. **Factual issues**

225. Before discussing the claims of the European Union and defences of Brazil concerning the Informatics programme, it is appropriate to spend a few words on some factual aspects of this programme and, notably, on the PPBs.

226. As already mentioned in section 4.1 of the EU’s opening oral statement, it would appear that the parties agree with regard to the description of the structure, architecture and functioning of the Informatics programme.\(^\text{151}\) Basically, the Informatics programme provides tax incentives to accredited companies that produce ICT products in Brazil in compliance with a PPB and invest in R&D activities in the ICT sector in Brazil.\(^\text{152}\) Those tax incentives come in the form of an exemption from or a reduction of the IPI rate normally applicable to the products listed in of Annex I of Decree 5,906/2006 (the incentivised products). Those products are identified on the basis of their NCM code and relative description. Raw materials, intermediate goods and packaging materials purchased by accredited companies are also included in the Informatics programme. Article 29 §1(I)(c) of Law 10,637/2002 suspends the IPI tax otherwise due on domestic sales of raw materials, intermediate goods and packaging materials employed in the production of goods incentivised pursuant to the Informatics programme, when the accredited company's gross revenue derived from the sale of those incentivised

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\(^{151}\) The same can be concluded also with respect to the overall explanation of the structure and functioning of the PADIS, PATVD and Digital Inclusion programme. Indeed, as confirmed by Brazil’s response to the Panel’s question to the Parties no. 17, the overall factual explanations of the complainant concerning those programmes are correct and Brazil basically contests the legal consequences that the complainants draw from those facts.

\(^{152}\) Brazil's first written submission, para. 108.

\(^{153}\) Exhibit EU/JE-7.
products exceeds 60% of its total gross revenue in the year prior to the year of purchase of the materials.  

227. The Parties also seem to agree about the fundamental role of PPBs, that is to ensure that a product is effectively produced in Brazil as well as with regard to the minimum content of the PPBs. In its first written submission, by paraphrasing Article 16 of Decree 5,096/2006, Brazil explains that to benefit from the Informatics programme a company "must commit to perform a minimum set of operations in Brazil, called PPBs, established by the Government in order to characterize the effective 'production' of a certain product." In other words, the PPBs indicate the minimum processing steps that an accredited company must carry out in Brazil if it wants its product to benefit from, inter alia, an IPI reduction or exemption pursuant to the Informatics programme. Carrying out those steps in Brazil characterise the effective "production" of the product.

228. Brazil, on the other hand, strongly disagrees with the EU's assertion according to which "in general, PPBs also require that the input, parts and components incorporated in the product are produced locally (sometimes also in compliance with the respective PPB) and that the local component reach a certain quota or minimum nationalisation index".  

229. The European Union demonstrated again in section 4.1 of its opening oral statement that this position is incorrect. Indeed, Brazil itself maintains that all

154 Article 29 §2 of Law 10,637/2002 ("The provisions in the header paragraph and indent I of § 1 apply to all industrial establishments of which the gross revenue derived from the abovementioned products in the calendar year immediately prior to the year of purchase exceeded 60% of their total gross revenue over the same period") (Exhibit EU/JE-94).

155 Exhibit EU/JE-7.

156 Brazil's first written submission, para. 128.

157 EU’s first written submission, paras 512-522.

158 EU’s first written submission, para. 522. In para. 523 of its first written submission the European Union explained that the local content requirements in the PPB are expressed in terms of value added through processing operation to be carried out in Brazil or in terms of local sourcing (input that must be produced by the accredited company in Brazil or products produced in Brazil that must be incorporated in the product the company is accredited for). The same concepts in different words are repeated in paras 533-538 of the EU's first written submission.

159 Brazil's first written submission, para. 135.
PPBs stem from the first PPB, *Portaria* 101 of 7 April of 1993,\(^\text{160}\) and that currently there are around 100 PPBs of which three are the general ones (*Portaria* 43/2013 for IT products, *Portaria* 278/2013 for industrial automation products, and *Portaria* 273/1993 for telecommunication products).\(^\text{161}\)

230. The European Union recalled in section 4.1 of its opening oral statement that the terms of those four PBBs require the use of domestic products. Indeed, by requiring assembly and soldering of all components in the printed circuit boards and assembly of the electrical and mechanical parts, which are totally separated, at a basic component level, the PPB requires in practice circuit boards and the other electrical and mechanical parts to be made or sourced in Brazil. In other words, companies that would like to import into Brazil such pre-assembled circuit boards and pre-assembled electrical and mechanical parts in order to produce an ICT product in Brazil would never comply with the PPB.

231. Similar requirements concerning processing steps that impose the accredited company or a subcontractor to produce intermediate products in Brazil are found in many other PPBs. The European Union has provided some examples in its response to the Panel's question to the Parties No 44.

232. By the same token the European Union has demonstrated that those three general PPBs mentioned by Brazil also define specific percentage thresholds of domestic intermediate products that must be used by the accredited company in the manufacturing of the product at issue. That percentage is generally calculated out of the total intermediate products produced or used in the calendar year by the accredited company.\(^\text{162}\)

233. In sum, an examination of the first model PPB or of the current three general PPBs mentioned by Brazil confirms the description given by the European Union in its first written submission. PPBs contain local content requirements expressed in terms of value added through processing operation or production steps to be

\(^{160}\) Exhibit BRA-27.


\(^{162}\) EU's opening oral statement, paras 113 ff.
carried out in Brazil and often also in terms of local sourcing (i.e. inputs that must be produced by the accredited company in Brazil or sourced locally).

234. In addition, Brazil claims that the European Union is wrong in arguing that all PPBs contain both value added and sourcing requirements. To prove its point Brazil refers to Exhibits EU/JE-27, EU/JE-31, EU/JE-34, EU/JE-35, EU/JE-38, EU/JE-40, EU/JE-42 and EU/JE-44.163

235. However, the European Union has simply argued that in general PPBs also require that specific shares of input, parts and components incorporated in the product are produced locally, not that all of them contain necessarily both value added requirements and local sourcing requirements. In other words, the point made by the European Union is that to the extent that PPBs require that the input, parts and components incorporated in the product are produced locally, they impose the use of domestic products instead of imported ones.

236. Concerning the examples made by Brazil the European Union notes the following:

- Article 1, §4 and §5 of Portaria 43 of 14 February 2013 (Exhibit EU/JE-27) concerning informatics products produced in Brazil, requires that certain percentage of components (like power source, direct current converters (AC-DC) or battery chargers) for video monitors must be produced in Brazil. A similar rule is provided for by Article 2, §2 with regard to Wi-Fi, Bluetooth or WiMax wireless communication interfaces, intended for informatics products, or Article 3 as regards the assembled printed circuit boards with electrical or electronic components referred to as High-Speed WAN Interface Cards (HWIC) used exclusively in Digital routers, and Article 5 with regard to power sources used in digital routers for wireless networks, switches, IP terminals, for the transmission and reception of voice/data (IP telephones), analogical telephone adapters for IP networks (ATA) and modulators/demodulators (ADSL). Thus, Portaria 43 contains explicit local content requirements expressed as share of a given intermediate product out of the total used by the accredited company in the calendar year that must be produced in Brazil.

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163 Brazil's first written submission, para. 144.
The same holds true for *Portaria* 278 of 4 September 2013 (Exhibit EU/JE-38) for industrial automation goods produced in Brazil, which contains limited exemptions from the requirement to carry out in Brazil some production steps leading to the production of critical components but linked to investing in R&D a greater amount of resources. Articles 3 and 4 of the *Portaria* contain such an option for frequency converters/drives. Article 5 then adds that the number of products that are exempted from those production steps shall be established based on the total amount of frequency converters/drives produced in accordance with the Basic Production Process and sold with IPI tax incentive, as set out in Article 4 of Law No 8,248 of 1991, in the calendar year.

Also *Portaria* 385 of 30 December 2013 (Exhibit EU/JE-42) concerning air traffic surveillance radar produced in Brazil contains similar exemptions from the requirement of production in Brazil for a limited share of intermediate products used by the accredited company that must be produced in Brazil (e.g. Article 1, IV and 1,§2).

Obviously, those limited exceptions mean that for the quota that is not exempted, the products/components in question must be produced in Brazil.

Thus, only a handful of *Portarias* (EU/JE-31, EU/JE-34, EU/JE-35, EU/JE-40, EU/JE-44) seem not to contain local content requirements expressed in percentage terms or shares of intermediate products that must be produced/sourced locally. However, a quick glance to those *Portarias* confirms that they contain local content requirements expressed in terms of components or intermediate products that must be manufactured by the accredited company or a third party in Brazil.

Brazil and the European Union also agree on the point that some PPBs (more than 1/3 of the currently applicable) require the accredited company to use, in the production of the product it is accredited for, a minimum percentage of products compliant with other PPBs. The example Brazil itself mentions is the *Portaria* for Tablet PCs with touch screen which, for a large number of components, sets

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164 Brazil's first written submission, para. 145.
165 Exhibit EU/JE-33.
out which share of each component must be made in compliance with its respective PPB. In Brazil's views, this reference to "nested" PPBs simply means that the basic production steps established in the nested PPB with regard to the production of the intermediate products must be carried out in Brazil, but that does not tantamount to impose the use of intermediate domestic products.

240. The European Union has already recalled that the very function of the PPB, in the words of Brazil, is to identify those products that are effectively produced in Brazil. Hence, a product that is made in compliance with a PPB is a product manufactured in Brazil and necessarily a domestic product for the purpose of the EU's claims under the GATT 1994, the TRIMs Agreement and the SCM Agreement.

241. In the closing statement at the first substantive meeting with the parties, Brazil argues that in order for a product to be "domestic" for the purposes of Article 3.1(b) of the SCM Agreement a substantial percentage of value of the product must have been added in the territory of the concerned country. However, Brazil fails to provide any objective criteria that would allow to establish when a product is domestic and when it is not. It merely makes the point that when the value of imported input is more that 90% of the product, than the product should not be domestic for the purposes of Article 3.1(b) of the SCM Agreement. The European Union has already shown that establishing added-value thresholds to consider a product as "domestic" under e.g. Article 3.1(b) of the SCM Agreement does not find textual support in that provision. Indeed, what is "domestic" must be juxtaposed with what is "imported". Taking an added-value criterion to determine the meaning of "domestic" in that provision would raise the issue as to what threshold should be taken in each case with respect to the product at hand. The European Union fails to see on what basis such a threshold could be determined.

242. The European Union will further deal with this argument below, but it is already important to stress that: (i) Brazil does not contest that a product

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166 Brazil's first written submission, para. 145.
167 Brazil's first written submission, para. 146.
168 Brazil's first written submission, para. 128.
169 Brazil's closing oral statement, paras 5-9.
manufactured/produced in Brazil according to a PPB is a domestic product pursuant to Article III:2 and III:4 of the GATT; (ii) among the examples provided by Brazil at pages 51 and 52 of its first written submission and in Exhibits BRA-32 and BRA-34 there are many intermediate products for which the value of the input imported in Brazil is below 90%.  

243. In any case, it is clear that Brazil relies on the costs of production of the inputs used for producing certain products in order to consider them as "imported" whereas (assuming that Brazil’s figures are reliable) only the inputs were imported. However, these products are manufactured in Brazil according to the relevant PPB, even though the import might have been imported. This is, in the EU’s view, a local content requirement. Indeed, as explained before, if the same components are assembled outside Brazil and the product is imported, such an imported product does not qualify for compliance with the PPB. The fact that imported input products might constitute a high proportion of the production cost of the final product (the Tablet PC in Brazil’s example) or of some of its components, does not contradict the assertion that those components and the Tablet PC must be manufactured in Brazil and that the Tablet PC must contain a minimum amount of components produced in Brazil in order to benefit of the tax exemption under the Informatics programme. A tablet PC assembled in Brazil with 100% imported component would never qualify for the tax incentive programmes at issue.

244. Again with respect to PPBs, Brazil argues that in about ¼ of the PPBs in force compliance with certain processing steps can be replaced with additional investments in R&D. Brazil refers to Exhibits EU/JE-34 and EU/JE-38, EU/JE-25, EU/JE-26, EU/JE-32 and EU/JE-43 as examples. It is not clear to the European Union what Brazil wants to demonstrate with that argument, but for the sake of completeness it is appropriate to underline that it is not substantiated, because Brazil has not explained which production steps may be exempted, for which products, and for how long.

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170 The European Union repeats, moreover, that Brazil has not demonstrated that the figures presented in those examples are reliable.

171 Brazil's first written submission, paras 129 and 155, and footnote 105.
245. In any event, such a possibility was only temporal until 31 December 2014 in the PPB submitted under Exhibit EU/JE-34 or is also linked to purchasing domestic inputs.\(^{172}\)

246. Furthermore, there is no such a possibility in the PPB submitted under Exhibit EU/JE-25. In the PPB submitted under Exhibit EU/JE-26, the possibility will be gone as of January 2017, and it is only limited to one production step. In other PPBs when that possibility is offered, again there is language excluding the costs of purchasing products incentivised under the challenged programmes (see the PPB submitted under Exhibit EU/JE-32). The PPB submitted under Exhibit EU/JE-44, also provides for a temporal possibility, which is no longer in force.

247. In summary, to the knowledge of the European Union the possibility of replacing some processing steps with additional R&D investment is limited as it concerns clearly a minority of the PPBs, and specific processing steps, but not all of the steps which make a product complying with PPB (be it intermediate or a final product) one that is effectively produced in Brazil and that is therefore domestic. Actually Brazil does not even argue that additional R&D investment can completely replace the need to produce the product in Brazil as a condition to benefit from the Informatics Programme. It follows that this argument of Brazil is irrelevant.

4.1.2. Legal Claims

4.1.2.1 Pre-market requirements altering the competitive relation between imported and domestic products fall within Article III of the GATT

248. Brazil makes a preliminary argument concerning Article III of the GATT 1994, to the effect that this Article (and thus the different obligations which it contains) would not be applicable to the pre-market requirements of the type imposed by the Informatics programme. In addition to the remarks made in the general comments section in this submission, the European Union considers it appropriate to deal

\(^{172}\) See the PPB submitted under Exhibit EU/JE-38, Article 6 “Additional investment in R&D to that required by legislation referred to in Articles 3 and 4 shall be calculated based on gross turnover in the domestic market resulting from the sale, with use of tax benefit, of frequency converters/inverters which enjoy the exemptions set out in Articles 3 and 4 less the corresponding contributions on such sales, as well as on the value of acquisitions of goods with the same incentive, in the calendar year”. 
with this argument as specifically raised by Brazil in the context of the Informatics programme.

249. Brazil argues that the measures at issue concern obligations regarding "production" and investment in R&D by producers, that is, they do not deal with or affect products and cannot be considered as such, as they are pre-market requirements.\textsuperscript{173} According to Brazil, only measures affecting products in the market place fall under the scope of Article III and measures regarding production, research, development and design are outside the scope of Article III and could only be questioned as actionable subsidies in the SCM Agreement.\textsuperscript{174}

250. In section 4.2 of its opening oral statement the European Union demonstrated that what Brazil has called "pre-market requirements" are in reality requirements that, when complied with, make sure that the accredited company can sell the incentivised products with tax advantages, thereby affecting the competitive position of imported and domestic like products in the Brazilian marketplace.

251. The pre-market requirements pursuant to the Informatics programme (as well as PADIS and PATVD programmes) relate to manufacturing steps, as well as R&D and development steps. All those requirements have a relation with the manufacturing of some "product", which is then to be put on the market and is capable of being traded.\textsuperscript{175} In other words, only because the accredited companies engaged in the production of the incentivised products in Brazil, an advantage is granted. A requirement pursuant to which some production steps of a given product must take place in Brazil, and some R&D investments have to be made in Brazil when producing that product, in order for the product to carry a lower fiscal burden when put on the Brazilian market, are manifestly relating to "products" in the marketplace.

252. There is a clear and undeniable link between those pre-market requirements and the competitive position of the subject products in the market. Compliance with the "pre-market" requirements provided for by the Informatics programme (or the

\textsuperscript{173} Brasil's first written submission, paras 179-185.

\textsuperscript{174} Brazil's first written submission, paras 181-183.

\textsuperscript{175} See Appellate Body Report, \textit{Canada - Renewable Energy}, para. 5.62 ("… 'product' in the sense of [Article III:8(a)] is something that is capable of being traded").
PADIS, the PATVD and the Digital Inclusion programmes) consists precisely in a
decrease of the fiscal burden that is imposed on each individual product produced
by the accredited company when that product is put on the market. Brazil itself
acknowledges that indirect taxes are normally reflected in the price of the product
when it is sold.\textsuperscript{176} Therefore, the benefit arising from complying with the
requirements of the Informatics programme (or any of the other programmes) \textit{does
relate to products} when they are put on the Brazilian markets.

253. It should also be recalled that Article III:1 refers explicitly also to “regulations
requiring the mixture processing or use of products …” and Article III:5 contains
similar language. Moreover, the illustrative list of TRIMs that are inconsistent with
Article III:4 contained in the Annex to the TRIMs Agreement refers explicitly to
measures which require the purchase or use of products of domestic origin or from
any domestic source by a producer. Thus, these provisions clearly make plain that
Article III also cover measures that concerns the production or processing of
products. And indeed the general objective of Article III is to ensure equal
treatment between imported and domestic products and for that purpose WTO
Members should not apply internal measures “so as to afford protection to
domestic production”\textsuperscript{177}

254. In practice, with its argument Brazil would like the Panel to forget a very
conspicuous portion of WTO jurisprudence which relates to measures incentivising producers to use local input instead of imported input in their
production process. Those measures, too, relate to the production process of some
other product and they were found to fall within the purview of Article III of the
GATT 1994. The European Union has also referred to this case law for instance in
its first written submission\textsuperscript{178} and Brazil does not even bother to engage in trying
to distinguish the present case from those referred to by the European Union.

255. In its response to the Panel's question to the Parties No 2(i),\textsuperscript{179} Brazil concedes that
Article III:5 “pertains to regulations affecting the production of goods” but it

\textsuperscript{176} Brazil's first written submission, para. 48.

\textsuperscript{177} See GATT 1994, Article III:1, final sentence (emphasis added).

\textsuperscript{178} EU’s first written submission, paras 133, 134, 135.

\textsuperscript{179} Brazil's responses to the Panel’s questions to the Parties, p. 4.
applies only to goods that must be used, processed or mixed in the production of another good. With this admission Brazil contradicts its assumption that Article III as a whole does not cover pre-market requirements.

256. Finally, Brazil's approach is also based on a wrong characterisation of what are the measures challenged by the European Union under Article III of GATT 1994 (or the SCM agreement). The European Union is not challenging any of the pre-market requirements per se (i.e. in abstract terms). The European Union is challenging a number of complex fiscal incentive programmes, which operate through a reduction of indirect taxes applicable on some products, when the producer of those products complies with a number of requirements, including those characterized as "pre-market" requirements by Brazil.

257. Indeed, in paragraph 589 of its first written submission, the European Union has referred to the Informatics programme as being the measure inconsistent with the GATT 1994, the TRIMs Agreement and the SCM Agreement. In paragraph 590 of its first written submission, in the context of the analysis in the light of Article III:2 of the GATT 1994 of the Informatics programme, the European Union has clarified that by means of this programme as a whole Brazil imposes internal taxes on imported ICT products in excess of those imposed on like domestic products. By the same token, in the context of the analysis under Article III:4 of the GATT 1994, the European Union has argued that two specific aspects of the Informatics programme are inconsistent with Article III:4 of the GATT 1994.180 Again, the European Union has argued in paragraph 662 of its first written submission that the Informatics programme is inconsistent with Article III:5 of the GATT 1994, in paragraph 690 it has argued that the Informatics programme is inconsistent with Article 2.1 of the TRIMS Agreement, in conjunction with Article 2.2 and with paragraph 1(a) of the Agreement's Illustrative List, and in paragraph 709 it has argued that the Informatics programme is inconsistent with Articles 3.1(b) and 3.2 of the SCM Agreement. The same claims have been developed by the European Union against the PADIS, the PATVD and the Digital Inclusion programmes in the relevant sections of the EU's first written submission.
258. Brazil instead would like the Panel to examine one element of those programmes (such as the "pre-market requirements") in clinical isolation from another element (like the tax exemptions or reductions).

259. In this respect, it is interesting to recall that the Appellate Body in *Thailand – Cigarettes*\(^{181}\) confirmed the panel's finding that the imposition of certain legal requirements on resellers of imported cigarettes to be complied with in order to recover VAT, when the same requirements would not apply when selling domestic cigarettes which were exempted from VAT, was a measure that discriminated against imported cigarettes falling within the purview of Articles III:2 and III:4.\(^{182}\)

260. Even though in the present case the requirements at issue apply to producers of domestic products and not to on the resellers of imported cigarettes, that case is particularly relevant in the present disputes for several reasons.

261. First, like the present case, it concerned an indirect value added tax. The Appellate Body underlined that the legal requirements applicable to the sellers of imported cigarettes had an impact on the amount of tax applicable on the sale of those cigarettes, while the sale of domestic cigarettes was exempted.\(^{183}\) The Appellate Body thus rejected the argument of Thailand according to which those requirements had to be analysed in isolation from their fiscal implications\(^{184}\) and also confirmed that a difference in the rate of indirect taxes applicable to the product fell afoul of Article III:2 of the GATT 1994.

262. Also in the present case, the European Union argues that the Panel cannot analyse the legal requirement imposed by a certain fiscal incentive scheme in isolation

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181 EU’s first written submission, para. 102.
183 Appellate Body Report, *Thailand – Cigarettes (Philippines)*, para. 114 (“…we also do not accept Thailand’s position that the measure at issue does not relate to the respective tax burdens imposed on imported and domestic cigarettes. Thailand’s measure subjects resellers of imported cigarettes to VAT when they do not satisfy prescribed conditions for obtaining input tax credits necessary to achieve zero VAT liability. Whether such conditions are satisfied thus *has a direct consequence for the amount of tax liability imposed* on imported cigarettes. Conversely, a complete exemption from VAT ensures that there can never be any VAT liability for resellers in respect of their sales of domestic cigarettes. We therefore agree with the Panel that Thailand’s measure affects the respective tax liability imposed on imported and like domestic cigarettes, and accordingly reject Thailand’s claim that the measure consists solely of administrative requirements that are not subject to the disciplines of Article III:2, first sentence, of the GATT 1994”) (emphasis added).
from the implications that those requirements have on the fiscal treatment of imported and domestic products.

263. The Appellate Body also underlined that the fact that seller of imported cigarettes could claim back the VAT paid on their purchase at a later stage through a tax credit mechanism did not save the measure from Article III:2 of the GATT 1994.\footnote{Appellate Body Report, \textit{Thailand – Cigarettes (Philippines)}, para. 117 (“...As Thailand puts it, a system of offsetting input tax against output tax cannot be said to be WTO-inconsistent "simply because private parties are required to comply with certain administrative requirements", or because it compels resellers "to limit claims for input tax credits to actual, legitimate purchases" of cigarettes ...we do not consider that Thailand's measure precludes a finding of inconsistency with Article III:2 due to the fact that resellers of imported cigarettes may take action to avoid the imposition of VAT liability..."}). This seems to be sufficient to reject Brazil’s argument that there is not difference between the situation of a company paying IPI on the input and claiming back the credit at a later stage and the situation of a company having the IPI suspended on the purchase of its input. Not only there is a difference in terms of time value of money but also in terms of administrative costs and delays that the first company has to face in order to claim back its tax credit, with no administrative costs at all for the second company.\footnote{See also Panel Report, \textit{Argentina – Hides and Leather}, paras 11.200 – 11.206 and 11.326 (noting how tax deferrals may amount to a violation of Article III:2 of the GATT 1994).}

264. In addition, when analysing the additional administrative requirements under Article III:4 of the GATT 1994,\footnote{Appellate Body Report, \textit{Thailand – Cigarettes (Philippines)}, para. 121 (“The Panel's finding under Article III:4 of the GATT 1994 concerned an exemption from three sets of VAT-related administrative requirements for resellers of domestic cigarettes, together with the imposition of these administrative requirements on resellers of imported cigarettes. These three sets of administrative requirements consist of: (i) requirements relating to form Por.Por.30; (ii) reporting and record-keeping requirements; and (iii) penalties and other sanctions”).} the Appellate Body confirmed that also fiscal obligations applicable to the reseller of imported cigarettes (and not only the obligation applicable to the products as such) could fall within Article III:4 if they had the effect of granting a less favourable treatment to imported products by imposing some operating costs on resellers of imported cigarettes, which were not imposed on resellers of like domestic cigarettes.\footnote{Appellate Body Report, \textit{Thailand – Cigarettes (Philippines)}, para. 137.}
265. Like in *Thailand – Cigarettes (the Philippines)*, the requirements under the programmes challenged in this dispute could not be assessed in isolation from their implications (as Brazil would like to do in the present case), because:

The analysis of whether imported products are accorded less favourable treatment requires a careful examination "grounded in close scrutiny of the 'fundamental thrust and effect of the measure itself', including of the implications of the measure for the conditions of competition between imported and like domestic products. This analysis need not be based on empirical evidence as to the actual effects of the measure at issue in the internal market of the Member concerned. Of course, nothing precludes a panel from taking such evidence of actual effects into account.

The implications of the contested measure for the equality of competitive conditions are, first and foremost, those that are discernible from the design, structure, and expected operation of the measure.\(^{189}\)

266. In conclusion, the argument of Brazil according to which the "pre-market requirements" do not concern products and do not fall within the purview of Article III of the GATT 1994 must be rejected.

267. To conclude this section the European Union would like to spend a few more words on the notion of product "developed in Brazil" with reference to Brazil’s response to the Panel’s question to the Parties no. 20. In that response Brazil argues that the concept of “developed in Brazil” under the abovementioned Portarias does not require that the product are manufactured in Brazil.

268. In this connection the European Union would like to recall that the Informatics programme grants additional tax advantages to PPB-compliant products that incorporate national technology, i.e. products that are certified as "developed" in Brazil, in accordance with Portaria 950/2006 and Portaria 1,309/2013.

269. Given that those products must also comply with PPBs, it follows that products developed in Brazil are products manufactured in Brazil in that they have

\(^{189}\) Appellate Body Report, *Thailand – Cigarettes (Philippines)*, paras 129-130. See also para. 134 ("… an analysis under Article III:4 must begin with careful scrutiny of the measure, including consideration of the design, structure, and expected operation of the measure at issue. Such scrutiny may well involve —but does not require—an assessment of the contested measure in the light of evidence regarding the actual effects of that measure in the market. In any event, there must be in every case a genuine relationship between the measure at issue and its adverse impact on competitive opportunities for imported versus like domestic products to support a finding that imported products are treated less favourably").
necessarily undergone some processing steps in Brazil and incorporate the domestic input as required by the relevant PPB.\textsuperscript{190} The same holds true for semiconductors incentivised under the PADIS programme that are produced in Brazil and can also qualify as products “developed in Brazil”.

270. In addition, as explained below in the section dedicated to the PATVD programme, to be eligible under the PATVD the product must always be manufactured in Brazil either according to the relevant PPB or in the alternative (when the PPB is not complied with) it must be a product developed in Brazil pursuant to \textit{Portaria} 950/2006.

271. In conclusion, products developed in Brazil must necessarily be manufactured in Brazil.

272. The European Union would also like to clarify that the concept of “developed in Brazil” is neither a synonym of "produced in Brazil" nor of "manufactured" in Brazil or "locally produced" in Brazil. All those expressions have a broader meaning than “developed in Brazil”. However, as it has been just mentioned, nearly any product developed in Brazil for the purpose of the challenged programmes is somehow also a product that has been manufactured in Brazil.

273. On a more general level the European Union is of the view that the development of a product is just a phase of its production process. Any activity of producing something (even the most simple of the goods) require a conceptualisation phase, during which the maker (or another subject) decide what to make and how. That phase can be very simple and short (e.g. a cook that prepares the same food everyday) or very complicated and lengthy (as it can happen for products with a high technological content); it can be carried out by the same person that manually makes the product or by different actors. In any case, there is no product or production which can be realised before a decision has been taken on what to make and how. So the development is just one of the steps necessary in order to obtain a product and as such it is part of the production process of a product.

\textsuperscript{190} In paras 162-167 of its first written submission, Brazil explains the additional IPI reductions for products that are “developed” in Brazil. In para. 162 it confirms that those tax incentives are available for products that are produced in Brazil according to the relevant PPB and moreover comply with the conditions laid down by \textit{Portaria} 950/2006.
The argument of Brazil that the development of the product is not part of the production process of the product and therefore the benefit arising from complying with *Portaria* 950/2006 do not “relate to the product but to its pre-market steps” is therefore incorrect.\(^\text{191}\) Since the benefit arising from the fact that the specifications, projects and design of an ICT product is carried out in Brazil and by technicians resident or domiciled in Brazil, as required by *Portarias* 950/2006 and 1,309/2013, consists in the decreased of the tax burden applicable on the ICT products when they are put on the market, it is clear that the tax benefits granted to products “developed in Brazil” do relate to the product in the market place.

4.1.2.2 Article III:2

4.1.2.2.1 EU's claims

In section 6.2.2.1 of the first written submission the European Union claims that pursuant to the Informatics programme Brazil imposes internal taxes on imported ICT products in excess of those applied to like domestic ICT products and, therefore, violates Article III:2 of the GATT 1994.

4.1.2.2 Brazil's arguments

Brazil wrongly argues that "the internal taxes applied on the production and development of ICT goods in Brazil under the Informatics Law are not concerned with the origin of products", since they are related to production and development requirements imposed on accredited producers.\(^\text{192}\)

Brazil also argues that with respect to intermediate goods (which according to Brazil represent about 30% of the ICT products covered by the Informatics programme), any difference in taxation between goods produced by the accredited companies and all other goods does not produce an effective difference in the tax treatment.\(^\text{193}\)

With regard to non-intermediate products (which must be about 70% of the ICT products covered by the Informatics programme) the only argument that Brazil

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\(^\text{191}\) Brazil's first written submission, para. 167.
\(^\text{192}\) Brazil's first written submission, para. 200.
\(^\text{193}\) Brazil's first written submission, para. 218.
makes is that the tax reduction are destined to producers and not to products.\(^{194}\) This argument of Brazil is linked to the preliminary argument raised by Brazil to the effect that Article III of the GATT 1994 would not apply to “pre-market requirements”.

279. Finally, Brazil also argues that the Informatics programme does not draw an origin-based distinction between products.\(^{195}\)

280. Since the preliminary argument has already been dealt with above, the European Union will not rebut it again. The European Union simply observes that to the extent that those general arguments are not well founded, the Panel should conclude that the Informatics programme subjects imported non-intermediate products to a tax burden which is higher than that imposed on like domestic products.

4.1.2.2.3 EU’s rebuttal

281. The European Union maintains that the Informatics programme draws an origin-based distinction between ICT products based on the local content of the product, defined on the basis of factors such as the place of production of the products, the place of production of the parts or components, the incorporation in the product of minimum shares of domestic intermediate products and the obligations assumed by the producer in relation to R&D investments and technological development in Brazil.

282. In a few words, only products produced in compliance with a PPB that, in the view of Brazil are effectively produced in the country, can enjoy the tax incentives granted under the Informatics programme.\(^{196}\) It is telling that the Portarias approving the PPBs refer to these products as product industrialised in the country ("produto...industrializado no pais") or produced in the country ("producido no pais").

283. By definition, like imported products cannot be produced in compliance with a PPB; they are normally produced by companies that are neither accredited nor

\(^{194}\) Brazil's first written submission, para. 217.

\(^{195}\) Brazil's first written submission, para. 217.

\(^{196}\) Article 17 of Decree 5,906/2006 (Exhibit EU/JE-7).
established in Brazil, that do not make any investments in R&D in the ICT sector in Brazil, and those products may not contain any input, part or component produced in Brazil. Likewise, PPB compliant product can be considered as “developed” in Brazil if the production step consisting in the design and development of the product and of its specifications has taken place in Brazilian facilities and by technicians resident or domiciled in Brazil. Imported products, which already do not comply with the PPB, may also have been developed outside Brazil and thus will not be eligible under the Informatics programme.

284. The European Union maintains that requiring certain production steps to be carried out in Brazil in order for a product to benefit from a tax incentive is necessarily non-origin-neutral, because like imported products that have not undergone the same production steps in Brazil are by definition excluded from the incentive. The same reasoning applies *a fortiori* when the PPB requires not only that certain production steps take place in Brazil, but also that the product incorporates inputs manufactured in Brazil (in compliance with the relevant PPB where applicable) or sourced in Brazil.

285. The position of the European Union is perfectly consistent with the case-law and notably with the Report of the panel in *Indonesia – Autos* which shows that origin based distinctions can come in the form of local content requirements.

286. In these circumstances, the European Union did not need to examine the various likeness criteria either under Article III:2 or III:4 of the GATT 1994, but simply explain that there are or could be like imported products. The European Union has duly provided that explanation. Many of those products are indeed imported in Brazil from the European Union.¹⁹⁷ In any event, the European Union has recalled that there are no differences between the incentivised products and imported like products in terms of their physical characteristics, end-uses, consumer preferences, and customs classification. Brazil, rather than taking a position to address the likeness aspect, prefers not to engage in the discussion. The European Union thus

¹⁹⁷ EU’s first written submission, para. 608 and footnote 400.
requests the Panel to draw the necessary inferences from Brazil's lack of response.  

287. With regard to the fiscal treatment granted to products incentivised pursuant to the Informatics programme, the European Union observes that it is not disputed that the Informatics programme provides for a reduction of the normally applicable IPI tax rate only in favour of the products produced by the accredited companies in compliance with the PPBs (and the other conditions under the Informatics programme).

288. The purpose of Article III:2, first sentence, is to ensure "equality of competitive conditions between imported and like domestic products". Since Article III:2, first sentence, is concerned with the competitive opportunities of imported and like domestic products, "what must be compared are the tax burdens imposed on the taxed products". The terms "in excess of" have been interpreted as encompassing even the slightest difference in the levels of taxation imposed on imported and domestic products. It is also well established that Article III:2, first sentence, of the GATT 1994 "is applicable to each individual import transaction".

289. The European Union maintains that the obligation contained in Article III:2 of the GATT 1994 does not differentiate between inputs and finished products. An intermediate product amounts to a final product from the perspective of the producer and, insofar as imported intermediate product are subject to a heavier tax burden when sold in that country compared to the tax burden applied to like domestic product, Article III:2 is breached. The question of knowing what the purchaser of that product will do with it (consume it or incorporate it in another product) or, in other words, whether the incentivised product is a product that can be used as input in other more complex products is clearly irrelevant, as Article III:2 applies to all types of products and each individual transaction.

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198 See e.g. Brazil's response to the EU's question no. 4.
199 Appellate Body Report, Canada – Periodicals, p. 18.
Moreover, when comparing the tax burden imposed on imported and domestic products, Article III:2 does not allow to make a comparison between tax burden imposed at different moments of the life of the products. Brazil indeed would like to compare the tax burden applied when an imported intermediate product is put on the Brazilian market, with the tax burden imposed on a domestic intermediate product (not when it is put on the Brazilian market but at the later stage) when the more complex product incorporating that domestic intermediate product is put on the market.\textsuperscript{202}

Given that only domestic products can comply with the Informatics programme requirements, it follows that Brazil imposes a higher IPI tax rate on imported ICT products than on domestic ones in all cases except when the ICT product in question (including the imported product) is taxed at zero rate. Therefore, the European Union contends that the programme, by its design, structure and operation, is inconsistent with Article III:2 of the GATT 1994.

The European Union will deal below in the section concerning Article III:4 of the GATT 1994 with the Brazil’s argument according to which different taxation between intermediate goods produced by accredited companies and all other intermediate goods does not produce an effective difference in the tax treatment.

At this stage, it is however appropriate to recall what the panel in \textit{Argentina – Hides and Leather} noted with regard to the fact that a tax credit system for a value added tax produces in itself an effective tax burden, which does not arise when the same tax is suspended:

The actual tax burden … may take one of two forms, depending on the factual circumstances of each case. First, in situations where taxable persons have disposable working capital to finance the pre-payment of the IVA or IG, they are forced, on account of the pre-payment requirement, to forego interest on that working capital in the interval between the tax pre-payment and its crediting. Alternatively, in situations where taxable persons do not have disposable working capital to finance the pre-payment of the IVA or IG, they need to raise the necessary capital and pay interest on it in the interval between the tax pre-payment and its crediting.

\textsuperscript{202} EU’s response to the Panel’s question to the Parties no. 48.
It is clear to us that both of these situations give rise to a financial burden, an opportunity "cost" in one case and a debt financing "cost" in the other. Likewise, it is readily apparent that that financial burden is incidental to and directly caused by [the measure at issue in that case]. For these reasons, it is properly regarded as an integral part of the actual tax burden imposed by [those measures]. As such, it falls squarely within the scope of Article III:2, first sentence.203

294. In other words, an actual tax burden arises even in situations where a tax liability will be offset by a tax credit. On the contrary, such tax burden obviously does not arise when the tax normally payable on the purchase of intermediate products is suspended or exempted. In such a case, taxes normally collected along the production chain are deferred at a later stage (when the product is sold to the final customer). It is then the State that bears the cost of not having those financial resources available at an earlier moment. Hence, a tax deferral has a cost for the government (which in turn becomes a benefit for the accredited companies).

4.1.2.2.4 EU’s comments on Brazil’s responses to the Panel’s questions

295. In its responses to the Panel’s questions no. 25 and 26, Brazil again repeats its argument that the four programmes concerning ICT products do not relate to products at all, but simply confer subsidies to Brazilian producers.

296. As explained before, the very purpose of PPB is to characterise the effective production of a product in Brazil. PPB require that several production step take place in Brazil and very often that certain share of input product must be sourced or produced in Brazil. Very often PPBs require also that the final assembly of the product takes place in Brazil.

297. A like imported product which has been produced abroad in practice will not comply with requirement that the production steps must take place in Brazil. Moreover, most likely it will be a product manufactured by a company that is not established and accredited, that has not made the required investments in Brazil and that contains no input of Brazilian origin.

298. In practice, therefore, imported product will necessarily not comply with the PPB and the other conditions to obtain the advantageous tax treatment provided for by

the Informatics programme as well as the PADIS, PATVD and Digital Inclusion programmes.

299. One might make a hypothetical example of a PPB that only requires some minimal processing steps in Brazil at the early phase of the production, the product has undergone those early production steps in Brazil, it has been exported and re-imported in Brazil after further transformation abroad. The EU is not aware of any such situation which seems to belong to the realm of speculations, as what effectively matters for Brazil is the domestic "industrialization" of the products.

300. In summary, it is clear that *in concreto* like imported product can never benefit from the challenged ICT programmes.

4.1.2.2.5 *Conclusions on Article III:2*

301. In view of the foregoing, the European Union maintains its claim that the Informatics programme is inconsistent with Article III:2 of the GATT 1994.

4.1.2.1 *Article III:4*

4.1.2.1.1 *EU's claims*

302. To recall, in section 6.2.2.2 of its first written submission, the European Union claims that two specific aspects of the Informatics programme are inconsistent with Article III:4 of the GATT 1994:

(1) the conditions for accreditation necessary for ICT products to benefit from the exemptions or reductions, which result in less favourable treatment granted to imported products (including both inputs as well as the final product) than that accorded to like domestic products (also including both inputs as well as the final product); and

(2) the imposition, under the terms of the corresponding PPBs, of an obligation to use local inputs in the production of ICT products, as a condition to benefit from the exemptions or reductions, which also affords less favourable treatment to imported inputs and equipment than that accorded to like domestic inputs and equipment.205

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204 In the present submission, for ease of reference, the European Union will use the general term “input” to refer to raw materials, parts, components, and equipment to be incorporated or used in the production of a final product, as the case may be.

205 The European Union recalls that, should the Panel find that the conditions for accreditation under the Informatics programme operating as a whole are contrary to Article III:4 with respect to both the inputs and the final ICT products, the European Union considers that the Panel could exercise
Brazil’s arguments

303. Brazil argues that Article III:4 of the GATT 1994 only applies to measures which affect a product once it has been produced and enters the domestic market, i.e. it refers only to market operations.\(^{206}\)

304. Brazil adds that the European Union should have demonstrated that the “pre-market requirements” at issue “effectively demand or incentivise locally-sourced inputs, which would thereby affect the “sale, offering for sale, purchase, transportation distribution or use of those inputs”.\(^{207}\)

305. Brazil argues that the R&D investment and production steps requirements do not have any relationship with the products or their origin.\(^{208}\) Indeed, Brazilian producers import a high proportion of their inputs and import of ICT product in Brazil has increased significantly.\(^{209}\)

306. Brazil also claims that the Appellate Body in Canada – Autos found that only requirements to use domestic inputs would amount to added value requirements contrary to the GATT or contingent upon the use of domestic over imported goods\(^ {210}\).

307. With regard to the “less favourable treatment” that the Informatics programme grants to imported product the only argument raised by Brazil is the general argument that, in the case of intermediate goods produced by the accredited companies, the indirect tax suspensions or exemptions applied under the challenged programmes do not even generate a difference in the effective tax burden due between imported and domestic products.\(^{211}\)

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\(^{206}\) Brazil’s first written submission, paras 224 – 227.

\(^{207}\) Brazil’s first written submission, para. 228.

\(^{208}\) Brazil’s first written submission, para. 231.

\(^{209}\) Brazil’s first written submission, para. 262

\(^{210}\) Brazil’s first written submission, para. 232, referring to the Appellate Body report in Canada – Autos, para. 130.

\(^{211}\) See, for example, Brazil’s first written submission, para. 185.
308. Finally, Brazil has not contested that the Informatics programme is composed of laws, regulations and requirements within the meaning of Article III:4.

4.1.2.1.3  EU's rebuttal

309. The European Union underlines that there is indeed a long saga of local content cases affecting production and producer's choices about which products should be used in their production process which shows precisely the opposite of what Brazil argues (e.g. Indonesia – Autos, India – Autos, Canada – Autos, Canada – FIT, Indonesia – Solar Panels). In that connection reference can be made to the Appellate Body findings in US-FSC (Article 21.5 I), which states: "The fair market value rule, therefore, influences the manufacturer's choice between like imported and domestic input products if it wishes to obtain the tax exemption under the ETI measure". 212

310. Brazil's narrow reading of the term "affect" is also quite telling and it goes against consistent case-law. The European Union has recalled this case-law in its first written submission and Brazil does not seriously dispute it. 213 The term "affecting" in Article III:4 has a broad scope of application and goes beyond laws and regulations which directly govern the conditions of sale, use or purchase to cover also any laws or regulations which might adversely modify the conditions of competition between domestic and imported products. This includes any measure capable of influencing a manufacturer's choice between the imported product and the like domestic product, there being no need to demonstrate that such choice is mandated or that such effects have actually been produced. 214 Indeed, as noted before, Article III of the GATT 1994 is about equalising the conditions of competition between domestic and imported like products and, thus, the term "affect" should be interpreted with that objective in mind.

311. It is plain that the tax incentives provided for by the Informatics programme applies only to a class of products (those produced in Brazil in accordance with a

212 Appellate Body report in US-FSC (Article 21.5 I), para. 212. See also para. 221.
213 EU's first written submission, paras 640, 641, 642, 647, 648, and 649.
PPB and by companies accredited in Brazil which comply with the other requirements of the Informatics programme, such as the minimum investment obligation in R&D in Brazil). The position of those products in the Brazilian market is therefore improved vis-à-vis like imported products which do not benefit from the same tax reductions or exemption.

312. The same can be concluded with regard to the R&D investment requirement or the requirement to develop the product in Brazil in order to benefit from greater tax advantages. Insofar as the investment requirement is linked to improving the incentivised products, it should be concluded that such a requirement "affects" the sale of those products in Brazil (by giving the product a qualitative technology advantage). In this respect, the panel and the Appellate Body in *US – Large Civil Aircraft (2nd complaint)* already noted that R&D subsidies may allow the recipient to put on the market a better product (qualitatively speaking) before the company could have done it without the subsidy.\(^{215}\) With respect to the Informatics programmes that link is not expressly stated. However, whilst the Informatics programme merely requires that the accredited company invest in R&D in the ICT sector, it is only reasonable to assume that the company will tend to invest in R&D activities that will benefit to its current or future production activities. In addition, the notion of product developed in Brazil explicitly refers to a product which is technologically more advanced.

313. Brazil's additional argument according to which the European Union should have demonstrated that the “pre-market requirements” at issue “effectively demand or incentivise locally-sourced inputs”, suggests that according to Brazil the European Union should have proved that the actual effects of the measures were to increase the use of domestic products in Brazil.

314. Also this contention should be rejected.\(^ {216}\) As already mentioned above, the implications of the contested measure for the equality of competitive conditions are, first and foremost, those that are discernible from the design, structure, and

\(^{215}\) Appellate Body Report, *US – Large Civil Aircraft (2nd complaint)*, paras 917, 918, 923-949, 970, 980 and 996.

\(^{216}\) See section 2.1.5. above.
expected operation of the measure, whereas empirical evidence is not necessary.\(^{217}\)

In any event, it is interesting to note that of the 12 examples of ICT incentivised products which Brazil claims are made with a great majority of imported input no one of them is an imported product or a product in which the totality of the costs of production is made of imported inputs.

315. Brazil argues that Brazilian companies purchase a high proportion of imported input and this should prove that there is not violation of Article III:4.

316. In its response to the Panel’s question to the Parties no. 36, Brazil explains that the figures provided in Exhibit BRA-32 where provided to the Brazilian government “by accredited companies by means of the sector representative, ABINEE”.

317. However, Brazil does not demonstrate that those figures are correct, let alone that it has done anything to check their reliability. Indeed, certainly it cannot be said that they were provided by companies that have no interest in the outcome of the present proceedings. It is obvious that accredited companies have an interest in maintaining the tax advantages that they are benefitting from under those programmes.

318. In any case, the high percentage of imported input used by accredited companies (assuming that the figures submitted by Brazil are reliable and representative of the multitude of products incentivised pursuant to the Informatics programme)\(^{218}\) would demonstrate, if anything, that the local content requirements contained in the PPBs so far have not been particularly effective in promoting local production of input for ICT products and that Brazilian producers still need to import most of those inputs in order to manufacture the ICT products they are accredited for. Also, when the design and structure of the programmes indicate otherwise, the increase in imports in ICT products cannot decisive for the assessment of the

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\(^{217}\) Appellate Body Report, *Thailand – Cigarettes (Philippines)*, paras 129-130. See also para. 134 (“… an analysis under Article III:4 must begin with careful scrutiny of the measure, including consideration of the design, structure, and expected operation of the measure at issue. Such scrutiny may well involve—but does not require—an assessment of the contested measure in the light of evidence regarding the actual effects of that measure in the market. In any event, there must be in every case a genuine relationship between the measure at issue and its adverse impact on competitive opportunities for imported versus like domestic products to support a finding that imported products are treated less favourably”).

\(^{218}\) Brazil's first written submission, paras 244 and ff.
Informatics Programme compliance with Article III:4 of the GATT. That phenomenon simply reflects the increased demand for those products in Brazil as in many other countries around the world, which has pushed up import as well as local ICT production.  

319. With regard to the fact that R&D investment and production steps requirements do not have any relationship with the products but only with their production, the EU makes reference to the arguments developed above in section 4.1.2.1. If the argument simply means that nothing in the measures challenged by the EU contains an explicit requirement to use, purchase domestic input or source it locally, then the EU makes reference to Section above 4.1.1 which proves that this argument is incorrect as a matter of fact.

320. The EU finds it surprising that Brazil invokes in its defence the finding in paragraph 130 of the Appellate Body report in *Canada – Autos* because that case concerned precisely what Brazil defines as a pre-market requirement, i.e. the requirement for car manufacturer to incorporate Canadian parts and materials in the motor vehicles produced in Canada. That finding related to the application of Article 3.1(b) of the SCM Agreement and in that case the Appellate Body concluded that Article 3.1(b) of the SCM Agreement also extends to subsidies contingent "in fact" upon the use of domestic over imported goods.

321. With regard to the “less favourable treatment” that the Informatics programme grants to imported product, the European Union has explained in its first written submission, in the opening oral statement and in the responses to the questions of the Panel that the Informatics programme has multiple implications on the equality of competitive opportunities of imported and like domestic products.

322. The less favourable treatment of imported products arises at three levels at least.

323. First, the mechanism for the calculation of the amount of resources that must be invested in compulsory R&D in the context of the Informatics programme (and the PADIS programme), where the amounts paid when purchasing incentivised

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219 Brazil's first written submission, paras 112, 115 and 116.
221 Appellate Body Report, *Canada – Autos*, para. 143.
products is deducted from the calculation, creates an incentive to purchase those products to the detriment of like imported products.222

324. Second, whenever a product benefits of an exemption or suspension of an indirect tax (or a very low rate) that implies a lower administrative burden for the purchaser of that product compared to the burden faced by the purchaser when it buys products subject to the tax (or subject to the full rate). That lower administrative burden creates an incentive on the Brazilian market in favour of domestic products incentivised under the programme, and in particular with respect to intermediate products which are purchased by other producers. Indeed, those producers will not have to claim compensation or reimbursement of any tax credit (or they will have very low tax credit to compensate).

325. Brazil has raised no argument to explain that these instances of less favourable treatment do not exist. On the contrary, as explained in the EU’s opening oral statement and in Brazil’s closing statement to the first substantive meeting, Brazil has confirmed both of them.

326. Third, the European Union has explained that imported products are treated less favourably because they are subject to a higher indirect tax burden when put on the Brazilian market, in comparison with like domestic products incentivised by the Informatics programme.

327. Brazil has claimed that for intermediate products the burden is at the end the same.

328. The European Union observes that by this argument Brazil admits that there is a less favourable treatment with regard products that are not intermediate (which according to Brazil should be around 70% of those incentivised pursuant to the Informatics programme).

329. Moreover, with regard to the neutrality of the tax burden the European Union has demonstrated in replying to Question 42 and 43 of the Panel that this argument is not well founded.

330. As already demonstrated, it is only when the tax rates for the final and the intermediate product are the same that the suspensions and exemptions of non-

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222 See EU’s opening oral statement, section 4.5.
cumulative valued added taxes along the production chain can lead to a result that in nominal terms is neutral. However, there is no requirement in Brazilian law pursuant to which the tax rates on final and intermediate product must be the same.

331. Moreover, Brazil’s argument completely ignores the time value of money and thus the tax deferral effect that the suspensions and exemptions procure to the purchasers of those products.

332. Third, it does not take into consideration the combined effects of the interplay of the different programmes. Indeed, the ICT-related programmes are designed to complement each other to increase the level of incentives to the subject products, while minimising overlaps in terms of the advantages granted. For instance, the Digital Inclusion programme provides for additional incentives to the retail sale of products produced in accordance with the PPBs under the Informatics programme.

333. Finally, as underlined by the panel in Argentina – Hides and Leather,\(^\text{223}\) the company purchasing an intermediate product for which indirect taxes are not suspended or exempted will have an opportunity "cost" or debt financing "cost", which it will not incur when purchasing a product for which indirect taxes are suspended or exempted. Again intermediate products incentivised pursuant to the Informatics programme will be more attractive in the Brazilian market compared to like imported products that are therefore treated less favorably.

334. Finally, Brazil's argument is not valid with respect to manufacturers of intermediate products which participate in the cumulative regime of PIS/PASEP and COFINS.\(^\text{224}\) This is because under the cumulative regime, companies must make a simple PIS/PASEP and COFINS payment which is not offset by credits.\(^\text{225}\) Thus, companies participating in the cumulative regime have an interest in purchasing intermediate products exempted from PIS/PASEP and COFINS, because they cannot claim back through the tax credit mechanism the PIS/PASEP and COFINS they have paid on their purchases. By suspending and exempting taxes due under the cumulative regime (as well as the non-cumulative regime) for

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\(^{223}\) Panel Report, Argentina – Hides and Leather, paras 11.187 – 11.188.

\(^{224}\) See Japan's first written submission in DS497, para. 12.

\(^{225}\) Specifically, under the cumulative regime, companies pay a simple 3.65% (i.e. 0.65% for PIS/PASEP and 3% for COFINS) of gross monthly revenues.
domestic products with domestic inputs as specified by relevant PPBs, the ICT Measures discriminate against imported goods, including those that could be characterized as intermediate.

4.1.2.1.4 Conclusions on Article III:4

335. In view of the foregoing, the European Union maintains that the conditions for accreditation under the Informatics programme, as well as the requirement to use imported over domestic inputs, are contrary to Article III:4 of the GATT 1994.

4.1.2.2 Article III:5

4.1.2.2.1 EU's claims

336. In section 6.2.2.3 of its first written submission, the European Union submits that the Informatics programme is inconsistent with Article III:5 of the GATT 1994, because:

• the conditions imposed under the terms of the corresponding PPBs regarding (a) the minimum number of processing activities that producers of ICT products need to perform in Brazil, and (b) the proportion of local inputs that producers need to use to manufacture ICT products in Brazil in order to benefit from the IPI exemptions or reductions, amount to an internal quantitative regulation relating to the processing or use of products, which requires a specified amount or proportion of the products to be supplied from domestic sources (Article III:5, first sentence); and,

• because, in any event, the conditions relating to the minimum processing activities that must be carried out in Brazil amount to an internal quantitative regulation that is applied so as to afford protection to domestic production (Article III:5, second sentence).

337. Hence, the European Union has raised two alternative claims under Article III:5, one based on the first sentence of that Article, and the other on the second sentence.

4.1.2.2.2 Brazil's arguments

338. Brazil has replied in extenso to the claim based on the first sentence of Article III:5, while making a very short remark on the claim based on the second sentence.

339. As regards the claim based on the first sentence of Article III:5, Brazil has argued that production requirements fall outside the scope of Article III:5 of the GATT
1994 since they require no specified amount or proportion of any product which is the subject of the regulation to be supplied by domestic sources.  

340. Moreover, it has proposed a very restrictive interpretation of this provision stating that in its view the provision only deals with products used as inputs in the "mixture, processing or use of products in specified amounts or proportions", not with production processes themselves, and that the Article's scope is to maintain the conditions of competition between domestic and imported products, in this case, when used as inputs in the production of other products.

341. Brazil also has a narrow interpretation of the terms "any internal quantitative regulation relating to the mixing …", and argues that an explicit reference to the amounts of the products to be used in the mixing, processing, or use is required for a measure to fall within that provision.

342. With regard to the second sentence of Article III:5, the only argument that Brazil develops as regards the second sentence of Article III:5 is based on the Ad Article to Article III:5 which states that “[p]aragraph 5 Regulations consistent with the provisions of the first sentence of paragraph 5 shall not be considered to be contrary to the provisions of the second sentence in any case in which all of the products subject to the regulations are produced domestically in substantial quantities….” Brazil concludes that, since the production steps requirements are not inconsistent with the first sentence, they are also not inconsistent with the second sentence.

4.1.2.3 EU's rebuttal

343. The European Union is of the view that the arguments developed by Brazil do not disprove either of the two independent claims in question.

344. The narrow reading of Article III:5 proposed by Brazil, which ultimately is based on the idea that production steps requirements can never fall within the paragraphs of Article III, is clearly not warranted as already explained above. It is an evidence

\[226\] Brazil's first written submission, para. 267.

\[227\] Brazil's first written submission, para. 266.

\[228\] Brazil's first written submission, paras 277 and 283.

\[229\] Brazil's first written submission, para. 285.
that Article III:5 also deals with the "processing" of the concerned product, thus production steps requirements, i.e. requirements that regulate how a given product must be produced, may fall within the purview of that provision.

345. Moreover, the authority to which Brazil refers to advocate a narrow interpretation of Article III:5 do not support Brazil’s case. In *EEC-Animal feed proteins* the panel examined some EEC measures which imposed on the:

… EEC domestic producers or importers of oilseeds, cakes and meals, dehydrated fodder and compound feeds and importers of corn gluten feeds … an obligation to purchase a certain quantity of skimmed milk powder held by intervention agencies and to have it denatured for use as feed for animals other than calves.²³⁰

346. The panel noted the following:

The Panel examined the obligation under the EEC Regulation, to purchase a certain quantity of denatured skimmed milk powder from intervention agencies, in terms of the provisions of Article III:5, that is whether the EEC measures constituted an "internal quantitative regulation relating to the mixture, processing or use" within the meaning of Article III:5.

The Panel noted that the Council Regulation (EEC) no. 563/76 referred, in its stated considerations, to the considerable stocks of skimmed milk powder held by intervention agencies and to the objective of increasing the utilization of skimmed milk powder as a protein in feedingstuffs for animals other than calves. In other words, the Regulation was intended to dispose on the internal market ("utilization") of a given quantity ("stocks") of skimmed milk powder in a particular form ("denatured" i.e. utilizable only for the intended purposes). The Panel therefore considered that the EEC Regulation was an "internal quantitative regulation" in the sense of Article III:5. However, the Panel found that this "internal quantitative regulation" as such was not related to "the mixture, processing or use ... in specified amounts or proportions within the meaning of Article III:5 because, at the level of its application, the EEC Regulation introduced basically an obligation to purchase a certain quantity of skimmed milk powder and the purchase obligation falls under Article III:1.

²³⁰ *EEC-Animal feed proteins*, para. 2.5.
Given the reference in Article III:5, second sentence, to Article III:1, the Panel then examined the consistency of the EEC Regulation as an “internal quantitative regulation” with provisions of Article III:1, particularly as to whether the Regulation afforded protection to domestic production. The Panel noted that the EEC Regulation considered, in its own terms, that denatured skimmed milk powder was an important source of protein which could be used in feedingsuffs. The Panel also noted that surplus stocks could originate either from domestic production or imports, but that the intervention agencies from which the buyers of vegetable proteins had to purchase a certain quantity of denatured skimmed milk powder only held domestically produced products. The Panel further noted that, although globally about 15 per cent of the EEC apparent consumption of vegetable protein was supplied from domestic sources, not all the individual products subject to the EEC measures were produced domestically in substantial quantities.

The Panel concluded that the measures provided for by the Regulation with a view to ensuring the sale of a given quantity of skimmed milk powder protected this product in a manner contrary to the principles of Article III:1 and to the provisions of Article III:5, second sentence.

Thus, the panel excluded a violation of Article III:5 first sentence because the measure simply laid down an obligation to purchase. However, it concluded that it still was a quantitative internal regulation which was contrary to Article III:5, second sentence because the obligation to purchase a certain quantity of denatured skimmed milk powder only applied to domestically produced milk, as the intervention agencies from which to buy the milk only held domestically produced milk and because not all not all the individual products subject to the EEC measures were produced domestically in substantial quantities. In summary, even though the panel followed a rather narrow interpretation of Article III:5 first sentence, it adopted a rather broad reading to Article III:5 second sentence.

Likewise, the panel report in Canada-FIRA cannot be considered conclusive for the definition of the scope of Article III:5. In the case the panel noted:

231 Ibidem., paras 4.5-4.8.
The Panel then considered the United States contention that purchase undertakings which obliged the investor to purchase in Canada a specified amount or proportion of his requirements were also contrary to Article III:5. The Panel noted that these cases had been characterized by both parties as purchase undertakings (paragraph 2.5) and had also been presented as such by the United States (paragraphs 3.1(a) and 3.12). In this regard the Panel noted that in paragraph 5 of Article III the conditions of purchase are not at issue but rather the existence of internal quantitative regulations relating to the mixture, processing or use of products (irrespective of whether these are purchased or obtained by other means). On the basis of the presentations made, the Panel (which was unable to go into a detailed examination of individual cases where purchase undertakings referred to percentages or specific amounts) therefore did not find sufficient grounds to consider the undertakings in question in the light of Article III:5, but came to the conclusion that they fell under the purchase requirements that had been found inconsistent with Article III:4.232

349. Hence, first of all the parties had presented the measures at issue in that case as purchase undertakings and not as internal quantitative regulations relating to the mixture, processing or use of products. Second, the panel was unable to go into a detailed examination of individual cases where purchase undertakings referred to percentages or specific amounts and therefore it did not find sufficient grounds to consider the undertakings in question in the light of Article III:5.

350. In substance, on the basis of these two panel reports Brazil concludes that the production step requirements laid down in the Informatics programme by means of the PPBs fall outside the scope of Article III:5. It is manifest, however, that those reports do not confirm the position of Brazil.

351. Moreover, it is worth underlining that in order to reply to the EU's arguments under Article III:5, Brazil pretends to forget a part of the EU's claims. As it is clear that the claim of the European Union under Article III:5, first sentence is twofold.233 The European Union claims that PPBs contain requirements relating to both (a) the minimum number of processing steps the producers of ICT products need to carry out in Brazil and (b) the proportion of local inputs that producers need to use to manufacture ICT products in Brazil. The European Union argues that both those set of requirements, which must be complied with in order to obtain a tax advantage, are falling within Article III:5, first sentence.

232 GATT Panel Report, Canada-FIRA, para. 5.13.
233 EU's first written submission, para. 662.
352. Brazil basically tries to rebut the part of sub-claim (a), but makes no argument with regard to sub-claim (b).

353. With regard to sub-claim (a), the European Union confirms its arguments contained its first written submission.\(^{234}\) For the sake of conciseness, it does not appear necessary to restate those arguments here.

354. On the other hand, it is more interesting at this stage to spend a few more words with regard to sub-claim (b).

355. The European Union has explained that many PPBs also contain requirements specifying the percentages of some input products that must be supplied from domestic sources (and some must also be made in accordance with their respective PPBs).\(^{235}\) It has provided a general description of those type or requirements, which are expressed either as a percentage of the total amount of the same input product used by the accredited company in the production of the final incentivised ICT product in the same calendar year, or as a requirement that some input product to be incorporated in the final incentivised ICT product shall be produced by the accredited company itself in Brazil, so that 100% of that input product must be produced in Brazil.\(^{236}\) The European Union has further provided several examples of the said requirements.\(^{237}\)

356. As recalled in section 4.1.1 above, in its first written submission Brazil has denied that any PPB establishes a “minimum percentage of components that must be produced locally, and the EU has already demonstrated above that this assertion is wrong. However, contradicting its own position, Brazil has admitted that some PPBs contain the requirement that a given percentage of specific input products must be produced in compliance with their own PPBs.

357. In so far as PPBs regulate the production process of a given ICT product and mandate the use of certain percentages of a given input to be supplied from domestic sources, either directly (as a percentage of the total annual consumption

\(^{234}\) EU’s first written submission, paras 664-675.

\(^{235}\) EU’s first written submission, paras 673-674.

\(^{236}\) EU’s first written submission, paras 536 and 537.

\(^{237}\) EU’s first written submission, paras 542, 543, 544, 547 and 550.
by the accredited company of that input product) or indirectly (by requiring that it be made in Brazil by the accredited company), it is crystal clear that they fall within Article III:5, first sentence, even when one takes the narrow interpretation followed by Brazil.

358. Indeed, to paraphrase Brazil first written submission,\textsuperscript{238} those requirements clearly deal with products used as inputs in the processing of ICT products. Likewise, they contain an explicit reference to a stated amount or proportion of the products to be used in the processing of the final product that must be sourced domestically, (and even Brazil admits that the obligation to source the input product domestically does not need to be explicit).\textsuperscript{239} They also have a substantial causal relationship between the final ICT incentivised product the company is accredited for and the use of a given input in specified proportions in the production process of that ICT product. Finally, those requirements fall perfectly within the objective attributed by Brazil to Article III:5, which is that of maintaining the conditions of competition between domestic and imported products when used as inputs in the production of other products,\textsuperscript{240} and are by all means similar to the requirement that was considered to run afoul of Article III:5 first sentence, by the Panel in US-Tobacco, which also Brazil admits it would fall within Article III:5 first sentence.\textsuperscript{241}

359. With regard to the second sentence of Article III:5, it is appropriate to recall that the European Union has argued that the minimum processing steps that must be carried out in Brazil constitute and internal quantitative regulation that is applied so as to afford protection to domestic production.

360. The European Union observes that Brazil does not contest that the Informatics programme contains also internal regulatory acts in the form of the Portarias approving the PPBs.

\textsuperscript{238} Brazil's first written submission, paras 266, 278, 282 and 275.

\textsuperscript{239} Brazil's first written submission, para. 283.

\textsuperscript{240} Brazil's first written submission, para. 269.

\textsuperscript{241} Brazil's first written submission, para. 268, and Brazil's first written submission in DS497, para. 231.
361. With regard to the question of whether those acts are quantitative within the meaning of the second sentence of Article III:5, the European Union notes that Brazil has not made any argument. Thus also this point should be considered as uncontested since the European Union has demonstrated that the production steps requirements are quantitative in the sense that they indicate the minimum quantity of production steps that must take place in Brazil and in the sense that this correspond to a minimum amount of local added value (or local content) that the final ICT product must possess in order to benefit from the tax advantages under the Informatics programme.\textsuperscript{242}

362. The production steps requirements would have to be considered as quantitative even if one were to take the definition of “quantitative” that Brazil develops in its first written submissions, referring to case law concerning Article XIII\textsuperscript{243}. Brazil argues that the word “quantitative” refers to something that can be “estimated or estimable by quantity”. Obviously, the quantity of local value added or local content that is implicit in the minimum number of production steps requirements laid down in the PPB can be estimated and it is estimable as a percentage of the total value of the ICT product.

363. By the same token, if one takes the view that the term “quantitative” in Article III:5 should be interpreted in light of the case law on Article XI it should be recalled that the Appellate Body has clarified that the coverage of Article XI includes those prohibitions and restrictions that limit the quantity or amount of a product being imported or exported. It also specified that this limitation need not be demonstrated by quantifying the effects of the measure at issue; rather, such limiting effects can be demonstrated through the design, architecture, and revealing structure of the measure at issue considered in its relevant context\textsuperscript{244}.

364. Now, unlike the first sentence, the second sentence of Article III:5 refers to quantitative regulations but it does not say that those regulations must require any specified amounts or proportion of any product which is the subject of the regulation to be supplied from domestic sources.

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\textsuperscript{242} EU's first written submission, paras 679, and 671.

\textsuperscript{243} Brazil's first written submission, para. 272.

\textsuperscript{244} Appellate Body Report, Argentina – Measures Affecting the Importation of Goods, para. 5.217.
365. It is therefore clear that a regulation for the purpose of the second sentence of Article III:5 can be considered as quantitative even when it does not specify directly or indirectly the amount or proportion of any product to be supplied from domestic sources, but it is intended simply to affect the quantities of imported product so as to afford protection to domestic production.

366. The only argument that Brazil develops as regards the second sentence of Article III:5 is based on paragraph 5 of the Ad Article to Article III:5. Brazil argues that given that the production steps requirements are not inconsistent with the first sentence, they are also automatically not inconsistent with the second sentence.\(^{245}\)

367. This argument cannot be accepted. It is up to Brazil that invokes the defence contained in that paragraph to demonstrate that all the individual products subject to the Informatics programme (as well as the PADIS, PTVD and Digital Inclusion programmes) are produced domestically in substantial quantities, and Brazil does not provide any evidence in that respect.

368. That burden of proof cannot be put on the European Union. First, from a legal perspective it is a general principle that a party affirming a fact should demonstrate it (\textit{Onus probandi incumbit ei qui dicit, non ei qui negat} or \textit{Onus probandi est qui dixit}).\(^{246}\)

369. Second, from a logical and practical perspective, Brazil is better placed to demonstrate that fact because no other WTO Member can have a better knowledge than Brazil of the products that are produced in Brazil in substantial quantities.

370. Third, accepting the argument of Brazil, without requiring it to demonstrate its assertion, would annihilate the scope of the second sentence of Article III:5. In practice the second sentence of that article would not apply as soon as the defendant party invokes the Ad Article.

\(^{245}\) Brazil's first written submission, para. 285.

\(^{246}\) This principle is generally applicable in Brazil, see http://www.jusbrasil.com.br/topicos/2307286/onus-probandi-est-qui-dixit.
371. Moreover, Brazil affirms that the Informatics programme is not designed, structured or applied so as to afford protection to domestic production and makes reference to section 5.1.2.3.3 of its first written submission.

372. The only paragraphs of that section that seem to be relevant in this context are paragraph 262, which claims that the fact that the Informatics programme has never been applied in a manner to afford protection is demonstrated by the increasing trade deficit registered by Brazil in the ICT sector, paragraph 263 that admits that the Informatics programme is designed to promote investment in Brazil and paragraph 264 that says that the data about sourcing decisions of Brazilian ICT producers and the import tariffs applied by Brazil show that the Informatics programme has no protective objective.

373. However, these arguments have already been discussed before. The tariff level, the sourcing decisions of Brazilian companies and Brazil trade deficit in the ICT sector has nothing to do with the design, architecture and revealing structure of the Informatics programme.

374. In summary, Brazil makes neither an effort to demonstrate that all the products subject to the regulations are produced domestically, nor does it bring any evidence/argument concerning the design, architecture and revealing structure of the Informatics programme that could disprove the EU claim under the second sentence of Article III:5. Of course, the same holds true for the other programmes concerning ICT products challenged in the present dispute.

375. In conclusion, the production steps requirements contained in the Informatics programme are quantitative regulation that fall within the purview of the second sentence of Article III:5.

4.1.2.2.4 Conclusions on Article III:5

376. In sum, the European Union maintains its claims under Article III:5 of the GATT 1994, first and second sentence, that the processing requirements included in the Informatics programme are inconsistent with these provisions.

4.1.2.3 TRIMs Agreement

4.1.2.3.1 EU's claims
377. In section 6.2.2.4 of its first written submission, the European Union has argued that the Informatics programme amounts to a trade-related investment measure that is inconsistent with Article 2.1 of the TRIMs Agreement, in conjunction with Article 2.2 and with paragraph 1(a) of the Agreement’s Illustrative List. Indeed, requiring, under the terms of the PPBs, the purchase or use of inputs of Brazilian origin or from Brazilian sources in order to benefit from the exemptions or reductions, squarely falls under the list of examples under paragraph 1(a) of the Annex to the TRIMs Agreement of measures that are inconsistent with Article III:4 of the GATT 1994.

4.1.2.3.2  Brazil’s arguments

378. Brazil argues that, whilst the Informatics programme is an investment measure, it is not a trade-related measure, since it deals with R&D and production and not trade in goods. The same arguments are raised by Brazil in connection with the other programmes concerning ICT products challenged in the present dispute, including the admission that those programmes are investment measures.

379. Moreover, with regard to intermediate products Brazil argues that the Informatics programme does not result in any tax benefit for those products. With regard to final products it argues that the fiscal benefits are not based on origin, and they constitute payments paid exclusively to domestic producers under Article III:8(b) of the GATT 1994.\footnote{Brazil's first written submission, paras 286-289.}

4.1.2.3.3  EU’s rebuttal

380. The European Union underlines that the arguments raised by Brazil under the TRIMs Agreement are in essence a restatement of general arguments already dealt with.

381. The European Union does not think it necessary to repeat the demonstration that those arguments are unfounded. It limits itself to recall that it has demonstrated in its first written submission that many PPBs contain local content requirements expressed in terms of minimum percentage of local parts or components (sometimes produced in accordance with their own PPBs) that the accredited
company must source in Brazil (purchase or manufacture itself) in the production of ICT products in order for the latter products to be incentivized in accordance to the Informatics programme and that the domestic content requirements included in the Informatics programme are undoubtedly "related to trade in goods", as they affect ICT products marketed in Brazil. In this sense, the panel in Indonesia – Autos found that domestic content requirements are "necessarily … 'trade-related' because such requirements, by definition, always favour the use of domestic products over imported products, and therefore affect trade". 248

382. Moreover, it is telling to observe that Brazil has chosen not to address in its first written submission the European Union's claim regarding paragraph 1(a) of the Annex to the TRIMs Agreement, which specifically address the requirement under the Informatics programme challenged by the European Union.

383. To the extent that Brazil has raised no argument to rebut the European Union claim under that Annex, the Panel should conclude that the said claim is well founded.

4.1.2.3.4 Conclusions on the TRIMS Agreement

384. In sum, the European Union considers that Brazil has failed to rebut the EU’s claims under the TRIMs Agreement.

4.1.2.4 Article 3(1)(b) of the SCM Agreement

4.1.2.4.1 EU’s claims

385. In section 6.2.2.5.1 of its first written submission, the European Union submits that the Informatics programme, as embodied and developed in the relevant legal instruments and also as applied by the relevant Brazilian authorities, is inconsistent with Brazil's obligations under the SCM Agreement, because it provides advantages that are subsidies within the meaning of Article 1.1 of the SCM Agreement, and which are inconsistent with Articles 3.1(b) and 3.2 of the SCM Agreement because they are contingent upon the use of domestic over imported goods.

4.1.2.4.2 Brazil’s arguments

386. In section 5.1.2.6 of its first written submission, Brazil argues that the Informatics programme includes the payment of subsidies exclusively to domestic producers of final products, in compliance with Article III:8(b) of the GATT 1994. As far as producers of intermediate products covered by the programme are concerned, the programme does not even provide a financial contribution as it is financially neutral. In addition, the requirements associated with the programme relate to R&D investments and production, rather than to products. There is no contingency upon the use of domestic products since there is no contingency upon the use of products at all.

4.1.2.4.3 EU's rebuttal

387. While Brazil admits that the Informatics programme grants subsidies to producers of ICT products which it considered to be final products, the reminder of its arguments boils down to a restatement of the general arguments already discussed in this submission.

388. Brazil’s argument to the effect that the tax incentives granted to intermediate ICT products by the Informatics programme would be neutral in terms of revenue collected by the government and accordingly would procure no financial advantage to the accredited companies producing those intermediate products, is clearly unfounded.

389. The European Union has demonstrated the unfounded nature of this argument in paragraphs 711-722 of its first written submission, in section 2.2.6 of its opening oral statement, in its reply to questions 10, 42, and 43 of the Panel.

390. The same hold with regard to the argument to the effect that the suspension of IPI on inputs acquired by companies accredited in the Informatics programme provided for by Article 29 §1(c) and 29 §4 of Law 10,637/2002 are a tax administration measure to prevent the accumulation of tax credits by these companies. Brazil argues that those provisions reflect an unwritten general rule according to which all credit accumulating companies (i.e. companies that mainly sell low taxed or exempted products) would be entitled to be exempted from the payment of direct taxes otherwise imposed on their purchases.
391. The European Union has demonstrated that such an unwritten general rule does not exist and it could not exist as a matter of logic as Brazil itself has explained that the general rule is precisely the opposite, i.e. that also companies that mainly sell low taxed or exempted products acquire tax credit that have to be deducted from their remaining tax liabilities or eventually reimbursed as the case may be.\(^{249}\)

392. In reply to the EU’s arguments that the Informatics programme provides for subsidies contingent upon the use of domestic over imported goods, in its first written submission Brazil has argued that the EU did not demonstrate that the production-step requirements under the Informatics programme require directly or indirectly the use of domestic over imported goods. It has argued that accredited companies are able to comply with the R&D requirement and the requirement to comply with the PPBs without a substantial use of Brazilian goods.\(^{250}\)

393. Again Brazil seems to hope that the Panel will forget the clear terms of many PPBs which require accredited companies to incorporate in their products intermediate products produced in Brazil, either by the same accredited companies or other companies, possibly in compliance with the PPBs for those intermediate products.

394. In this connection it is also important to recall the developments of the European Union in section 2.2.7 of its opening oral statement in which it has explained that it is not arguing that all production subsidies are necessarily contingent upon the use of domestic over imported goods in the sense of Article 3.1(b) of the SCM Agreement. However, in the present case Brazil grants subsidies in relation to the production of a final product contingent upon carrying out certain production steps of that product in Brazil. In turn those steps result in a requirement that intermediate products are produced in Brazil. Even if a significant amount of input product could be imported, the resulting intermediary products as well as the final products necessarily are made in Brazil. In other words, the EU argues that if the resulting final product can only be subsidised if a given intermediate product is sourced locally or made in Brazil by the recipient, that is if the input is a

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\(^{249}\) For the sake of conciseness the European Union refers to its response to the Panel’s question to the Parties no. 41.

\(^{250}\) Brazil's first written submission, paras 299-304.
"domestic" good and not an imported good, then the subsidy must be considered as contingent upon the use of domestic over imported products.

395. Brazil moreover has argued that in Canada – Autos, the Appellate Body clarified that even a measure containing, among others, a requirement to use domestic over imported goods would not be a prohibited subsidy if the subsidy could be received by complying with other requirements.\(^{251}\)

396. In this connection the European Union recalls that according to the text of Article 3.1(b) of the SCM Agreement, the condition to use domestic over imported goods can be one among several conditions imposed to obtain the subsidy. Thus, for instance, if a government requires compliance with some emission requirements and/or local content requirements to obtain a subsidy, such a subsidy would be contingent "whether solely or as one of several other conditions" upon the use of domestic over imported goods. In other terms, the requirement to use domestic over imported goods must not be the only requirement, nor must it be a requirement that must always be fulfilled to receive the subsidy. If it were sufficient to provide for an alternative way to obtain the subsidy (be it theoretical or not) to avoid the application of Article 3.1(b) of the SCM Agreement, that provision would in practice be deprived of any effect.

397. Brazil reading of paragraph 130 of the Appellate Body in Canada – Autos is not correct. That paragraph 130 is contained in the section of the report where the Appellate Body discusses the question whether the measure at issue in that case was contingent "in law" upon the use of domestic over imported goods. The Appellate Body rejected the Panel’s reasoning that under no circumstances any value added requirement can result in a finding of contingency “in law” upon the use of domestic over imported product. The Appellate Body explained that contingency in law could result also from the level of the value added requirement set out in the measure at issue in that case.

398. Then the Appellate Body criticised the panel for failing “…to examine fully the legal instruments at issue here and their implications for individual manufacturers…” and concluded that this “vitiates [the panel] conclusion that the

\(^{251}\) Appellate Body Report, Canada – Autos, para. 130.
CVA requirements do not make the import duty exemption contingent "in law" upon the use of domestic over imported goods … 252

399. At the same time, the Appellate Body recognised that Article 3.1(b) of the SCM Agreement also extends to subsidies contingent "in fact" upon the use of domestic over imported goods253. Unfortunately, the Appellate Body could not complete the analysis neither on the contingency in law nor on the contingency in fact.254

400. A subsequent Appellate Body report casts light on how contingency on the use of domestic over imported good "whether solely or as one of several other conditions" should be interpreted in the context of Article 3.1(b) of the SCM Agreement.

401. In assessing a similar type of contingency in the context of Article III:4 of the GATT 1994 the Appellate Body found in US – FSC (Article 21.5) that:

Turning to the fair market value rule, we recall that, under the ETI measure, a taxpayer producing property in the United States will be eligible to obtain a tax exemption in respect of income derived from an export-sale of such property on the condition that, \textit{inter alia}, not more than 50 percent of the fair market value of the product is attributable to articles produced outside the United States or to direct costs for labour performed outside the United States …

Any taxpayer that seeks to obtain a tax exemption under the ETI measure must ensure that, in the manufacture of qualifying property, it does not "use" imported input products, whose value comprises more than 50 percent of the fair market value of the end-product. The fair market value rule, thus, places an express maximum limit on the extent to which the value of qualifying property can be attributable to imported input products. A manufacturer's use of imported input products always counts against the 50 percent ceiling in the fair market value rule, while in contrast, the same manufacturer's use of like domestic input products has no such negative implication. Manufacturers wishing to obtain the ETI tax exemption are not restricted, in any way, on the use they make of domestic inputs. The fair market value rule, therefore, influences the manufacturer's choice between like imported and domestic input products if it wishes to obtain the tax exemption under the ETI measure.255

In our view, the above conclusion is not nullified by the fact that the fair market value rule will not give rise to less favourable treatment for like imported products in each and every case.

There may well be, as the United States maintains, property which does not require extensive material and labour inputs such that the fair market value rule would not, in those cases, bear upon the input choices manufacturers make. Even so, the fact remains that in an indefinite number of other cases, the fair market value rule operates, by its terms, as a significant constraint upon the use of imported input products. We are not entitled to disregard that fact.\(^\text{256}\)

402. The European Union submits that *mutatis mutandis* the same logic should apply when the Panel assess whether the Informatics programme constitutes a prohibited subsidy within the meaning of purpose of Article 3.1(b) of the SCM Agreement.

403. In addition, in its closing statement of the first substantive meeting with the Parties, Brazil argues that several products produced according to a PPB are not domestic within the meaning of Article 3.1(b) of the SCM Agreement. According to Brazil, the discipline contained in Article 3.1(b) requires a definition of “domestic” that makes economic sense, whereas the position of the EU according to which “domestic product” is any product that “comes into existence within the territory of the country concerned”\(^\text{257}\) would not make economic sense according to Brazil.

404. Brazil argues that in order for a product to be “domestic” for the purposes of Article 3.1(b) of the SCM Agreement a substantial percentage of value of the product must have been added in the territory of the concerned country. However, Brazil fails to provide any objective criteria that would allow to establish when a product is domestic and when it is not. It merely makes the point that when the value of imported input is more that 90% of the product, than the product should not be domestic for the purposes of Article 3.1(b) of the SCM Agreement.\(^\text{258}\)

405. The European Union has already recalled that the very function of the PPB, in the words of Brazil, is to identify those products that are effectively produced in

\(^{256}\) Appellate Body Report, *US – FSC (Article 21.5)*, para 221 (emphasis added).

\(^{257}\) See in this connection the EU’s response to the Panel’s question to the Parties no. 3.

\(^{258}\) Brazil’s closing oral statement, paras 5-10.
Brazil. Hence, a product that is made in compliance with a PPB is a product manufactured in Brazil and necessarily a domestic product.

406. However, Brazil postulates the existence of products that would be effectively produced in Brazil, that have not been imported in Brazil and still should not be considered as “domestic goods” for the purposes of Article 3.1(b) of the SCM Agreement, because a given percentage of their production costs is constituted by imported input. However, Brazil fails to clarify what this percentage should be.

407. This position finds no support in the text, structure or objective of that provision, nor has Brazil ever pointed to any case law that could support this reading.

408. The position of Brazil is simply absurd. An ICT component that comes into existence in Brazil (for instance because imported inputs are assembled in Brazil in compliance with the PPB in order to obtain a new product) and which Brazil itself considers as effectively produced in Brazil is necessarily a domestic good under any latitude, and notably for the purpose of Article 3.1(b) of the SCM Agreement.

409. Indeed, the ultimate purpose of this provision is to prevent the use of subsidies in order to influence producers sourcing decision between imported goods and goods that were produced domestically, regardless of the importance of the domestic production. Article 3.1(b) of the SCM Agreement makes no distinction as to the degree of domestic production or processing that must characterise a “domestic good”, nor makes any reference to a minimum domestic added value that a good must contain in order to be domestic. This is not an oversight, of the drafters of the SCM Agreement, but it can be explained by very good reasons.

410. In summary, any good that is not imported but that was produced domestically or that came into existence as a result of a manufacturing or processing operation that took place on the domestic market, must be considered as a domestic good for the purposes of Article 3.1(b) of the SCM Agreement. Indeed, this provision does not contemplate a third category of products which are non-imported but are also non-domestic because they are made in prevalence of imported material.

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259 Article 16 of Decree 5,096/2006 (Exhibit EU/JE-7) reads as follows “The Basic Production Process – PPB is a minimum set of operations performed at a manufacturing facility that characterizes the actual industrialization of a given product”. See also Brazil's first written submission, para. 128.
411. Furthermore, Brazil’s position would lead to a high degree of legal uncertainty. It would mean that a subsidy would become a prohibited subsidy or cease to be one depending on the amount of imported input incorporated in the intermediate product used by the subsidy beneficiary. So, for instance, if during a given period an ICT producer used printed circuits or other components assembled in Brazil in the percentage required by the PPB, but made prevalently of imported materials, that would not entail a subsidy contingent upon the use of domestic goods. If in another period, it were to use printed circuits or other components assembled in Brazil in the percentage required by the PPB, but made prevalently of materials produced in Brazil, suddenly it will be receiving a prohibited subsidy.

412. Furthermore, since according to Brazil it is not possible to define beforehand what is the percentage of domestic added value that makes a good domestic for the purpose of Article 3.1(b) of the SCM Agreement, the producer of the ICT product would not be in a position to know when it is receiving a prohibited subsidy.

413. Also the Member concerned could not know when it is granting a prohibited subsidy and when it is not, both because the threshold is not defined and because the proportion of imported materials in the printed circuits or other component may change over time.

414. In summary, it is clear that Brazil defends a position that has not legal basis, it would lead to unworkable results and it is in conflict with simple common sense considerations.

415. It follows, that any time a PPB require the use of intermediate products produced in Brazil (be it in compliance with a relevant PPB or not) by the accredited company or by a third parties, as a condition to benefit from a subsidy in the form of an indirect tax reduction or exemption, then the Informatics programme grants a subsidy contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the SCM Agreement.

416. The European Union would also like to repeat that conditioning the receipt of a subsidy on defined domestic production steps may require the use of domestic over imported goods, depending on the level of detail of those production steps requirements or, in other terms, on the way they are described. In summary, if the level of details is such that the production steps results in a requirement to use
domestic components, produced either by the subsidy beneficiary or by a third party, then the subsidy must be considered as contingent on the use of domestic over imported goods, because the purchase and use of imported goods would not allow the company to receive the subsidy.

417. By conditioning the granting of a subsidy to make (and thus use) an input locally to be incorporated later into the final product, the recipient is not free to source those inputs from elsewhere (i.e. through imports), thereby altering the competitive relationship between domestic and imported products in the market. In this sense, the subsidy would be contingent upon the use of domestic (inputs) over imported (inputs).

418. This is what occurs in the present case where the PPBs expressly require that the producer of the final product also produces the inputs or intermediate products (or uses intermediate products produced in Brazil) to be incorporated into the final product.

419. If a Member would be allowed to escape the discipline of Article 3.1(b) of the SCM Agreement by simply disguising a requirement to use domestic over imported goods into a production requirement (i.e. a subsidy for the production of bicycle is contingent on the use of domestically produced wheels, manufactured by the same subsidy beneficiary or a third party), it would become all too easy to circumvent that Article.

4.1.2.4.4 EU’s comments on Brazil’s responses to the Panel’s questions

420. In its response to the last part of the Panel’s question to the Parties no. 2, Brazil argues that the Appellate Body in *Canada – Autos* concluded that contingency prohibited under Article 3.1(b) of the SCM Agreement “must be demonstrated not only “in law”, "on the basis of the words of the relevant legislation, regulation or other legal instrument", but also “in fact”.

421. However, this is clearly not what the Appellate Body found in that case. As already mentioned the Appellate body found that a subsidy could be contingent on the use of domestic over imported good in law or in fact. Sure, if a claim is made

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260 Brazil’s responses to the Panel’s questions to the Parties, p. 5.
that the contingency is *de facto* a panel should look into the totality of facts to reach such conclusion. However, in that cases the Appellate Body did not say that in a *de jure* situation panels need to go beyond the measures at issue to confirm that such a measure expressly or by necessary implication requires the use of domestic over imported goods.

422. In its response to the Panel’s question to the Parties no. 3 Brazil asserts that there is no general rule establishing the criteria used by each Member to determine whether a product is domestic under Article 3.1(b). Brazil therefore seems to suggest that it is up to each Member to determine whether a product is domestic under Article 3.1 (b), e.g. by reference to what makes economic sense for the country concerned. But of course a Member will never consider a product to be domestic for the purposes of that provision so as to avoid its application altogether.

423. Then in the second paragraph of that response, Brazil seems to contradict the first assertion and appears to share the European Union’s concern that the determination of whether a product is “domestic” under Article 3.1(b) of the SCM Agreement must be based on uniform criteria for all Members. It states that *it is not legally sound* to make the distinction between domestic and imported goods depending on the rules of origin of each country because those rules may vary from one Member to another.

424. Again, in disagreement with the European Union, Brazil adds that *a product could [not] be considered "domestic" under Article 3.1(b) of the SCM Agreement in the location where it was merely assembled (i.e., where it came into existence), even if the product was composed only of imported inputs and then it repeats that it is not possible, nor advisable, to determine in abstract a fixed percentage of value added in a certain country for the characterization of a product as “domestic”. Brazil underlines that the definition of "domestic" cannot depend on each Member, but at the same time provides no uniform rule that could give a general guidance on where draw the difference between domestic and imported. It argues that it should depend on the amount of domestic value added to each product, but it is unable to suggest any meaningful threshold

425. Those contradictory statements reflect the confused and groundless nature of Brazil’s position.
426. Hence, contrary to what Brazil argues, for elementary reasons of legal certainty and uniform treatment of all Members, it is advisable and necessary to provide a demarcation line between domestic and imported which is as clear cut as possible. The approach advocated by the European Union provides such a line.

427. In its response to the Panel’s question to the Parties no. 2, Brazil underlines that “there is no legal prohibition to requirements related to the performance of a minimum set of industrial operations (production steps) when they do not impose discrimination by origin on the inputs or products involved”. The European Union shares this point of view and all along this case it has demonstrated that the programmes in question define the production steps in such a way so as to impose or incentivise the use of domestic products instead of imported like products.

428. In its response to the Panel’s question to the Parties no. 21, Brazil keeps on arguing that there is a general rule according to which all credit accumulating companies should be exempted from paying indirect taxes on their purchases. However, Brazil keeps on failing to point to any legal provision that would demonstrate the existence of such a general rule. Therefore, if ever this rule would exist – quod non – it would be necessarily an unwritten rule.

429. At the same time in the first paragraph of that response Brazil underlines as well that “in the normal course of business” companies accrue tax credit on their purchases which then can be deducted from other tax liabilities or reimbursed. As mentioned in the European Union responses to the Panel’s questions, if the norm is accrual of tax credits and subsequent deduction or reimbursement, tax suspension of exemption must be, as a matter of logic, the exception.

430. Brazil further argues that it would be impossible to predict as a general rule and for all situations when a company that accumulates credits becomes a structurally credit accumulating company. However, the European Union does not understand why this would be impossible.

431. Brazil could easily define the notion of “structurally credit accumulating company” according to the general criteria that it may consider most appropriate (e.g. the level by which tax credits exceed tax liabilities in absolute or proportional

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261 Brazil’s responses to the Panel’s questions to the Parties, p. 4.
terms, or the period or frequency of such excess taking place). Instead, it argues that when companies that tend to accumulate tax credit request for the suspension of indirect taxes, then they are included in this mysterious general measure of which no written trace can be found. It is striking that such an elaborated and complex fiscal system as the Brazilian, contains neither any provision setting out when a company can request for the inclusion nor how the procedure for making such a request is regulated.

432. Finally, Brazil argues that all tax credit accumulating companies are included in the exemption or suspension of the indirect taxes on their purchases. However, the example it provides at page 18 of its response to the Panel's question confirm that companies benefitting of the suspension/exemption of the IPI are not necessarily those benefitting of the suspension/exemption of the PIS/PASEP and COFINS. However, the sale of products which are exempted from indirect taxes or subject to a low rate should logically lead to a situation of tax credit accumulation for PIS/PASEP, COFINS and IPI.

433. In its response to the Panel’s question to the Parties no. 22, Brazil explains that the reimbursement of tax credit that cannot be compensated is a lengthy and time consuming procedure that can take years. That confirms once again that the advantage received by the companies that benefit from the exemption/suspension of indirect taxes on their purchases is very significant both in terms of positive cash flow as well as in terms of avoidance of administrative burdens.

434. In its response to Panel’s question to the Parties no. 30, Brazil comes back on the slides contained in Exhibit BRA-109 to demonstrate that tax exemption/suspension of intermediate product is neutral both in terms of revenue collection and in terms of competitive advantage granted to the product in the market place.

435. In commenting slides 3 and 4 Brazil confirms that its simulation works only to the extent that the IPI tax rate is the same “through all the stages of production”. However, it is constant (and Brazil recalls it in its response to Panel’s question to the Parties no. 21) that the Government has the authority to change the IPI rate applicable to each product and such changes are not uncommon.

436. Slide 3 purports to describe the situation where none of the challenged programme applies. Brazil argues that:
When “Company A” sells inputs to “Company B” for R$ 100.00, the IPI tax due is of R$ 10.00. “Company B” pays that duty and accrues a tax credit of R$ 10.00. When “Company B” sells its intermediate products to “Company C” for R$ 300.00, the original IPI tax of R$ 30.00 is deducted of the tax credit of R$ 10.00 accrued. This means that, when “Company C” purchases intermediate products from “Company B”, it pays an IPI tax duty of R$ 20.00. “Company C” accrues, however, a tax credit of R$ 30.00, which corresponds to the sum of IPI tax duty paid by “Company B” and by “Company C”. Consequently, when “Company C” sells its products to the final customer for R$ 700.00, the original IPI tax of R$ 70.00 will be deducted of the tax credit of R$ 30.00 accrued, resulting in an IPI tax duty of R$ 40.00, which is paid by the final customer in the form of cost of purchase (emphasis added).

437. This explanation is confusing and simplistic. It is obvious that when C purchases intermediate products from B it cannot pay a tax duty of 20 and gain a credit of 30.

438. Indeed, each company pays the IPI due on the price of the intermediate products it purchases. Assuming a 10% rate, if B buys for 100, it pays 10. If C buys for 300, it pays 30. B will have an IPI credit of 10 that eventually it will compensate with its other tax liabilities or ask for reimbursement. C will have an IPI credit of 30 that eventually it will compensate with its other tax liabilities or ask for reimbursement. In turn, if the price of the final product is 700, the final customer will not pay 40, but of course 70 (i.e. 10% of 700). It is also true that at the end (i.e. when all the IPI credits are compensated or reimbursed) the total IPI collected by the State will be 70 nominally, because from the total imposition of 110 a credit of 10 will be compensated or reimbursed to B and a credit of 30 will be compensated or reimbursed to C.

439. If this situation is compared to the situation in slide 4 where only the final customer is taxed because IPI is suspended on the purchase of intermediate products, it is clear that company B and C do not have to make any IPI payment when they purchase the input. They are therefore better off in terms of available liquidity. Also in this case at the end the State collects 70, but that happens only at the end of the production chain. The State gives up the availability of the sums anticipated by B and C when they made their purchases in the normal situation of slide 3, over the period that goes from the payment of that IPI amount to the compensation/reimbursement of the credit.
In slides 7 and 8 Brazil examines the scenario where B is accredited under the PADIS but C is under no regime. Brazil argues that:

In that example, “Company B” benefits from an IPI duty suspension when it purchases inputs and from an IPI duty exemption under the PADIS when it sells its intermediate products to “Company C”. Thus, only the sale of “Company C” to the final customer will incur in the payment of the IPI tax. Since the sale was of R$ 700.00, the IPI tax due is R$ 70.00. In addition, since the previous stages of the added value chain did not pay any IPI tax, there are no tax credits to be used to offset the R$ 70.00 tax that is to be paid by the final customer. Therefore, in this scenario it is possible to verify that the final tax burden incurred is the same as that observed in the previous scenarios and was not affected by PADIS.

This explanation is misleading.

Brazil starts from the premise that B benefits from IPI suspension when it purchases inputs and IPI exemption when it sells its products because it is a PADIS beneficiary. However, it sells its products to company C for the same price as in the previous slides. It is obvious that, if a company benefits of those tax advantages, it will be capable of offering lower prices for its products. Then the prices of the product sold by B to C would be lower than 300 (which was the price in including IPI in the previous example). As a result also the prices of the final product sold by C to the final customer can be lower. As a consequence, the IPI collected by the State is also lower, as it represents a percentage of the price.

In slides 9 and 10 Brazil presents an example of how the debit/credit system operates in a scenario where the Informatics Law and the PADIS are applicable, where B is accredited under the PADIS and C under the Informatics programme. The total IPI due in this case will be 14, even if the transaction prices are assumed to be the same as in all the previous slides. Brazil pretends to compare this situation with that described in slides 11 and 12 where no companies in the chain of production are accredited under PADIS and C is accredited under the Informatics programme. In this connection Brazil states:
Company C” benefits from an IPI duty suspension when it purchases intermediate products and from an IPI duty reduction of 80% under the Informatics Law when it sells its product to the final customer. Accordingly, the IPI tax is regularly paid by “Company B” when it purchases inputs from “Company A” and the amount paid of R$ 10.00 is accrued as tax credit. Since the IPI tax is suspended on the transaction between “Company B” and “Company C”, the tax credit accrued can be used to offset the IPI tax due on other operations of “Company B”. This tax credit cannot be used by one of the other companies that integrate the added value chain. In turn, the sale of R$ 700.00 of “Company C”, that benefits from an IPI duty reduction of 80% under the Informatics Law, will incur in an IPI tax of R$ 14.00. Therefore, the only effect of the Informatics Law on the added value chain was of reducing the tax burden of the producer of the final good. Here the tax burden was the same as in the previous example.

444. However, also this description is incorrect.

445. In slides 9 and 10 Brazil assumes that the price of the product sold by A to B (B is a PADIS beneficiary) is 100 and this price includes no IPI as PADIS beneficiaries do not pay IPI on their purchases. In slides 11 and 12 B still pays 100 for the same product sold by A, but that includes the payment of IPI amounting to 10 (indeed B gets a credit of the same amount). According to Brazil, therefore, the price of two identical products with or without IPI should be the same. On top of being counterintuitive because the IPI is calculated as a percentage of the price, that does not make much sense also because price competition in the ICT market is fierce and any indirect tax advantage is likely to be reflected on prices.

446. In other words, in order to show that the total IPI cashed in by the State is the same with or without PADIS, in slide 9 and 10 Brazil has increased the IPI-free price of the product sold by A to B to the same level of the product sold by A to B in slides 11 and 12, which instead includes an IPI of 10. Now, if B does not need to pay IPI on its inputs (slides 9 and 10) it will have lower production costs and it will be able to sell its products at a lower price to B (notably lower than 100 which is the price of the same product with 10 of IPI in slide 11 and 12). B in turn will also have lower costs and will also be able to offer lower prices in its sales to C and so on and so forth. It follows that the transactions values in slides 9 and 10 would be lower than those in slide 11 and 12 and that the total IPI collected by the State would be less when PADIS and Informatics programme apply cumulatively than when only the latter programme applies.
447. In sum, Brazil's response and those slides do not portray a fair reflection of how the tax system would operate and thus fails to show the actual amounts that the State foregoes as a result of suspending/exempting taxes which are normally due along the production chain.

448. In its response to the Panel’s question to the Parties no. 32, Brazil argues that it is possible to comply with those PPBs requiring that products be manufactured in Brazil, by exclusively using imports in the manufacture or assembly of such products.

449. The European Union argues instead that it is not. PPB-compliant products must contain intermediate products produced in Brazil by the accredited companies and/or other companies (sometimes in compliance with a PPB). A production step requirement which takes the form of inputs manufactured by the local producer as part of the processing operations excludes the possibility of importing such inputs. A production step requirement that takes the form of a minimum percentage of components that must be produced in Brazil limits the possibility of using the same imported component. It is telling that Brazil does not provide a single example of a product produced in Brazil entirely made of imported intermediate product.

4.1.2.4.5 Conclusions on Article 3(1)(b) of the SCM Agreement

450. In sum, the European Union maintains that the Informatics programme, insofar as requires the use of domestic over imported products as explained before, is inconsistent with Articles 3.1(b) and 3.2 of the SCM Agreement.

4.1.2.5 Conclusions

451. In light of the foregoing, the European Union considers that Brazil has failed to rebut the EU’s claims that the Informatics programme is inconsistent with the GATT 1994, the TRIMs Agreement and the SCM Agreement.

4.2. PADIS PROGRAMME

452. With regard to the PADIS programme, Brazil essentially incorporates its previous legal arguments developed with reference to the Informatics programme. For the sake of conciseness the European Union will therefore focus on some factual
issues that characterise this tax incentive programme and will underline a few specific points. For the rest, all of the legal arguments developed by the European Union in its first written submission, in its opening oral statement and in its replies to the Panel's questions, with regard to the PADIS programme should be considered as incorporated in this submission. By the same token, the general legal arguments developed above as well as those concerning the Informatics programme apply mutatis mutandis to the PADIS programme.

453. Brazil recalls that the PADIS programme was set up to promote the development of the semiconductor industry in Brazil, that companies accredited under PADIS are obliged to make R&D investments in the specific sector targeted by the PADIS programme (semiconductors, display and relative components, and software), that the programme is related to a mix of different development, production and service activities, and that, in keeping with its overall objective (development of semiconductor industry), in essence the PADIS programme provides tax advantages to domestic semiconductors and displays producers.

454. Brazil also underlines that PADIS does not refer to PPBs but nevertheless defines similar R&D and production steps requirements. Brazil however denies that those requirements pertain to products, but exclusively to production and therefore it argues that they should fall outside the scope of Article III.

455. For the reasons already explained, these are not general production requirements that are unrelated to specific products. They relate to the production of certain specified goods, which are listed in Annex I of Decree 6,233/2007, and which

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262 Brazil's first written submission, para. 316.
263 Brazil's first written submission, para. 319.
264 Brazil's first written submission, para. 318.
265 Brazil's first written submission, paras 327, 328, 329, 330.
266 Brazil's first written submission, para. 329. PADIS provides for the adoption of PPBs for producers of strategic inputs and equipment, but apparently there are no companies accredited for the production of those products yet.
267 Such would be for instance an obligation to use a certain percentage of green energy in any production activity, or requirements about emission of pollutants in the context of manufacturing activities and so on and so forth.
268 Exhibit EU/JE-73. See also Brazil's first written submission, para. 325.
the decree itself qualifies as “final products”. Only the final products that comply with those requirements are eligible under the PADIS programme.

456. Moreover, just as like the production steps requirements defined in the PPBs, the production steps requirements contained in PADIS are designed in such a way so as to incentivise the use of domestic over like imported goods.269

457. For instance, in the case of semiconductors, sub-paragraph I of Article 2 of Law 11,484/2007 requires that any of the following activities be carried out by accredited companies in Brazil: (i) concept, development and design (design); (ii) diffusion or physical-chemical processing; or (iii) cutting, encapsulation and testing. All the activities listed within each sub-heading must be carried out by the entity in question in order to qualify. Hence, if a company only deals with the concept (but does not engage in the development and design of the semiconductor) in Brazil, or if a company does not cut the wafer but encapsulates the chips and tests them in Brazil, such a company will not qualify under the programme. Thus, for instance if a company imports a wafer that was already cut into individual chips, the use of such an intermediate product will not allow the final semiconductor to benefit from the PADIS programme. In other words, PADIS incentivises the use of semiconductors cut, encapsulated, tested and in Brazil, to the detriment of semiconductors that are produced abroad (for instance they are cut and encapsulated abroad and only tested in Brazil).

458. In the case of displays, sub-paragraph II of Article 2 as well as Article 4 §2 of Law 11,484/2007 require that either the concept, development and design (design) is conducted in Brazil, or that the photosensitive, photo or electroluminescent elements and light emitting diodes must be manufactured in Brazil. Thus, if those elements and/or diodes are imported (as opposed to source locally), the final product will not benefit from the benefits under the PADIS programme.270

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269 EU’s first written submission, paras 828, 829, 830, 873 and 874.

270 For the sake of clarity, the European Union notes that, the fact that a company importing those elements and diodes may fall under the programme if it also conducts the concept, development and design of the semiconductor in Brazil does not mean that there is no contingency in the sense of Article 3.1(b) of the SCM Agreement. To recall, that provision speaks about conditioning the subsidy upon the use of domestic over imported products, "whether solely or as one of several other conditions". This may cover the situation where a subsidy is simultaneously subject to two or more cumulative conditions. But it may as well apply to the situation where a subsidy is subject to two or
459. It is also important to keep in mind that like for the Informatics programme also the R&D investment requirement of the PADIS programme provides for a deduction of the cost of acquiring incentivised inputs.\textsuperscript{271}

460. Likewise, it is worthy to recall that Brazil acknowledges that PADIS provides subsidies to domestic producers through Corporate Income Tax exemption in order to offset R&D investment and production-step requirements\textsuperscript{272} as well as through an exemption from CIDE and custom duties on purchases by the accredited companies.\textsuperscript{273}

461. Brazil seems to suggest that the CIDE is not at issue in this dispute.\textsuperscript{274} Whilst the European Union's challenge mainly relates to indirect taxes (and in particular the IPI tax and the PIS/PASEP/CONFINS and PIS/PASEP/COFINS-Importação contributions), the European Union has also mentioned import duties and one direct tax (CIDE). Even if there are other tax advantages which accredited companies may receive through the programmes at issue, the European Union does not take issue in these proceedings with them. However, it is clear that the import duties and the CIDE exemption enjoyed by the PADIS beneficiaries have always been within the scope of this dispute.\textsuperscript{275}

462. In light of the above, the European Union maintains that the PADIS programme is inconsistent with the GATT 1994, the TRIMs Agreement and the SCM Agreement.

\textsuperscript{271} EU’s opening oral statement, section 4.5 and EU’s responses to the Panel’s questions to the Parties, para. 26.

\textsuperscript{272} Brazil's first written submission, para. 327.

\textsuperscript{273} Brazil's first written submission, para. 330.

\textsuperscript{274} Brazil's first written submission, para. 331.

\textsuperscript{275} The European Union understands that Brazil is not arguing that the CIDE exemption in the context of the PADIS programme (as another tax incentive) is outside the Panel's terms of reference.
4.3. **PATVD PROGRAMME**

463. With regard to PATVD programme Brazil essentially incorporates its previous legal arguments developed with reference to the Informatics programme. However, with regard to this programme, Brazil argues that it should be considered as justified under Article XX(a) of the GATT 1994.

464. For the sake of conciseness, the European Union will therefore focus on Brazil's legal defence, while not repeating points already made. In this respect, all of the legal arguments developed by the European Union in its first written submission, in its opening oral statement and in its replies to the Panel questions, with regard to the PATVD programme should be considered as incorporated into this submission. By the same token, the general legal arguments developed above as well as those concerning the Informatics programme apply *mutatis mutandis* to the PATVD programme.

4.3.1. EU's rebuttal of Brazil's Article XX(a) defence

465. Brazil has argued that the PATVD programme contributes to closing the "digital divide" and ultimately to improving people’s standard of living. Since proper and timely access of the Brazilian population to information and education through TV broadcasting is a matter of public interest in Brazil, Brazil claims that the PATVD contributes to the protection of public morals in Brazil, by making sure that Brazil develops an industry capable of producing digital TV transmitters compatible with the technological standard adopted by Brazil. 276

466. The European Union has demonstrated that the PATVD programme is not justified under Article XX(a) of the GATT 1994 because it does not aim to protect Brazil’s public morals but merely aims at pursuing an industrial policy objective of Brazil.

467. First, the public moral objective advanced by Brazil is just a general social and economic development objective which characterise nearly any governmental action and thus it does not constitute standards of right and wrong conduct maintained by or on behalf of a community or nation. 277 Public policy objectives that ultimately refer to the social and economic development of a country (like

276 For example, Brazil's first written submission, paras 408 – 412 and 423.
277 EU's opening oral statement, paras 156-160,
access to information and education) are part and parcel of the objectives pursued by any government that strives to improve the social and economic condition of its community. As such, they do not reflect standards of right and wrong conduct maintained by or on behalf of a community or nation, but rather they underlie almost any governmental action. Therefore, accepting that such general objectives may fall within public morals within the meaning of Article XX, would in practice tantamount to say that Article XX is virtually available to justify any governmental action which is taken in the public interest.

468. In any event, the PATVD programme does not pass the necessity test. It does not make a material contribution to the protection of the alleged public morals objective. The facts confirm that the PATVD has a purely industrial policy objective (develop the production of digital TV transmitters in Brazil in order to prevent import). In any case achieving the alleged public morals objective (promoting access to digital TV) does not require discriminating between domestic and imported digital TV transmitters.278

469. An equivalent (actually a more important) contribution could have been achieved by WTO-consistent, less trade restrictive means.279

470. Finally, the measure at issue does not fulfil the requirements of the chapeau of Article XX also because Brazil did not demonstrate that it does not discriminate between countries where the same conditions prevail.280 Moreover, the PATVD programme constitutes a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail. The domestic content requirements in PATVD (i.e. the requirements that beneficiaries use domestically produced printed circuit board components and electrical and mechanical parts) discriminate between Brazil and other countries, and this discrimination runs counter to the purported objective of PATVD, since it reduces the producers’ flexibility in making component sourcing decisions. In addition, the PATVD programme constitutes a disguised restriction on international trade. Brazil has introduced a

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278 EU’s opening oral statement, paras 161-164, EU’s response to the Panel's question to the Parties no. 5.
279 EU’s opening oral statement, para. 165, EU’s response to the Panel's question to the Parties no. 5.
280 EU’s opening oral statement, paras 167-171.
measure that discriminates on the basis of national origin not only with respect to digital TV equipment, but also with respect to the components of such equipment and it tries *ex post* to justify that measure as a means to increase public access to information and education. However, such discrimination has no connection with the policy objectives that the PATVD is supposed to serve, according to Brazil.

471. It is striking to note that all third parties that have commented on Brazil’s Article XX(a) defence concerning the PATVD programme agree with the complainants that this defence does not hold.

### 4.3.2. EU's comments on Brazil's responses to the Panel's questions

472. In its response to the Panel’s question no. 8, Brazil explains that to be accredited under PATVD producers must commit to invest in R&D and perform activities of development and manufacture of digital television radiofrequency transmitting equipment, pursuant to the corresponding PPB, or, alternatively, meet the criteria for products developed in Brazil, as set forth by Implementing Order n. 950/2006.

473. In this respect the EU would like to clarify that, according to Article 13 of Law 11,484/2007, any Brazilian company that invests "in research and development (R&D), pursuant to Article 17 of this Law, and which engages in development and manufacturing activities of radio frequency signal transmitter equipment for digital television", may become a PATVD beneficiary. Thus, both development and manufacturing activities are required, together with certain investment conditions.

474. This is also confirmed by Article 6 of Decree 6,234/2007, which reads as follows:

> The accreditation referred to in Art. 5 may only be requested by a legal entity investing in research and development (R&D), pursuant to Art. 8, and who engages in development and manufacturing activities of radio frequency signal transmitter equipment for digital television, registered under the NCM code 8525.50.2, listed in Annex I of this Decree.\(^{281}\)

475. More specifically, companies that carry out the following activities are eligible under the PATVD programme:

- invest a minimum percentage of their gross sales revenues in Brazil in research and development projects (approved by the executive branch) in

\(^{281}\) Exhibit EU/JE-85.
the abovementioned digital TV transmission equipment, software and supplies for production of such equipment, and

- are involved in the development and manufacture of digital TV transmitters in accordance with the relevant PPB or meeting the criteria for products developed in Brazil.

476. Only companies that fulfil both conditions can be accredited under the PATVD programme.²⁸²

477. In substance, to be eligible under the PATVD the product must always be manufactured in Brazil either according to the relevant PPB or, when the PPB is not complied with, it must be a product manufactured in Brazil and which qualifies as a “product developed” in Brazil pursuant to Portaria 950/2006.

478. It should also be underlined that in its response to the Panel’s question to the Parties no. 7, Brazil confirms that just after the introduction of the standard for digital TV “it considered necessary to adopt a specific Program that would ensure that the country would have the capacity of developing and manufacturing digital transmitting equipment for the manufacturing of digital television transmitters adapted to the Brazilian Digital Television System”.

479. In other words, Brazil confirms that the objective of the PATVD programme is of an industrial policy nature, i.e. ensuring that digital TV transmitters compatible with the Brazilian standard are produced in Brazil rather than elsewhere. Brazil did not even argue (let alone demonstrate) that equivalent digital TV transmitters could not be imported in Brazil.

480. In its response to Panel's question to the Parties no. 33, Brazil refers to Decree 4,901/2003 (Exhibit BRA-40), establishing the Brazilian System of Digital TV (SBTVD), and Decree 5,820/2006 (Exhibit BRA-41) relating to the implementation of the SBTVD, establishing directives for the transition from the analogue to the digital system of transmission.

481. The European Union notes that Decree 5,820/2006 does not appear to state any specific objective pursued by that measure.

²⁸² Articles 5 and 6 of Decree 6,234/2007 (Exhibit EU/JE-85). In the same sense see Brazil's first written submission, para. 369.
On the other hand, Article 1 of Decree 4,901/2003 states that the Brazilian System of Digital TV (SBTVD) has the purpose of “achieving, among others” a list of eleven objectives ranging from promotion of social inclusion and cultural diversity, creation of a universal network of distance education, encouraging research and development and fostering the expansion of Brazilian technologies and national industry related to information technology and communication to establishing business actions and models for digital television appropriate to the economic reality and business environment of the Country and enhancing the use of the radiofrequency spectrum, and so on.

It is therefore quite clear that with the establishment of the SBTVD the government intended to pursue objectives of very different nature, whilst the PATVD serves the development of a domestic industry in digital transmitting equipment compatible with the SBTVD and not of objectives related to social inclusion through access to digital television, which can be easily attained avoiding discrimination between domestic and imported products and local content requirements.

It follows that the reference to the two decrees is an attempt by Brazil to ex post rationalize its invocation of Article XX(a) of the GATT 1994.

In any event, the objectives mentioned by Decree 4,901/2003 are those that the Brazilian government declared it would pursue by setting the SBTVD as the standard for digital TV transmission in Brazil. They are not the objectives pursued by the PATVD programme that is a fiscal incentive programme for the production of digital TV transmitters in Brazil compliant with the SBTVD. The PATVD programme is manifestly not a constitutive element of the technology standard for digital TV transmission in Brazil.

Moreover, it is clear from Exhibit EU/JE-109 that the PATVD pursues just one objective and that objective is of a purely industrial policy nature. That Interministerial Explanatory Memorandum states that:

The aim of establishing PATVD is to encourage the setting-up in Brazil of companies involved in the development and manufacturing of radio-frequency transmitter equipment for digital television …

the fact that the timeframe for designing and building factories manufacturing transmitters is around 24 months … if the
incentives set out in this proposal are not adopted swiftly, there is a risk that these products will be imported, thus undermining the creation of an industrial base for the sector.

487. In any event, the objectives of promotion of social inclusion and cultural diversity by means of access to digital technology could well be attained through different means, and especially by facilitating the access to imported transmitters.

488. Instead, the PATVD programme provides for tax advantages contingent on the following production steps taking place in Brazil: assembly and soldering of components on printed circuit boards, assembly of electrical and mechanical parts at a basic component level, and integration of the printed circuit boards with the electrical and mechanical parts in the final product, or contingent on meeting the conditions for products “developed in Brazil”. However, Brazil fails to explain why subsidies to domestic producers of digital TV equipment, contingent on the domestic production of inputs for such equipment, or on developing the equipment in Brazil are supposedly necessary to promote proper and timely access to information and education. These contingencies seem to bear no relation whatsoever to the objective of promoting public access to information and education. For example, if the components of printed circuit boards used in digital TV equipment were manufactured in a country other than Brazil, or if the equipment were developed by technicians who are not resident in Brazil or in facilities outside Brazil this would not diminish the Brazilian public’s access to digital TV.

489. In its response to the Panel’s invitation to provide information on the alternative measures suggested by the complainants, and notably on their availability, Brazil replies that the complainants have only alluded to such measures and therefore it is premature for Brazil to comment on this matter.\(^{283}\)

490. In reality, the complainants and third parties have not simply alluded to those alternative measures, but they have provided clear indication of what those measures would be.\(^{284}\) The United States have done the same in their third party written submission.

\(^{283}\) Brazil's response to the Panel’s question to the Parties no. 5.

\(^{284}\) See the references contained to the opening oral statements of the European Union and Japan.
491. Therefore, Brazil was perfectly capable of identifying what these alternative measures are and comment on them. By this waiting tactic Brazil simply deprives the complainants of the possibility to reply in writing already in their second written submissions to the comments that Brazil might have on this matter.

4.3.3. Conclusions

492. In light of the above, the European Union maintains that the PATVD programme is inconsistent with the GATT 1994, the TRIMs Agreement and the SCM Agreement.

4.4. DIGITAL INCLUSION PROGRAMME

4.4.1. EU's rebuttal

493. With regard to Digital Inclusion programme Brazil incorporates its previous legal arguments developed with reference to the Informatics programme. For the sake of conciseness, it appears expedient to refer to the legal arguments developed by the European Union in its first written submission, in its opening oral statement and in its replies to the Panel's questions, which should be considered as incorporated in this submission. By the same token, the general legal arguments developed above as well as those concerning the Informatics programme apply mutatis mutandis to the Digital Inclusion.

494. From a factual viewpoint, it is worth recalling a precision made by Brazil. The Digital Inclusion programme exempts the retail sales of certain consumers electronics produced in Brazil (which fall within the Informatics programme) from the application of PIS/PASEP and COFINS.

495. In this connection, Brazil has clarified that retail sale includes only sales to individual “end customers”, but also to companies and government. Therefore, besides retail sales to private companies, leasing companies, public agencies and entities, foundations and other organizations directly or indirectly controlled by the Public Administration may also benefit from the Digital Inclusion programme. 285

496. That implies that the tax advantages provided for by the Digital Inclusion programme are not only available to the sellers of those products at the retail level,

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285 Brazil's first written submission, para. 475.
but also to the producers (already benefitting from the Informatics programme) that may sell consumers electronics directly to companies or governmental entities.  

4.4.2. EU's comments on Brazil's responses to the Panel's questions

497. In its response to the Panel's question to the Parties no. 1, Brazil seems to suggest that accreditation is also necessary for the Digital Inclusion programme. However, to the knowledge of the European Union there is no accreditation requirement under the Digital Inclusion programme as such. The tax breaks under the Digital Inclusion programme are granted to retailers in the Brazilian market that sell the domestic consumer electronics included in the programme. All local retailers qualify for the incentives, with the exception of companies that are eligible under Simples (simplified taxation system designed for certain companies).

498. The European Union understands that the suggestion of Brazil concerning accreditation under the Digital Inclusion programme has to be seen in the context of the above precision concerning the notion or retail sale within the meaning of that programme.

499. Therefore, if a company is accredited under the Informatics programme for the production of consumers electronics that fall also within the Digital Inclusion programme, it will be entitled to benefit from the tax incentives provided by both programme when it sells those consumers electronics to other companies or governmental entities.

4.4.3. Conclusions

500. In light of the above, the European Union maintains that the Digital Inclusion programme is inconsistent with the GATT 1994, the TRIMs Agreement and the SCM Agreement.

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286 And indeed Brazil admits that the Digital Inclusion programme provides additional subsidies to domestic producers accredited under the Informatics programme (Brazil's first written submission, para. 477).

287 Article 30 of Law 11,196/2005 (Exhibit EU/JE-91). To recall, Simples is a simplified taxation system designed for companies that in a calendar year had a gross income equal or lower than 240,000 reais. Simples enables companies to pay several taxes using a single and simplified payment form for a number of taxes and contributions, inter alia, PIS/PASEP, COFINS, IPI and ICMS. Simples is set out by Law (Lei Complementaria) 123, of 14 December 2006. More information at http://www8.receita.fazenda.gov.br/SimplesNacional/.
5. **MEASURES PROVIDING TAX ADVANTAGES TO PREDOMINANTLY EXPORTING COMPANIES**

501. Finally, in this Section the European Union will address the arguments raised by Brazil relating to the measures providing tax advantages to "predominantly exporting companies" in Brazil, i.e. the RECAP\(^{288}\) and the programme of fiscal incentives with respect to raw materials, intermediate goods and packaging materials.\(^{289}\)

5.1. **CLAIMS RELATING TO THE RECAP PROGRAMME**

502. To recall, in its first written submission, the European Union showed that the RECAP programme amounts to a subsidy which is contingent upon export performance in the sense of Article 3.1(a) of the SCM Agreement and, thus, Brazil acts contrary to Article 3.2 of the SCM Agreement.

503. In a nutshell, pursuant to the RECAP programme, accredited companies committing to a particular export performance threshold (i.e. generally, companies whose export revenue was at least 50% of their gross turnover over the preceding year) can have their PIS/PASEP, COFINS, PIS/PASEP-Importação and COFINS-Importação contributions suspended and ultimately exempted on sales (and imports) of capital goods. Thus, if an accredited company meets this threshold, it benefits from better cash flow conditions in respect of all its operations (i.e. not only exports, but also domestic sales) when compared to companies operating under the general PIS/PASEP, COFINS, PIS/PASEP-Importação and COFINS-Importação non-cumulative regimes.

504. Brazil, in turn, argues that the RECAP programme is another regime aimed at preventing the accumulation of credits in companies which structurally tend to have more credits than debits. In this respect, Brazil considers that the RECAP programme does not amount to a subsidy and much less a prohibited subsidy in the sense of Article 3.1(a) of the SCM Agreement.

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289 Article 29 of Law 10,637 of 30 December 2002 (Exhibit EU/JE-94) and Article 40 of Law 10,865 of 30 April 2004 (Exhibit EU/JE-181).
505. As explained below, the European Union maintains that Brazil has failed to rebut the EU’s claim that the RECAP programme amounts to a prohibited subsidy under Article 3.1(a) of the SCM Agreement.

5.1.1. The RECAP programme provides subsidies in accordance with the definition under Article 1.1 of the SCM Agreement

506. The European Union will show below that Brazil’s arguments against the EU’s claim that the RECAP programme amounts to a subsidy within the meaning of Article 1.1 of the SCM Agreement are unwarranted. Indeed, the purpose of the RECAP programme is precisely to confer a tax advantage to the accredited companies,290 and not a general measure for good administration, as Brazil wrongly purports it.

5.1.1.1 Article 1(1)(a)(1) of the SCM Agreement: financial contribution

507. Brazil argues that Brazil has two general rules of taxation, one for companies which normally have tax debits higher than tax credits, and another for companies which tend to structurally accumulate credits as the goods they produce are subject to low or no taxation. Brazil concedes that the term for these programmes – special regimes – is misleading. According to Brazil, it would have been clearer to have established a general rule for predominantly credit-accumulating companies; however, the tax authorities cannot predict ex ante which sectors will be in this situation, as it will depend on various public policy goals and economic situations, so it must act on a case-by-case basis. Brazil thus considers that the appropriate normative benchmark in this case is comparing the treatment under the RECAP programme with the tax treatment of similarly situated predominantly tax credit accumulating companies (i.e. companies that tend to accumulate tax credits). Brazil further argues that, contrary to what the European Union asserts, pursuant to

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290 See Explanatory Memorandum of Provisional Measure 252/2005 of 15 June 2005 (Exhibit EU/JE-185), stating that the programme "aims at encouraging investment on production and improving exports by correcting the distortions that generate a cost on the capital goods of predominantly exporting companies".
Article 1, XII of Law 11,774/08, the totality of PIS/COFINS tax credits generated by the purchase of capital goods may be offset.\textsuperscript{291}

508. The European Union respectfully disagrees in view of the following reasons.

509. First, as explained before, there is no general rule of taxation by which "predominantly credit accumulating companies" are exempted from paying PIS/PASEP, COFINS, PIS/PASEP-\textit{Importação} and COFINS-\textit{Importação} contributions in Brazil. Brazil has failed to show this alleged rule as the "prevailing domestic standard" established by the tax rules in Brazil. Brazil has equally failed to demonstrate that this rule is part of its organising principles.\textsuperscript{292} Specifically with respect to the RECAP programme, Brazil has not adduced evidence showing why the 50% export threshold is appropriate with respect to RECAP companies.\textsuperscript{293} Thus, it appears that Brazil's argument amounts to an ex-post explanation of its measures, which should be rejected.

510. Second, the European Union strongly disagrees with Brazil's allegation that tax authorities cannot make a horizontal rule for predominantly credit accumulating companies. Brazil wrongly focuses on the difficulties in predicting \textit{ex ante} which sectors would be in a credit accumulation situation, as this depends on various public policy goals and economic situations. The European Union considers that Brazil could device a general rule to prevent tax credit accumulation with respect to companies (as opposed to sectors) whereby e.g. companies accumulating a particular amount of tax credits in the preceding or preceding years could benefit from a suspension of taxes. The ultimate exemption could be subject to the company actually having more tax credits than debits in a given year (and interest may be foreseen for the difference if the company ultimately had more debits than credits).

511. Third, the European Union observes that Brazil alleges the existence of a general rule to avoid credit accumulation but exempts the sales of products by RECAP

\textsuperscript{291} Brazil's first written submission, paras 860 – 863.
\textsuperscript{292} Appellate Body Report, \textit{US – Large Civil Aircraft (2nd complaint)}, paras 811 – 814.
\textsuperscript{293} The only explanation for this threshold is a table in paragraph 848 of Brazil's first written submission which no source or explanation as to how it has been made. In this respect, it is unclear as to why companies generally would require the same export performance regardless of whether they accumulate credits relating to inputs, capital goods or any combination thereof.
accredited companies in the Brazilian market. In other words, pursuant to the RECAP programme Brazil exempts the payment of regular contributions on the purchase of capital goods by RECAP companies even when those companies could offset those credits in the normal course of business when selling locally. While the European Union understands the logic of exempting taxes on capital goods of exporting companies (which are not subject to taxes when exporting their products), the European Union fails to understand the logic of also exempting from the payment of those contributions when the RECAP company sells e.g. 49% of its production in Brazil. To recall once more, this is the precise aspect of the RECAP programme the European Union takes issue with and which results in a better treatment for domestic products when compared to like imported products.

512. Fourth, the appropriate normative benchmark in this case should be the tax treatment of comparable income of comparably situated taxpayers, i.e. the purchase of capital goods by non-accredited companies under the RECAP programme. It is undisputed that those transactions are normally subject to PIS/PASEP, COFINS, PIS/PASEP-Importação and COFINS-Importação contributions in Brazil. In contrast, the RECAP programme exempts them for accredited companies.

513. Fifth, when the government suspends/exempts the collection of PIS/PASEP, COFINS, PIS/PASEP-Importação and COFINS-Importação contributions on those transactions made by a RECAP accredited company, it foregoes or does not collect revenue otherwise due. The suspension (and ultimate exemption) of taxes otherwise due increases the cash flow of the accredited company, which does not need to anticipate the amounts to the tax authorities.

514. Sixth, the European Union disagrees that pursuant to Article 1, XII of Law 11,774/08, the totality of PIS/COFINS tax credits generated by the purchase of capital goods may be offset immediately. The European Union understand that if a company purchased a machine for 100 and the corresponding credit on that amount would be e.g. 10, that the company could offset 10 immediately the following month. Rather, the company would be entitled to offset the amount of tax credit calculated on the basis of the monthly depreciation or amortisation of the machine (i.e. always less than the full amount paid). Other possibilities to offset tax credits on the purchase of capital goods would remain available to the
company. Thus, there would always be a risk that the tax authorities would collect less revenue.

515. Moreover, this possibility applies only with respect to the purchase of new capital goods as of 3 August 2011. Before that date, for capital goods acquired between May 2008 and 3 August 2011, the previous 12 month period as well as any other possibilities to offset tax credits on the purchase of capital goods are in force. 294

516. Even if pursuant to Article 1, XII of Law 11,774/08, the totality of PIS/COFINS tax credits generated by the purchase of capital goods may be offset immediately, i.e. the month following the acquisition of the capital good, the fact is that thanks to the RECAP programme accredited companies do not bear the cost of money during that period of time which, as explained before, in view of the high legal interest and inflation in Brazil, could amount to a significant figure. Indeed, to recall, the amounts of the tax credits are based on the value of the capital goods so purchased. In any event, under the general PIS/PASEP and COFINS regime, the Brazilian authorities do not bear any risk with respect to the collection of taxes when the capital goods are acquired by companies. In contrast, under the RECAP programme, the tax authorities depend on the accredited company to e.g. continue doing business and/or sell locally in order to collect the same nominal amount (i.e. without legal interest). Therefore, the government ends up foregoing revenue that was otherwise due in the sense of Article 1.1(a)(1)(ii) of the SCM Agreement.

517. Finally, the European Union observes that Brazil does not contest the fact that, under the normative benchmark, when purchasing certain capital goods non-accredited companies are subject to an additional 1% in the case of COFINS-Importação that does not generate any right to a tax credit. 295 Other than arguing that this issue does not fall under the terms of reference of the Panel, Brazil does not deny that the RECAP beneficiary never pays the COFINS-Importação amounts due on the import transaction, including the additional 1%; and later on, with regard to the revenue from domestic sales, a lower COFINS rate applies, without any additional percentages. That means that the additional 1% is definitely lost to the government with respect to RECAP companies.

294 Article I §3 of Law 11,774/02.
295 EU’s first written submission, para. 1199.
518. In sum, the European Union considers that there are multiple ways to conclude that the RECAP programme provides a financial contribution to the accredited companies in the form of revenue otherwise foregone or not collected in the sense of Article 1.1(a)(1)(ii) of the SCM Agreement.

5.1.1.2 Article 1(1)(b) of the SCM Agreement: benefit

519. Brazil argues that the RECAP programme essentially equalises the conditions of competition by making all companies in the Brazilian market not credit accumulators. Brazil further argues that a tax suspension such as the one provided under the RECAP or PEC programmes does not translate into a better cash flow and may in fact increase the price of inputs.

520. The European Union disagrees. As shown before, even if the RECAP programme were to be considered merely as a tax deferral (*quod non*), the programme would be improving the cash flow conditions of the accredited companies, which do not need to advance the money when it was due in comparison to the prevailing normative benchmark. This in itself would provide a benefit to the accredited companies pursuant to the RECAP programme.

521. The European Union also fails to see how the tax suspension (and ultimate exemption) pursuant to the RECAP programme could increase the price of inputs. Brazil has not explained this in its submissions credibly. Whether the seller to a RECAP company will decide to increase its price is pure speculation. Rather, the reality would indicate the opposite. According to the RECAP programme, the invoices to the RECAP entity must specify that the transaction is made subject to the PIS/PASEP and COFINS suspension. Thus, it should be expected that the price of the capital good is equal or less than the price charged by the same producers to other non-accredited companies.

522. Finally, the European Union disagrees that the RECAP programme merely equalises the conditions of competition by making all companies in the Brazilian market not credit accumulators. The RECAP programme provides an advantage in the form of better cash flow for the accredited companies when compared to what

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296 Article 4 § 1 of Law 11,196/2005.
the rule would be absent the programme. This was clearly spelled out in the Explanatory Memorandum of the programme.297

5.1.2. The RECAP programme provides subsidies which are contingent upon export performance

523. Brazil argues that the criteria for the accreditation under the programme (i.e. the 50% export requirement) do not constitute export contingency, but an objective threshold above which tax credits are accumulated. The European Union disagrees.

524. In addition to the fact that Brazil has failed to show on which basis it sets the 50% export requirement generally, the text of Article 13 of Law 11,196/2005 cannot be clearer: in order to obtain the RECAP benefits, the company in question must commit to a certain level of export performance.298 The reasons behind requiring such an export commitment are irrelevant to determine whether the subsidy is contingent upon export performance in the sense of Article 3.1(a) of the SCM Agreement.

525. Brazil wrongly relies on the panel report in Australia – Leather II, para. 9.57, which refer to de facto contingency.299 Indeed, in a de facto case, all facts must be taken together to determine whether a neutral measure in fact conditions the subsidy upon export performance. This is not the case in a de jure claim, where the text of the measure already contains the contingency (explicitly or by necessary implication).300

5.1.3. Conclusions

526. In view of the above, the European Union requests the Panel to find that the RECAP programme amounts to a subsidy which is contingent upon export performance in the sense of Article 3.1(a) of the SCM Agreement and, thus, Brazil acts contrary to Article 3.2 of the SCM Agreement.

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297 See EU’s first written submission, paras 1171 – 1172.
298 EU’s first written submission, paras 1208 – 1215.
299 Brazil’s first written submission, para. 852.
300 Appellate Body Report, Canada – Autos, para. 100; and Appellate Body Report, EC and certain Member States – Large Civil Aircraft, para. 1038.
5.2. **CLAIMS RELATING TO THE SCHEME OF EXPORT CONTINGENT SUBSIDIES FOR THE PURCHASE OF RAW MATERIALS, INTERMEDIATE GOODS AND PACKAGING MATERIALS**

527. In its first written submission, the European Union showed that, pursuant to Indent II of Article 29§1 of Law 10,637/2002 and Article 40 of Law 10,865/2004, Brazil suspends (and ultimately exempts) the application of the IPI tax as well as of the PIS/PASEP, COFINS, PIS/PASEP-Importação and COFINS-Importação contributions with regard to certain purchases (local or imported) of raw materials, intermediate goods and packaging materials by accredited or registered legal persons that are "predominantly exporting companies", that is, producers that exported at least 50 percent of their gross turnover over the preceding year. These benefits are therefore conditional on those companies achieving or exceeding a certain export target, expressed as a percentage of the companies' turnover (i.e. at least 50% of the preceding year). The suspension is not limited to the inputs to be used in the production of goods for export (which can be exempted from indirect taxes), but it applies also as regards inputs processed or otherwise used in the production of goods for the domestic market. The European Union demonstrated that this scheme amounts to a subsidy which is contingent upon export performance. Under this scheme, Brazil improves the cash flow and operations of beneficiary companies by foregoing or not collecting revenue otherwise due, and makes those benefits contingent upon the export performance of the beneficiary companies. Brazil therefore acts contrary to Article 3.2 of the SCM Agreement.

528. Brazil, in turn, does not contest the facts as described by the European Union in its first written submission but argues that this scheme is another regime aimed at preventing the accumulation of credits in companies which structurally tend to have more credits than debits. Hence, Brazil considers that this scheme does not amount to a subsidy and much less a prohibited subsidy in the sense of Article 3.1(a) of the SCM Agreement.

529. As explained below, the European Union maintains that Brazil has failed to rebut the EU’s claim that the scheme at issue amounts to a prohibited subsidy under Article 3.1(a) of the SCM Agreement. Since the reasons alleged by Brazil with respect to the RECAP and PEC programmes are identical, the European Union incorporates in this section, *mutatis mutandi*, the comments made on Brazil’s
arguments with respect to the RECAP programme. The European Union will make some specific comments though.

5.2.1. The PEC programme provides subsidies in accordance with the definition under Article 1.1 of the SCM Agreement

530. The European Union will show below that Brazil's arguments against the EU's claim that the PEC programme amounts to a subsidy within the meaning of Article 1.1 of the SCM Agreement are unwarranted. Indeed, the purpose of the PEC programme is precisely to confer a tax advantage to the accredited companies, and not a general measure for good tax administration, as Brazil wrongly purports it.

5.2.1.1 Article 1(1)(a)(l) of the SCM Agreement; financial contribution

531. Like under the RECAP programme, Brazil argues that Brazil has two general rules of taxation, one for companies which normally have tax debits higher than tax credits, and another for companies which tend to structurally accumulate credits as the goods they produce are subject to low or no taxation. Brazil considers that the appropriate normative benchmark in this case is comparing the treatment under the PEC programme with the tax treatment of similarly situated predominantly tax credit accumulating companies (i.e. companies that tend to accumulate tax credits).

532. The European Union respectfully disagrees in view of the reasons already mentioned before in the context of the RECAP programme. In addition, the European Union would like to note the following.

533. First, Brazil makes an artificial distinction between companies that do not tend to accumulate credits and, hence, "operate normally in the credit-debit system", on the one hand, and "credit accumulating companies", such as a PEC, on the other

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301 See Explanatory Memorandum of Provisional Measure 66 of 29 August 2002 (Exhibit EU/JE-180), stating that the programme "establishes a suspension of the [IPI] in accordance with terms and conditions to be established by the Secretariat of the Federal Revenue, with a view to supporting national export activities".

302 Brazil's first written submission, paras 805 – 839.
hand, "which are not similarly situated with regard to their tax burden". 303 Brazil wrongly assumes that companies whose gross profit predominantly originates from products subject to taxation "can expect to offset regularly the totality of their credits in the next month of production", whereas companies whose gross profits originate predominantly from products subject to low taxation or exempted, such as a PEC, structurally and increasingly accumulate credits tied up with the tax authority. Whether a company can offset its tax credits in the next month of production depends on multiple factors. In fact, for many companies, it may take more than a month between the purchase of inputs and the making/selling of the final product incorporating those inputs. Companies in the normal course of business will attempt to offset tax credits as soon as possible, including offsetting them with other tax liabilities. However, in the case of added-value taxes, the company working under the tax credit system will always carry the "cost for money", i.e. the cost of having to advance the tax collected on inputs even if it is later offset when selling the final product. Thus, in the normal course of business companies may or may not tend to accumulate tax credits depending on their organisation, profitability, economic activity, etc. Companies will choose to offset tax credits or ask for a reimbursement from the tax authorities.

534. By creating an exception for some companies, such as predominantly exporting companies, Brazil is lifting the regular "cost for money" for companies for which it may or may not take longer to offset their tax credits or to obtain a reimbursement.

535. Brazil also wrongly argues that in the case of predominantly exporting companies most taxes on inputs are not due as in principle they are incorporated into exempted final products, and thus would have to be reimbursed. 304 This argument defeats the mere purpose of an added-value tax in a non-cumulative regime. 305 If that would be the logic of the Brazilian system, Brazil would limit to impose IPI, PIS/PASEP and COFINS only on the sale of final products. However, this is not

303 Brazil's first written submission, para. 814.
304 Brazil's first written submission, para. 816.
305 Of note, unlike with respect to the IPI tax, Brazilian companies may choose between following a cumulative and a non-cumulative regime under PIS/PASEP and COFINS. Companies may also choose to pay all their main taxes at once under the Simples regime.
the case. The logic of Brazil's taxation system in a non-cumulative regime is that it decides to impose a cost of the companies purchasing the inputs (and having to advance taxes on the inputs) even if those amounts are compensated (with no legal interest) later on. In other words, the "cost of money" is with the companies, not with the government. This is the choice by even enshrined in Brazil's Federal Constitution.\(^{306}\) Thus, Brazil's argument is incorrect and entirely circular.

536. In addition, Brazil wrongly argues that the PEC programme, as well as the other "special regimes" identified by Brazil in its first written submission (including the RECAP programme) are an expression of a general rule of taxation (according to which tax debits are to be greater or equal to tax credits along the production chain) and the proper tax regulation for certain types of companies – those which tend to accumulate credits – and for a certain type of product – those with low or no taxation.\(^{307}\) As mentioned before, the European Union does not consider that a general rule of taxation can be inferred in this case from a very limited set of similarly tax incentivising schemes. Indeed, those programmes target very specific sectors in an effort to boost their performance. Nothing is said in the stated purpose of those programmes about "credit accumulating companies".

537. For instance, the Special Tax Regime for the Exportation Platform of Information Technology Services, REPES (Regime Especial de Tributação para a Plataforma de Exportação de Serviços de Tecnologia da Informação), is a special taxation regime to promote exports of technology and IT services.\(^{308}\) The Special Regime

\(^{306}\) Pursuant to Article 155 of Brazil's Federal Constitution, the States and the Federal District have the power to impose taxes on: "II. transactions relating to circulation of goods and the performance of services of interstate and inter-county transportation and communications, even when the transactions and performance begin abroad". Article 155 §2° further states that "[t]he tax provided for in subparagraph II shall conform to the following: I. it shall be noncumulative, with an offset against the tax owed on each transaction of circulation of goods or performance of services by the amount charged on previous ones by the same State, by another State or by the Federal District". Specifically with respect to the IPI tax, Article 153§3° of Brazil's Federal Constitution provides that it "shall be noncumulative, with an offset against the tax owed on each transaction of the amount charged on previous transactions".

\(^{307}\) Brazil's first written submission, para. 818.

\(^{308}\) See Explanatory Memorandum Interministerial No 00084/2005 - MF MDIC, para. 2 (Exhibit EU/JE-185), stating that "the creation of REPES aims to improve our tax system, enabling a better inclusion of Brazil's exports of information technology services - IT, with competitive prices compared to those offered in the international market, thus creating stimulating export value-added services and based on high technology, and the expansion of job creation, to support digital inclusion programs and facilitating access of small and medium-sized enterprises to this market."
for the Brazilian Aerospace Industry RETAERO (*Regime Especial para a Indústria Aeroespacial Brasileira*), created by Law 12,249 of 2010 is not aimed at addressing the issue of tax credit accumulation within suppliers of aerospace inputs. Rather, RATAERO seeks to boost the competitiveness of the domestic aeronautic industry and substitute imports.\(^{309}\)

Likewise, the Special Regime for the Defense Industry, RETID, created by Law 12.598/2012, is aimed at creating a special tax regime for companies engaged in national defense industry. The purpose of the programme is to achieve independency and to improve the competitiveness of this industry.\(^{310}\)

Finally, the Special Regime to Incentive Computers for Educational Use, REICOMP, aims at incentivising the use of computers in schools; however, it only incentivised computers made in accordance with a PPB in Brazil. This again shows that the common features of those special regimes are not tackling the phenomenon of credit accumulation. Rather, they are incentivising Brazil's industries in several ways.

538. Of note, most of these programmes were introduced at the same time by Law 12,715/2012, which also introduced the INOVAR-AUTO programme.\(^{311}\)

539. More generally, the European Union considers that a Member cannot legitimate adduce evidence of other similar supporting programmes in order to demonstrate the existence of a general rule of taxation. The fact that the government provides similar incentives elsewhere cannot be used to show that there is no revenue foregone to begin with. For example, in *US – Large Civil Aircraft (2nd Complaint)*, the United States tried to argue that because several transactions in Washington State were taxed at the same low rate when compared to other general rates, there

Moreover, with the creation of REPES should increase the participation of small and medium enterprises in Brazilian IT exports").

\(^{309}\) See Explanatory Memorandum No 180/2009, para. 65 available at http://www.planalto.gov.br/ccivil_03/_ato2007-2010/2009/Exm/EMI-00180-MF-MDIC-09-Mpv-472.htm ("With respect to the urgency and relevance of RETAERO, we note that, as mentioned before, will provide incentives to invest in the aeronautic industry in Brazil, allowing manufacturers of parts, components, etc to be installed in the country, thereby reducing the imports of these means of production. It will also allow for increasing the competitiveness of domestic products in the national market, reducing the export dependency for the maintenance in the sector").


\(^{311}\) See Provisional Measure No 563/2012 (Exhibit EU/JE-124).
was no revenue foregone. The panel rightly rejected the US argument, noting that "deviations from [the general taxation rate applicable to manufacturing activities] are an exception".  

540. In that case as well the panel noted that the need to comply with certain requirements in order to benefit from "preferential" tax rate also supported the conclusion that the reduced rate was exceptional. Similarly, in the case at hand, the fact that in order to benefit from the special regimes companies must be accredited and comply with certain requirements demonstrate that the programmes fail to establish a general rule of taxation.

541. In sum, the reasons provided by the PEC programme, as well as other special regimes, do not speak about credit accumulation; rather, they specify that those programmes provide tax incentives to promote the Brazilian industry.

542. Moreover, the European Union disagrees with Brazil's characterisation of the EU's argument as merely proposing a "but for" test without any regard to the specificities of the Brazilian tax system. In this respect, the European Union has shown the organising principles of the taxes and contributions at issue, especially with respect to non-cumulative regimes, and how the programmes at issue, as "special regimes" depart from the general rule in the context of added-value taxes, thereby foregoing or not collecting revenue otherwise due. In other words, the European Union has looked into other rules of taxation applicable to the purchase of capital goods and inputs by non-accredited companies in Brazil.

543. The European Union also disagrees with Brazil's perception that the EU's reasoning would impose an excessive burden on predominantly credit-accumulating companies and would ultimately lead to an additional cost for the government, which would have to pay interest on the amounts reimbursed to these companies. As explained before, Brazil could well tackle the phenomenon of

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313 Brazil's first written submission, para. 822.


315 Brazil's first written submission, paras 823 – 826.
credit accumulation by foreseen a general rule which ensures that the tax credits/tax debits are even out quickly. However, the RECAP and PEC programmes have no mechanism to offset ex post the benefits conferred through tax suspension based on the actual credit/debit balance. They amount to a "white check" for those companies regardless of the amounts of tax credits they could have accumulated.

544. In addition, Brazil wrongly asserts that the PEC programme is an effective means to apply the destination principle reflected in footnote 1 of the SCM Agreement, which further demonstrates that there is no revenue foregone otherwise due. Footnote 1 of the SCM Agreement states that the precise remission of indirect taxes when a product is exported does not amount to a subsidy. However, as explained before, the European Union does not take issue with the fact that under the PEC (or RECAP) programme exported products are not subject to indirect taxation; rather, the European Union considers that the same exemption with respect to products sold locally amounts to a subsidy. Brazil then further makes incorrect economic assumptions to show that a predominantly exporting company would bear an additional burden of the credits that could not be offset. In this respect, the European Union notes that the tax credits borne by exported products would need to be refunded in any way by the tax authorities, in accordance with the general rules for reimbursement of tax credits.

545. Finally, Brazil wrongly argues that is no revenue foregone if the good is destined to the domestic market, since the full weight of the tax liabilities apply without any credits with which to offset them. The European Union has shown in its first written submission that, even if the same nominal amount is collected by the government, it does so at different moments, thereby improving the cash flow of the beneficiaries at the expense of the financial loss for the government when compared to the general regimes.

546. In sum, the European Union considers that the PEC programme provides a financial contribution to the accredited companies in the form of foregoing or not

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316 Brazil's first written submission, para. 827.
317 Brazil's first written submission, para. 837.
318 EU's first written submission, paras 1238 – 1245.
collecting revenue otherwise due in the sense of Article 1.1(a)(i)(ii) of the SCM Agreement.

5.2.1.2 Article 1(1)(b) of the SCM Agreement: benefit

547. Brazil argues that the PEC programme essentially equalises the conditions of competition by making all companies in the Brazilian market not credit accumulators. Brazil further argues that a tax suspension such as the one provided under the PEC programmes does not translate into a better cash flow and may in fact increase the price of inputs.

548. As stated in the context of the RECAP programme, the European Union disagrees. The PEC programme improves the cash flow conditions of the accredited companies, which do not need to advance the money when it was due in comparison to the prevailing normative benchmark. Brazil also fails to show how the tax suspension (and ultimate exemption) pursuant to the PEC programme could increase the price of inputs. Finally, the European Union disagrees that the PEC programme merely equalises the conditions of competition by making all companies in the Brazilian market not credit accumulators. The PEC programme provides an advantage in the form of better cash flow for the accredited companies when compared to what the rule would be absent the programme. This was clearly spelled out in the Explanatory Memorandum of the programme.319

5.2.2. The PEC programme provides subsidies which are contingent upon export performance

549. Like in the context of the RECAP programme, Brazil argues that the criteria for the accreditation under the PEC programme (i.e. the 50% export requirement) do not constitute export contingency, but an objective threshold above which tax credits are accumulated. The European Union disagrees.

550. The text of Article 29 of Law 10,637/2002 as well as Article 40 of Law 10,865/2004 cannot be clearer: in order to obtain the PEC benefits, the company in question must commit to a certain level of export performance.320 If a company does not meet the 50% export requirement, the benefits are not granted. The

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319 See EU’s first written submission, para. 1153.
320 EU’s first written submission, paras 1249 – 1252.
reasons behind requiring such an export commitment are irrelevant to determine whether the subsidy is contingent upon export performance in the sense of Article 3.1(a) of the SCM Agreement. In any event, the PEC programme does not establish any linkage between eligibility for the advantages and the credit/debit balance of the company; however, there is a clear and direct relationship between eligibility and export performance.

5.2.3. Conclusions

551. In light of the foregoing, the European Union submits that the PEC programme amounts to a subsidy which is contingent upon export performance. Brazil therefore acts contrary to Article 3.2 of the SCM Agreement.

5.3. EU'S COMMENTS ON BRAZIL'S RESPONSES TO THE PANEL'S QUESTIONS ON RECAP AND PEC

552. In its response to the Panel's question to the Parties no. 17, Brazil confirms the basic requirements to benefit from the RECAP and PEC programmes, as described by the European Union in its first written submission. Brazil thus confirms that to benefit from those programmes a company must achieve a particular threshold of export performance or commit to it.

553. In its response to the Panel's question to the Parties no. 13, Brazil appears to argue that tax suspensions are a common feature of the Brazilian tax system, which apply to companies that tend to accumulate tax credit. According to Brazil, this shows the existence of a general rule applicable to all credit accumulating companies. In this respect, the European Union notes that taxes in Brazil are suspended for reasons other than tackling the phenomenon of credit accumulation. For instance, under the Informatics programme, Article 29 of Law 10,637/2002 suspends the IPI on sales of inputs to accredited companies in order to provide them with an advantage, i.e. as an incentive to comply with the required steps under the programme to boost Brazil's local industry. Moreover, suspension of taxes in Brazil does not seek to address to credit accumulation problems in general terms. For instance, in the case of the other incentivising programmes in Brazil,
such as REPORTO\textsuperscript{321} and RETAERO,\textsuperscript{322} the beneficiaries from those suspensions (and ultimately exemptions) are subject to taxation.\textsuperscript{323} With respect to PIS/PASEP and COFINS, the issue becomes even clearer as the incentivised products are subject to standard rates in most cases and, thus, the tax suspended could have been offset as tax credits when selling the resulting products in Brazil. In other words, the use of a tax suspension by Brazil aims at providing an advantage (and hence an incentive) when compared to the general rule on taxation for certain companies. Brazil’s attempt to provide for categories where the credit accumulation

554. Brazil also argues that it is impossible to predict a general rule for companies that accumulate credits so that they do not become structurally credit accumulating companies. The European Union disagrees. Brazil alleges that the programmes at issue seek to avoid credit accumulation; however, if the phenomenon were to be generalised for the companies under a particular set of circumstances, why would it be necessary for those companies to be accredited under a programme? Moreover, as noted before, there are no caps or mechanisms to check under those programmes in order to avoid overcompensation (i.e. to ensure that only the amounts that normally the company could not offset under the normal course of business, could be suspended).

555. In its response to the Panel’s question to the Parties no. 22, Brazil confirms (a) that companies can accumulate tax credits when they do not have sufficient tax liabilities to offset those credits. The European Union further notes that in Brazil companies can bear tax liabilities which do not generate tax credits and, therefore, cannot be offset later on. For instance, the purchase of capital goods does not generate an IPI tax credit. However, under e.g. the PADIS/PATVD programme,


\textsuperscript{323} See e.g. under RETAERO where manufactures of aircrafts under TIP Heading 88.02 (which benefit from IPI, PIS/PASEP and COFINS suspensions on their acquisitions) are subject to 10% of IPI (the latest version of the IPI table is available at http://idg.receita.fazenda.gov.br/acesso-rapido/tributos/ipi - last updated February 2016).
the payment of any IPI which normally would be due on the purchase of capital goods is exempted. With respect to (b), Brazil confirms that tax credits may be offset with other tax liabilities in Brazil, thereby making it easier for companies in most cases to accumulate tax credits. The European Union fails to understand, however, Brazil's observation that "while IPI and PIS/COFINS credits amount roughly to 25% of the companies' purchases, IRPJ and CSLL amount to 24% of profits, an insufficient amount". If this is just a numerical example, it shows that the possibility to offset tax credits depends on multiple factors, such as the profits of the company. Brazil has failed to explain on what basis it had calculated the 50% export performance thresholds under the RECAP and PEC programmes to take into account, e.g. the profitability of multiple economic sectors falling under those programmes. Finally, under (c), Brazil acknowledges that the procedure to obtain the reimbursement of the tax credit may be long and burdensome. Indeed, companies benefiting from the programmes at issue do not need to wait to obtain their reimbursements. At the same time, under the general system, Brazil already benefited from having collected the taxes which may or may not need to refund later on.

556. For the reasons mentioned before, the European Union disagrees with Brazil's response to the Panel's question to the Parties no. 23.

6. **CONCLUSIONS**

557. In view of the foregoing, as well as the previous submissions made before in these proceedings, the European Union requests the Panel to find that the measures at issue are inconsistent with the GATT 1994, the TRIMs Agreement and the SCM Agreement and to recommend that Brazil brings itself into compliance with its obligations under the covered agreements.

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324 See paras 514 - 517 above.