CANADA - CERTAIN MEASURES CONCERNING PERIODICALS

SECOND SUBMISSION OF CANADA

November 1, 1996

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SECOND WRITTEN SUBMISSION OF CANADA SUBMITTED TO THE PANEL ESTABLISHED BY THE DISPUTE SETTLEMENT BODY (DSB) OF THE WORLD TRADE ORGANIZATION (WTO) TO EXAMINE THREE CANADIAN MEASURES CONCERNING PERIODICALS

I. INTRODUCTION

1. The United States is challenging, pursuant to the General Agreement on Tariffs and Trade 1994 ("GATT 1994"), Part V.I of the *Excise Tax Act* (the "Act"); Code 9958 of Schedule VII to the *Customs Tariff*; and the commercial and subsidized postal rates for the delivery of periodicals. The first submissions of the United States and Canada were submitted on September 5, 1996 and September 26, 1996 respectively. Both parties presented their oral arguments at the first substantive meeting of the Panel on October 11, 1996. At that meeting, the United States and the Panel posed sixteen (one and fifteen respectively) questions to Canada.[1] Canada gave preliminary answers to some of these questions while reserving its rights to address them more fully in its written rebuttal.

2. Canada's second written submission will provide the Panel with further explanations on some points that need clarification, as well as responses to issues that were raised by the United States in its oral presentation. Responses to specific questions of the United States and the Panel are provided throughout the body of Canada's written rebuttal as the subject matter of each question arises.

II. ARGUMENTS

1. Article III of the GATT 1994 does not apply to Part V.I of the *Excise Tax Act* because advertising services is a General Agreement on Trade in Services ("GATS") matter

3. Part V.1 of the Act is a measure pertaining to advertising services not covered by Article III of the GATT 1994.[2] The selling by publishers of advertising space in their magazines has long been recognized as a service activity.[3] Canada has clearly established in

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[1] The list of questions referred to Canada is provided in Exhibit A.

[2] Canada's First Submission, paras. 57-66.

[3] "As magazines came to depend on advertising for economic support, the role of the typical publisher underwent a major change. No longer was he interested in the reader as just a reader; he became interested in the reader as a consumer of the advertiser's goods and services. No longer was he a

its First Submission that the provision of advertising services is a GATS matter.

4. In its Oral Statement, the United States alleged that the excise tax applies directly to magazines since the tax is applied to each split-run edition and on a "per issue" basis. The United States also alleged that the tax applies directly to magazines because it is imposed on persons who produce or trade in magazines (publisher, distributor, printer or wholesaler). It was argued as well by the United States that the tax applies "indirectly" to magazines in that it reduces the appeal of split-run magazines to Canadian readers by effectively eliminating advertisements of interest to them. Finally, the United States claimed that the measure affects the internal sale or use of split-run magazines contrary to Article III:4 of the GATT 1994.

5. Contrary to the allegations made by the United States, the tax is not applied directly to a split-run magazine and in particular it is not based on, or applied to, the price of a split-run magazine. As previously explained, the tax is applied to the value of advertising carried by each issue of a split-run magazine and is assessed against the publisher of the split-run magazine, as the seller of the advertising service. The expression "in respect of each edition" serves as a basis for determining and calculating liability that relates to advertising revenue as the subject matter of the tax. The significant point, which decisively identifies the subject matter of the tax, is that the tax is measured not in terms of the price of the magazine but in terms of the advertising revenues it generates.

6. The tax is imposed on the publisher in the publisher's capacity as a provider of advertising services. The tax is tied to the service provided rather than the good. The publisher is the person responsible for the payment of the tax. The distributor, the printer and the wholesaler have been identified as potentially liable where it would be impossible to collect the tax in Canada from the publisher. In such cases, the Act grants those persons a right of recovery against the publisher.[4] Accordingly, there is no doubt that the ultimate liability falls on the publisher, and because the *ad valorem* basis of the tax is advertising, this

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producer of just a convenience good; he became also the seller of a service, that of carrying the advertiser's message to a group of consumers..." (T. Peterson, *Magazines in the Twentieth Century* (Urbana: University of Illinois Press, 1964) at 27; see also *ibid.* at 69 (Exhibit B)).

[4] *Excise Tax Act*, R.S.C. 1985, c. E-15 as amended by S.C. 1995, c. 46, s. 41.3(2) (U.S. First Submission, Exhibit D). Where a person other than the publisher pays the excise tax in respect of a split-run edition, the person is deemed to have paid the tax on behalf of the publisher of the periodical. The legislation authorizes the person to recover the amount of the tax from the publisher in a court or to deduct or withhold the amount from any amount payable by the person to the publisher of the periodical. This is further reinforced by a split-run tax amendment that will exempt from the tax the first split-run issue of a magazine if the person who would otherwise be responsible for paying the tax is the distributor, printer or wholesaler.

liability arises directly out of the services dimension of the publisher's business.[5] The collection mechanism is designed to ensure that there is always a person in Canada from whom the tax can be collected. It is doubtful whether collection machinery should ever be used as a basis for characterizing the nature of a tax, and in the particular circumstances of this case it would be entirely inappropriate.

7. The question of whether the excise tax is covered by Article III:2 of the GATT 1994 by reason of the expression "indirectly" must be examined in light of the relationship between the GATS and the GATT 1994. To the extent that the two agreements cover measures that pertain to trade in services, it is essential to interpret the provisions of the two agreements so as to avoid or at least minimize any overlap between their respective disciplines, and thus to preserve the coherence of the system as a whole. Any such overlap could lead to divergences or conflicts between different provisions of the WTO Agreement that would have to be resolved in accordance with customary rules of interpretation of public international law.[6] Given that the GATS is a more specific expression of the intention of WTO Members with respect to disciplines applicable to trade in services, it should prevail over the GATT 1994 in case of a true conflict, where the conflict relates primarily to trade in services. The more appropriate approach is clearly to interpret both agreements so as to minimize any overlaps and resulting conflicts, and thus to preserve the integrity and independence of each regime as the negotiators intended.

8. To determine which disciplines apply to a given measure, one must first examine the nature and object of the measure in question. Some relevant factors for such a determination are: the nature of the economic activity covered by the measure, the structure and effects of the measure and the intention of the measure. A measure may have different aspects and may, as a result, attract different disciplines under different agreements, but no single aspect of a measure should be subject to both disciplines at the same time. In any case at the margins of the two disciplines, Canada suggests that the dominant or essential characteristics of the economic activity at issue should control the determination of whether the GATT or the GATS is applicable.

9. In the present case, it is clear that the measure pertains to the marketing of advertising services. The tax is assessed on the value of the advertising services provided. The ultimate responsible taxpayer is the publisher in the publisher's capacity as a service provider. The tax is intended to prevent the penetration of the Canadian advertising market

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[5] In a hypothetical situation, where split-runs would be illegally imported into Canada despite the border prohibition, the Panel asked, in Question 2, if the publisher or the distributor could be subject to the excise tax. Should split-runs be imported notwithstanding Code 9958 of the *Customs Tariff*, both the publisher and the distributor could be subject to the tax. The publisher would be liable as a provider of advertising services. The distributor, who has to pay the tax, would have a right of recovery from the publisher.

[6] *Understanding on Rules and Procedures Governing the Settlement of Disputes*, Article 3:2.

by publishers who sell their advertising services in association with split-run magazines. It is clear that the measure pertains to the supply of a service and as such is a measure that WTO Members intended to be disciplined under the GATS.[7] This was recognized by the United States Trade Representative, in the *1995 National Trade Estimate Report on Foreign Trade Barriers*, where Canada's practices with respect to split-run advertising were listed and described under the heading Services Barriers.[8]

10. Nor is the excise tax one that applies "indirectly" to a good within the meaning of Article III:2.[9] The "concept of indirectly" in Article III:2 does not capture measures that are disciplined under the GATS. It is intended to capture taxes that apply to "inputs" that contribute to the production of a good - raw materials, service inputs, intermediate inputs, etc. Taxes on such production inputs are properly subject to Article III:2 because they affect the costs and prices, and therefore the competitive position of goods that are subject to Article III:2.

11. It is important, however, to distinguish service inputs that are "end-products" in their own right. As mentioned in Canada's First Submission, a magazine provides two distinct products to two distinct markets. The publishers' advertising services, although closely

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[7] The split-run advertising practice under consideration involves the supply of advertising services by foreign publishers to foreign or Canadian advertisers in Canada. It could fall under any of the modes of delivery identified in Articles I:2(a), (b) or (c) of the GATS.

[8] See *1995 National Trade Estimate Report on Foreign Trade Barriers* (Washington, D.C.: United States Trade Representative, 1995) at 38 (Exhibit C).

[9] The terms "directly or indirectly" appeared initially in Article III:2 for ease of translation into French of an English draft proposal. In initial discussions at the London session of the Preparatory Committee, it was suggested that while "directly or indirectly" in the US Draft Charter referred to "taxes and other internal charges imposed on or in connection with like products", the rapporteur in the Working Party on Technical Articles had used the phrase "directly or indirectly" instead. owing to the difficulty of obtaining the exact equivalent in the French text. Proposal by United Kingdom, EPCT/C.II/W.5, at 5.

According to later discussions in Commission A at the London session of the Preparatory Committee (EPCT/A/PV/9, at 19; EPCT/W/181, at 3), the word "indirectly" covers a tax not on a product as such but on the processing of the product. The Panel report in *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages* (Report of the Panel adopted on 10 November 1987, GATT Doc. L/6216, BISD 34S/83 at 118, para. 5.8 [hereinafter *Japanese Liquor Tax I*]) gave an interpretation of the term "indirectly" that is consistent with this reading:

> "The Panel ... found that the wording "directly or indirectly" and "internal taxes ... *of any kind*" implied that, in assessing whether there is tax discrimination, account is to be taken not only of the rate of the applicable internal tax but also of the taxation methods (e.g. different kinds of internal taxes, direct taxation of the finished product or indirect taxation by taxing the raw materials used in the product during the various stages of its production) and of the rules for the tax collection (e.g. basis of assessment)."

associated with the magazines, are separate products. They are not involved in the production process of the magazines. The advertising services of the publisher are not, like labour in the production of a car, an input in the production of the good.

12. If allowed, the U.S interpretation of the expression "indirectly" would force Canada to accord national treatment to foreign publishers with respect to advertising services when it did not make any commitment in that respect in the GATS. Such an interpretation would create an imbalance in carefully negotiated concessions on services sectors made by WTO Members during the last round of Multilateral Trade Negotiations. It would also void the GATS of its effectiveness as it concerns Canada's right not to make commitments on advertising services. This unreasonable result can simply not be the intended result of the expression "indirectly" in Article III:2 of the GATT.[10]

13. If the expression "indirectly" is interpreted as broadly as the United States would propose, it would have the effect of sweeping the regulation of services in through the back door of the GATT and undermining the integrity of the GATS. The result would be to distort the relationship between the two agreements, and to erode the balance of specific commitments negotiated in the framework of the GATS.

2. Article III:2, first sentence

(a) Split-run periodicals are not "like" products to periodicals containing editorial material created for the Canadian market

14. The first part of Canada's argument in respect of Article III:2, first sentence, is that split-runs based on foreign content, and magazines based on content specifically created for the Canadian market, are not "like products". Canada's approach is based upon a narrow construction of the expression "like products", and the case-by-case approach mandated in the recent decision of the Appellate Body.[11] It puts the emphasis on the editorial content as the characteristic that distinguishes one magazine from another. In determining whether or not publications created for Canada are "like" publications replicated from foreign editions, the critical factor is content developed for the Canadian market. The United States puts all magazines into a single, all-encompassing category of "like products". The United States has ignored both requirements established by the jurisprudence, i.e., that the expression be narrowly construed and the determination be made on a case-by-case basis.

15. As the complainant, the United States bears the burden of proving that Canada acted inconsistently with its obligations under Article III:2, first sentence. This is a principle of

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[10] Paragraphs 7 to 12 address issues raised by the Panel in Questions 1, 4 and 5.

[11] *Japan – Taxes on Alcoholic Beverages* (Report of the Appellate Body, 4 October 1996), AB-1996-2, WTO Doc. WT/DS8/AB/R, WT/DS10/AB/R and WT/DS11/AB/R [hereinafter *Japanese Liquor Tax Appeal*].

long standing in GATT jurisprudence.[12] To date the United States has made no effort to discharge this burden. Instead, it has relied upon general allegations and assertions such as the following one which was made during the U.S. Oral Statement:

> "there is no identifiable difference between split-run magazines, on the one hand, and magazines without a companion edition, on the other hand, in terms of their physical characteristics, appearance, uses, tariff classifications, or even editorial content."

Such statements do not constitute the empirical evidence required to both substantiate the claim made by the United States that all magazines are the same or that magazines based on local content are the same as magazines replicating foreign content; and to fulfil the burden of proof borne by the United States.

16. The United States submits that the only distinctive aspect of a split-run magazine is whether a similar edition with different advertising is sold abroad, drawing the conclusion that because the definition is based on an external factor, and not an inherent property of the product itself, it cannot serve as the basis of a distinction between "like" and "unlike" products. This contention ignores the fact that, even on the face of the legislation, the critical factor is not the mere existence of a companion edition in another country but the presence of replicated or reproduced content with domestic advertising in the split-run as marketed in Canada. The idea that content developed for the Canadian market is the same as recycled content is simply not tenable. As both common sense and the examples to be examined below confirm, a magazine replicating foreign content is markedly different from one originally created to serve the Canadian market.[13]

17. The U.S. argument also fails to respect the principle of narrow construction in its reliance on the Canadian tariff classification in heading 49.02. If the United States were correct, this would have the effect of sweeping not only all periodicals, but newspapers as well into a single very comprehensive classification. The inappropriateness of this kind of result was pointed out by the Appellate Body in its recent decision on *Japanese Liquor Taxes*, when it said that "tariff bindings that include a wide range of products are not a reliable criterion for determining or confirming product 'likeness' under Article III:2".[14] The use of tariff classifications in this case is especially inappropriate. Code 9958 of the *Customs Tariff* has effectively carved split-runs out of the general tariff classification; it has been in effect for over 30 years, through several GATT rounds, including the most recent Uruguay

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[12] See *Japan - Taxes on Alcoholic Beverages* (Report of the Panel, 11 July 1996), WTO Doc. WT/DS8/R, WT/DS10/R and WT/DS11/R at para. 6.14 [hereinafter *Japanese Liquor Tax II*]. That complainants have the burden of proof to show that products are like is an aspect of the report that was not appealed.

[13] This paragraph addresses issues raised by the Panel in Questions 3 and 7.

[14] *Japanese Liquor Tax Appeal*, *supra* note 11 at 22.

Round. The *de facto* exclusion of split-runs from the general tariff classification means at the very least that the U.S. position can derive no support from tariff classification.[15]

18. The United States has suggested that the Canadian approach to like products would threaten the foundations of the international trading system, allowing governments to favour imported goods designed exclusively or primarily for their markets. In reality, the Canadian approach has no such implications. It is inappropriate to generalize. What is true of magazines is not necessarily true of other products. There are few if any physical products that can be identified with a specific national market through their inherent properties (as opposed to traditional consumer tastes, which is an entirely different matter). The spectre raised by the United States is based on an unwarranted generalization, an extrapolation from magazines to products in general. Any such generalization is incompatible with the "case-by-case" approach mandated by the jurisprudence.

19. The United States, in its Oral Statement, kept treating magazines as if they were ordinary items of merchandise trade and ignoring their distinctive feature. The distinguishing trait of a magazine is found in its editorial content and not the physical medium in which the content is captured. Unlike other products that are distinguishable on their physical qualities, the editorial content of a magazine is its chief distinguishing characteristic. The editorial content makes magazines more individualized than other manufactured products and, as a result, they possess sufficiently strong distinctive features to warrant distinguishing them from other goods for policy purposes.

20. A table[16] comparing the editorial content of the October 7, 1996 issue of *Maclean's*, *TIME Canada* and *TIME U.S.* provides compelling evidence. *Maclean's* is a news magazine produced in Canada for the Canadian market, *TIME Canada* is a U.S. news magazine produced in Canada for the Canadian market[17] and *TIME U.S.* is a U.S. news magazine produced in the United States for the U.S. market. While all three magazines contain a wide variety of topical news items, the table illustrates that the editorial content of *Maclean's* is distinct from the editorial content of *TIME* and *TIME Canada*. Apart from the two international news features common to the three magazines, one on peace in the Middle East and the other on the political impact of President Yeltsin's health, *Maclean's* and *TIME Canada* provide very different coverage of the week's issues. Without in any way neglecting extensive coverage of international events, *Maclean's* editorial content focuses almost solely on news items concerning, or in some way related to, Canadian issues, individuals or interests. In contrast, the editorial content of *TIME Canada* features news items concerning, or in some way related to, issues, individuals or interests of the United States, again without neglecting coverage of international news. In fact the table shows that while *TIME Canada*

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[15] This paragraph addresses issues raised by the Panel in Question 6.

[16] See Exhibit D.

[17] *TIME Canada* is grandfathered pursuant to section 39 of the *Excise Tax Act*.

contains no editorial content, other than letters to the editor, that reflects the market to which it is addressed, it does contain a great deal of the same editorial content of *TIME U.S.*[18]

21. The table illustrates that not only does *TIME Canada* not provide content directed to the market for which it is produced, it does not need to rely on advertising revenues to underwrite the cost of editorial content. These costs have been covered by the higher priced magazine sold in the much larger home market. By reproducing material from *TIME U.S.*, *TIME Canada* is able to produce a magazine that appears physically comparable to *Maclean's* for a fraction of the cost. Low editorial costs reduce *TIME Canada*'s needs to rely on advertising revenue and, in a highly competitive advertising market such as exists between *TIME Canada* and *Maclean's*, allows it to both offer advertising at extremely competitive rates and take most of the advertising revenue it earns as pure profit.[19] This problem is exacerbated by the fact that *TIME Canada* sells its content at a cover price that is less expensive than the comparable U.S. cover price when converted at current rates of exchange.

22. The comparison of editorial content that is shown in this table demonstrates that the problems that the *Excise Tax Act* amendments were designed to address are very real. Notwithstanding that it is ostensibly produced for the Canadian market, *TIME Canada* fails to provide editorial content that is anything other than the editorial content that was originally produced for either the U.S. market or for easy inclusion in *TIME U.S.*'s other international editions. As *TIME Canada* contains no material produced for the market in which it is distributed, it incurs no additional cost in producing its editorial content prior to distribution in the Canadian market and it sells its content at a cover price that is less expensive than the comparable U.S. cover price when converted at current rates of exchange. The diversion of advertising revenues from a market without the provision of any corollary editorial benefit to the market is exactly the practice that the *Excise Tax Act* provisions are designed to discourage.

23. The Panel queried the rationale of the grandfathering clause in the Act. Where a *prima facie* case is established that the tax is payable in respect of advertising in a particular edition, the potential taxpayer may be able to establish that the particular edition is covered by the grandfathering provision in the legislation. The rationale for the inclusion of a grandfathering clause is the recognition of the principle that vested rights should be respected and that a legislative measure, such as a tax on advertising revenues, should not have a

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[18] The material that is not identical has an international focus for easy inclusion in *TIME U.S.*'s other international editions.

[19] As is expected in a highly competitive market, the advertising pages contained in each of *TIME Canada* and *Maclean's* will vary considerably by issue. For example, in the October 7, 1996 issue *Maclean's* carries more advertising than does *TIME Canada*. However, the September 1996 issues of *TIME Canada* contained more advertising than did the same issues of *Maclean's*. In September 1996, issues of *TIME Canada* contained a total of 125 advertising pages while issues of *Maclean's* contained 93 advertising pages.

retroactive application. The grandfathering provision was adopted to ensure fairness to foreign publishers who have vested rights in the publication of split-run editions of their magazines in Canada. The exemption for existing split-run editions applies to publishers that distributed split-run editions in Canada before March 26, 1993. This is not an arbitrary choice made by the Government of Canada since it is the date on which the Task Force on the Canadian Magazine Industry was established.

24. The Panel also asked about the significance of the domination of the Canadian market by foreign magazines. The penetration of the Canadian market by foreign magazines is an undisputed fact.[20] Canada is neither controlling market access nor limiting the penetration of foreign magazines into the Canadian market. Respect for freedom of expression has always be very strong in Canada. Canadian readers enjoy their unrestricted access to imported magazines. At the same time, Canadian readers have demonstrated that they value magazines that address their distinct interests and perspectives. It is only access to the advertising services market that is being controlled, not access to the magazine market. Access to the advertising market is being controlled to ensure that magazines created for the Canadian market exist. The continued existence of such magazines is vital to ensure that Canadians have a choice that includes vehicles where ideas are expressed from a Canadian perspective. Notwithstanding the demand for such products, the size and nature of the market - not the least characteristic of which is the very real presence of the United States as an English-speaking neighbour and the very open border that Canada insists on maintaining - requires a Canadian magazine policy that favours conditions in the marketplace that promote the economic viability of Canadian magazines and that allow them to compete for readers with foreign publications.[21]

(b) The *Excise Tax Act* does not discriminate against imported products

25. The tax is in any event non-discriminatory in form and in fact - *de jure* and *de facto*. It is therefore consistent with Article III:2, first sentence, whose object and purpose, like that of Article III as a whole, is to prevent discrimination against imported products.

26. That the tax is free from any taint of overt discrimination is clear from the terms of the legislation, which make no distinction between domestic and imported products. It could hardly be suggested that the tax is discriminatory in its practical operation, since it was designed to prevent the production in Canada of split-runs. Even in the hypothesis of a removal of Code 9958, there is no reason to believe that imported split-runs would dominate the market. The economics of local production and distribution, combined with the ease and economy of digital transmission (shown by the existing practice of *TIME Canada*), point

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[20] Foreign English-language magazines aimed at the general public dominate the Canadian market, accounting for half of the circulation of English-language magazines, both subscription and newsstand, and for over 80 per cent of newsstand sales. See Canada's First Submission, para. 22.

[21] Paragraphs 23 and 24 address issues raised by the Panel in Questions 10 and 11.

decisively in the opposite direction. The Appellate Body has observed in *Reformulated Gasoline*[22] that where there is no discrimination either in form or in reality, there is no reason why any inconsistency with Article III should arise. That principle is equally applicable here.

27. Even if the products at issue here were "like products", the non-discriminatory nature of the measure would provide a complete answer to the U.S. complaint. In its recent decision on *Japanese Liquor Taxes*,[23] the Appellate Body held that where imported products are taxed in excess of "like domestic products", the general principle set out in Article III:1 may be assumed to have been violated. There is consequently no need to apply that principle as a "separate test" in order to find an inconsistency with Article III:2, first sentence. The Appellate Body has thus established a balance in the interpretation of Article III:2. The concept of "like products" is to be very narrowly construed, on a case-by-case basis in a way that requires "discretionary judgment"; but once the determination is made, excess taxation of imported products entails a violation without any need to conduct a further inquiry under paragraph 1. The essential elements of the interpretation of this provision have thus been authoritatively identified.

28. One question, however, was not addressed in the recent decision: whether taxation of imported products "in excess of" like products is to be determined in terms of classes of products, or whether any single instance of differential taxation creates an automatic *per se* violation even when it results from fiscal classifications that are not themselves discriminatory in form or in fact. The answer is clear both from the wording of Article III:2, first sentence, and from the object and purpose of Article III as a whole, which is the prevention of discrimination against imported products. The use of the plural in referring to "imported products" and "like domestic products" indicates clearly that the concern is with classes of products, not with the isolated instances of differential taxation that necessarily result when product "A" is taxed at a different rate than product "B" because it happens to fall into a different, but non-discriminatory, fiscal classification.

29. This interpretation also seems necessary to create a workable rule. Article III:2 was not intended to impose fiscal harmonization in rates, methods or classifications. It therefore remains not only possible but inevitable that domestic fiscal classifications may in certain instances have the effect of subdividing or straddling "like product" categories, or otherwise crossing "like product" category lines. Since fiscal classifications have no other purpose than to allow differences in tax treatment, any such classifications that failed to correspond precisely to "like product" categories under Article III:2, first sentence, would automatically lead to a violation. Quite apart from imposing a degree of harmonization that goes beyond the language or the purpose of this provision, such an interpretation would lead to an

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[22] *United States – Standards for Reformulated and Conventional Gasoline* (Report of the Appellate Body, 29 April 1996), AB-1996-1, WTO Doc. WT/DS2/AB/R.

[23] *Japanese Liquor Tax Appeal*, *supra* note 11.

intolerable unpredictability so long as "like product" determinations are to be made on a case-by-case basis, as the recent decision has reaffirmed.

30. It could also lead, paradoxically, to results that would make nonsense of the Appellate Body's assumption that excess taxation under Article III:2 automatically entails a departure from the general principles in Article III:1; and that would in fact make nonsense of the underlying purpose of Article III. It could lead to situations where fiscal classifications decisively *favouring* imported products would be considered inconsistent with the first sentence of Article III:2, so long as the tax classification attracting the higher rate contained at least *some* imported products. It makes no sense to say that Article III is automatically violated in any case where tax differences result from domestic classifications that are "origin-neutral" in form and that might even favour imported products in effect - as might well be true of the tax at issue here. A particular instance of differential taxation in such circumstances should not create a *per se* violation, absent a discriminatory effect or cause to believe such an effect to be probable.[24]

3. Article III:2, second sentence

(a) Split-run periodicals and periodicals containing editorial material created for the Canadian market are not directly competitive or substitutable

31. The U.S. First Submission and Oral Statement provide no real evidence on the substitutability issue. The United States, in its Oral Statement, contested Canada's assertion that split-run periodicals and Canadian magazines are not competitive or substitutable as information vehicles. However, the United States offered nothing to substantiate its position. The complainant bears the burden of proof.[25] The United States has not demonstrated, as it is required to do, that split-runs and other magazines are competitive or substitutable.

32. As confirmed by the Appellate Body in *Japanese Liquor Tax II*[26], cross-price elasticity of substitution might not be the only relevant factor in determining the degree of substitutability between two products. As we explained at the hearing, substitution implies

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[24] This reflects previous GATT panel practice. *Japanese Liquor Tax I* (*supra* note 9 at 30), for example, was quoted with approval in the passage of the recent decision of the Appellate Body (*supra* note 11) dealing with the interpretation of Article III:2, first sentence and its analysis therefore deserves some weight. The *Japanese Liquor Tax I* Panel held specifically that Article III:2, first sentence does not preclude product differentiation by Contracting Parties within "like product" categories, the unmistakable implication being that some instances of differential taxation may be permissible according to the circumstances.

[25] *Japanese Liquor Tax II*, *supra* note 12 at para. 6.28. The Panel's statement on the burden of proof concerning direct competitiveness or substitutability was not appealed.

[26] *Supra* note 11.

interchangeability. Once content is accepted as relevant, it seems obvious that magazines created for different markets - not to mention those on different topics - are not interchangeable. They are not substitutes, and certainly not direct substitutes. They serve different end-uses. Ultimately, of course, there may be some degree of competition for disposable income between all cultural products and all luxury products - for everything beyond the necessities of life - but this is far too remote. It is not direct competition and it does not therefore fall within the rule. There would not be 1440 different magazine titles produced in Canada alone if the products were directly substitutable, or directly competitive, in the sense contemplated by the Ad Article to Article III:2.

(b) The *Excise Tax Act* is not protectionist

33. Protection is afforded to domestic production for the purpose of Article III:2, second sentence, if there is a "discriminatory or protective effect against imported products". "Imported products" means products physically transported into the territory of a Member. The United States conceded at the first substantive meeting of the Panel with the parties that the *Sports Illustrated* innovation that led to the legislation involved a domestic product, where the only thing "imported" was the electronically-transmitted foreign content. The United States has thus conceded, in the case of *Sports Illustrated Canada*, that there was no discrimination or protective effect against imported products. It follows that "foreign based" split-runs are not imported products if they are printed and published in Canada.

34. The *Excise Tax Act* thus applies to domestic and imported products without distinction, and it is primarily aimed at a form of domestic product. While the tax secures advertising revenues for Canadian publishers, protection in the sense of Article III:1 as read into III:2 means protection against *imported products*. As the preceding paragraph has shown, split-runs are not intrinsically imported products. Even if there were no import prohibition, given the economies of local production and distribution and the ease of electronic transmission, it is likely that most split-runs would be locally produced. It is highly significant, moreover, that, as the U.S. delegation noted in response to a question at the hearing, the effect of the tax was to induce *Sports Illustrated* to cease its Canadian production and to resume direct imports from the United States. The substitution of imports for domestic products, as the result of a public policy measure, is the direct opposite of what almost everyone understands by protectionism. It suffices by itself to refute the contention that the *Excise Tax Act* operates to "afford protection to domestic production".

35. The excise tax measure is designed to prevent the diversion of advertising to low-cost publications reproducing recycled editorial content, at the expense of publications created for Canadians. It does not guarantee the survival of Canadian magazines that the public does not want. It does not stimulate or create an artificial demand. It ensures fair competition, a "level playing field", no more and no less.

36. The table referred to above[27] illustrates that not only does *TIME Canada* not provide content directed to the market for which it is produced, it does not need to rely on advertising revenues to underwrite the cost of editorial content. These costs have been covered by the higher priced magazine sold in the much larger home market. As a result of being able to rely on the pre-paid editorial content of its parent *TIME*, the advertising income that *TIME Canada* siphons from the Canadian market appears to be pure revenue unmatched with the editorial expenses usually incurred in producing a magazine for a particular market. The diversion of advertising revenues from a market without the provision of any corollary editorial benefit to the market is exactly the practice that the *Excise Tax Act* provisions are designed to discourage.

37. The *Excise Tax Act* is carefully designed to deal with a particular combination of circumstances. What it targets, very simply put, is the combination of recycled editorial content plus Canadian advertisements. This combination, because the crucial input of content comes with minimal cost, is destructive of fair competition in the market place. Split-run editions of magazines compete unfairly for advertising revenues with regular magazines, since their editorial costs are largely paid for in their original market. Canadian magazines derive approximately 60 per cent of their revenues from advertising and such an unfair competitive practice would have a deleterious effect on the production of editorial material created for the Canadian market.

38. It is not Canadian public policy to restrict either the importation or the circulation of foreign magazines. The *Excise Tax Act* does not have that effect. It is based upon a public policy purpose that has nothing to do with trade protectionism.[28]

4. The principle of national treatment does not apply to the commercial postal rates charged by Canada Post

39. As explained in Canada's First Submission, Canada Post Corporation's commercial publication rates are set on the basis of generally accepted commercial and marketing considerations that exist in a competitive environment. They are not influenced by government policy. Canada Post does not have a monopoly over the delivery of publications. Foreign and domestic customers are free to use competing delivery channels. As in all open and competitive markets, all customers have the ability to negotiate rates in a manner reflecting their purchasing power.[29]

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[27] *Supra* note 16.

[28] In response to Question 8 of the Panel, Canada adds that the effect of the *Excise Tax Act* is not to direct advertising revenue to Canadian magazines but to direct advertising revenue away from split-run publications. The split-run publications that the advertising revenue is directed away from are both Canadian and imported publications without distinction.

[29] Canada's First Submission, paras. 104-113.

40. The United States, in its oral statement, contended that the nature of the legal relationship between the Government and Canada Post and the degree of control of the Government over the Corporation were such that the commercial postal rates are necessarily regulations within the meaning of Article III:4 of the GATT 1994. The United States also argued that Canada Post's "discrimination" could not be justified on the basis of commercial motivation. Canada disagrees with these contentions.

41. Government ownership is not in itself sufficient to qualify the practices of an enterprise as regulations for the purposes of Article III:4 of the GATT. The independent nature of Canada Post's commercial operations for the distribution of publications and the competitive environment within which it operates and sets its rates remove such rates from the provisions of Article III:4.

42. Although at one time the Post Office was an integral part of the Government of Canada and its rates were set by statute and regulation, that relationship was changed in a fundamental way in 1981. Concerned with issues relating to service, management, labour relations and the financial performance of the Post Office Department, the Government decided to turn over the postal administration to a Crown corporation with a commercial orientation and an independent management charged with attaining financial self-sufficiency.[30] Significantly, the *Canada Post Corporation Act* gave the Corporation the powers of a natural person, an attribute more typical of a private sector corporation than of traditional Crown corporations. The *Financial Administration Act* later confirmed the Corporation's status as an entity expected to operate in a competitive environment, not to be dependent on appropriations, earn a return on equity and pay dividends to its shareholder.

43. At the time of the creation of Canada Post Corporation, there were those who suggested that it remain under the direct control of the Government. It was proposed that its activities be overseen by the Postmaster General assisted by a Secretariat. Had that been the case, the U.S. contentions that Canada Post policies are in reality government regulations or requirements might be a little more plausible. However, what did happen was that supervision of the Corporation was entrusted to a board of directors composed of independent outside directors and officers of the Corporation (none of whom are civil servants). The Board, like traditional private sector boards of directors, is empowered to establish the general policy of the Corporation, including the making of decisions concerning finance, personnel management and commercial orientation, without the restrictions inherent in government departments. The Board has, since incorporation, pursued the goal of financial self-sufficiency by allowing management the latitude, in commercial operations, to generate revenues through rate and product management and to manage the Corporation's expenditures in a manner consistent with any competitive enterprise, essentially free of

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[30] See "The Mandate of Canada Post Corporation and its Development" (Exhibit E). This paper describes the Canada Post's mandate and its development from 1981 to present. It surveys the process of the enactment of the *Canada Post Corporation Act*, and subsequent reviews, statutory changes and decisions of courts and administrative agencies relating to the mandate of Canada Post.

government intervention.

44. As indicated in footnote 46 on page 17 of Canada's First Submission, the Canadian and international commercial categories of rates have been set by Canada Post outside of the regulations since March 1994 and March 1992, respectively. Non-subsidized publications formerly subject to the rates set out in the *Newspapers and Periodicals Regulations* are now subject to commercial Canadian Publications Mail and International Publications Mail rates, respectively, which are established and approved by Canada Post senior management. They are not established by Canadian Government regulations.[31]

45. Canada Post is a corporation with a distinct legal personality. It can contract separately from the Government. It contracts with the Government for the supply of postal and other services. The Corporation is obligated to pay corporate income tax to the Government on its revenues.[32] Contrary to U.S. assertions, employees of the Corporation are not employees of the Government. Indeed, section 12 of the *Canada Post Corporation Act* authorizes Canada Post to hire employees, fix the terms and conditions of their employment and pay them their remuneration. The statutory regime[33] applicable to employees of the Government does not apply to employees of Canada Post, whose employment conditions and labour relations are governed by the same provisions of the Canada Labour Code that apply to the federal private sector.[34] Furthermore, if Canada Post employees had government employee status, there would have been no need to include a special "deeming" provision in the Act in order to preserve employees' pension rights at the time of the creation of the Corporation. The above attributes are certainly not those of a corporation over which the Canadian Government maintains a "hands-on" level of administrative control as the United States would like the Panel to believe.

46. The degree of control that the Government exercises over Canada Post's commercial operations is one dictated by the Government shareholder's interests. The Government

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[31] Exhibit P of Canada's First Submission is an amendment to the *Newspapers and Periodicals Regulations* published in the Canada Gazette. The amendment approved the removal of the Canadian non-subscriber publications rate (rate code 4) from the regulations. Exhibit Q is another amendment to the *Newspapers and Periodicals Regulations* which approved the removal of the international publications rate (rate code 5) from the regulations. As stated in the Regulatory Impact Analysis Statement, which accompanied the amendments, these items are now subject to commercial rates (which are set by the Corporation). Paragraph 44 addresses issues raised by the Panel in Question 14.

[32] *Income Tax Regulations, amendment*, SOR/94-405 (Exhibit F).

[33] Employees of the Government are appointed by the Public Service Commission under the unique provisions of the *Public Service Employment Act*. Employment conditions and labour relations are governed by the *Public Service Staff Relations Act* and the *Public Service Employment Act*.

[34] The federal private sector includes such industries as banks, interprovincial trucking, radio, television, railways, ports and the aeronautics industry.

requires sound financial administration of the Corporation's business and a fair return on its equity investments. To achieve this goal, the Corporation must offer satisfactory services to customers at a competitive price that will maximize profits. In a competitive environment, pricing policies of Canada Post must take into account basic economic principles of supply and demand. It must consequently consider the effects that its commercial postal rates will have on current or potential competition.

47. As stated above, Canada Post does not have a monopoly with respect to the delivery of publications (newspapers and periodicals) in Canada. Canada Post, through the *Canada Post Corporation Act*, does have a limited exclusive privilege with respect to the collection, transmission and delivery of "letters" in Canada including addressed advertising mail, but the Corporation has no statutory protection for the remainder of its business and must compete with existing or potential competition, as the case may be.[35] Any publisher, foreign or domestic, is free to arrange for the delivery of the publisher's newspapers or periodicals to subscribers or newsdealers via Canada Post at the applicable rate for which the publisher is eligible or alternatively, with private distributors in Canada. Additionally, as mentioned in Canada's First Submission, foreign publishers have the option of mailing their copies addressed to Canadian subscribers or newsdealers with their own postal administration at the applicable international printed matter rates.

48. As stated in paragraph 113 of Canada's First Submission, almost 50 per cent of foreign publications mailed in Canada are accorded special rates negotiated by major foreign publishers pursuant to long-term agreements with Canada Post. Those rates are substantially less than the commercial International Publications Mail rate and relatively close to the commercial Canadian Publications Mail rate.[36] The willingness of the Corporation to enter into such special-rate agreements reflects the reality that large foreign publishers have the resources and purchasing power to credibly threaten full or partial delivery in Canada via current and potential private distributors. Smaller foreign publishers have neither the volume nor the density of mailings to warrant their effort to access private distribution (often organised on a city by city basis) in Canada. Canadian commercial publishers have credibly threatened to move to private distribution in the past.[37] This has motivated the Corporation to develop commercial Publications Mail rates that are financially attractive when compared to that of current or potential private distributors.[38]

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[35] See the correspondence and internal memoranda set out in Exhibit G.

[36] Contrary to what the United States contends, several large foreign publishers enjoy discounts, pursuant to long-term agreements, similar to the mail preparation discounts offered to Canadian publishers.

[37] Those threats are substantiated by certain factors such as the proximity of the Canadian publications to their markets, generally greater density of those markets (typically commercial trade publications oriented towards businesses in urban areas) and concentration of ownership in the industry.

[38] Paragraphs 47 and 48 address issues raised in the Question of the United States to Canada.

49. Canada Post currently faces competition for delivery of addressed publications.[39] The principal form of competition for the delivery of addressed subscriber copies of daily and weekly newspapers (those not eligible for subsidized postal rates) is delivery by the publishers themselves. In general, almost all such newspapers choose to deliver their own publications wherever volume densities warrant, with the residual volumes being mailed to subscribers via Canada Post's commercial Publications Mail rates. There is somewhat less competition for the delivery of addressed periodicals, where competition exists mainly in the dense urban areas. Competition for the delivery of addressed periodicals is limited because commercial publications rates are designed to attract the delivery of addressed periodicals not eligible for subsidized rates. It is also limited due to Canada Post's successful bid to the Department of Canadian Heritage for the delivery of publications eligible for funded rates. Canada Post's competitors cannot enter into the same arrangement with the Department of Canadian Heritage because all available program dollars have been committed to the arrangement signed with Canada Post.[40]

50. The economic factors applicable to foreign and domestic periodicals are not the same which is why their respective rates are different. Those rates are a reflection of competitive situations, not the result of discriminatory practices as it is argued by the United States. Canada Post has no policy of giving a competitive advantage to one segment of its customers over another, and would have no interest in pursuing any such practice. Given appropriate competitive factors, it might very well be that certain foreign periodicals would enjoy better rates than non-subsidized Canadian magazines. This is exactly the type of scenario that Article III of the GATT 1994 is intended to preserve. If foreign magazines are in better competitive situations, they should be able to take advantage of it. If on the contrary, they are not in such a position, Article III should not be there to grant them advantages that market forces do not provide. In the commercial and competitive environment in which Canada Post operates, it is under no obligation by virtue of Article III:4 to subsidize U.S. publications by setting a better postal rate then what their specific market conditions require.

5. The funds paid by the Department of Canadian Heritage to Canada Post to ensure that Canadian periodical publishers can mail periodicals at reduced postal rates are allowable subsidies under Article III:8(b) of the GATT 1994

51. The United States argues that funds paid to Canada Post - which charges lower postal rates to eligible Canadian publications - by the Department of Canadian Heritage cannot be considered subsidies paid exclusively to Canadian publishers of periodicals, as provided in

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[39] Examples of such competitors are Globe and Mail Distribution Services Ltd., AITours Ltd. (bundle distribution of magazines to business/professional offices), C.D. Woods Ltd., (Vancouver B.C.), Roltek Ltd., Insurance Courier Services Ltd. and an emerging co-operative delivery venture of Canadian trade publications.

[40] Paragraph 49 of this Submission addresses issues raised by the Panel in Question 15.

Article III:8(b). The United States claims that Panel reports have uniformly found that the only subsidies permitted under Article III:8(b) are those involving actual payments made directly to domestic producers. As stated in Canada's First Submission[41] and in the written version of its Oral Statement,[42] the Panel reports referred to by the United States lend no support to its position.

52. The provision of reduced postal rates is a way of paying subsidies that is compatible with GATT 1994. The sole purpose of the government payments to Canada Post is to allow eligible Canadian publishers the benefits of reduced postal rates. The position held by the United States is based on a difference of form, not substance. The specific form in which the subsidy is paid is irrelevant to the operation of Article III:8(b), provided that actual payments are made. There is simply no analogy to tax preferences involving no payment at all, particularly in view of the need to preserve the integrity of Article III:2. In this case, the postal subsidy involves the Federal Government making payments to Canada Post four times a year in return for its undertaking to deliver eligible publications at the agreed reduced postal rates. The benefit of the subsidy flows directly to eligible Canadian magazine publishers.

53. Whether the subsidy is paid to Canada Post or directly to the publishers of magazines does not make any difference from an economic perspective - eligible publishers are the beneficiaries of the subsidy. The effect is the same except for the costs associated with managing the subsidy program, which would differ substantially. In practical terms, payments to individual publishers would be a cumbersome and ineffective method of delivering this subsidy. The administrative and financial burden of such a process would erode the benefits of the program. The current process - where the Department of Canadian Heritage provides Canada Post with an agreed-upon payment on a quarterly basis - is far more efficient in minimizing the administrative overhead related to the program. The United States has not pointed to a convincing reason why the Panel should adopt an interpretation of the GATT 1994 that would have the effect of replacing the current efficient system with an entirely new, costly and inefficient one - with no impact at all in terms of the competitive position of Canadian and U.S. magazines.

6. Code 9958 of Schedule VII to the *Customs Tariff* is justifiable under Article XX(d) of the GATT 1994

54. Code 9958 is a measure intended to secure the attainment of the objectives of section 19 of the *Income Tax Act*. The conformity of the *Income Tax Act* with the GATT 1994 is not being challenged. While the provision is not contested in this proceeding, Canada's

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[41] Paras. 116 and 119.

[42] At 32-33.

position is that as a services-related measure it raises no issues under the GATT.[43] Code 9958 and section 19 of the *Income Tax Act* were conceived to deal with the problem of split-runs with inserted Canadian advertising. The idea was that the income tax provision would cover magazines printed in Canada and the border measure would cover magazines printed outside the country. The effectiveness of the non-deductibility provision standing by itself would obviously be very limited. The problem is that of foreign companies that sell into the Canadian market but are not subject to Canadian income tax. This would be more than a loophole, given the open nature of the Canadian economy and the degree of import penetration. It would largely destroy the effectiveness of the income tax measures.

55. Each term of Article XX(d), including the preamble, should be given consideration when examining whether Code 9958 can be justified as a necessary measure within the meaning of the treaty. Since Code 9958 is a "measure" directed against imports from all foreign countries, it "is not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail", as stated in the preamble to Article XX. Similarly, having regard to the application of Code 9958 since its adoption, it cannot be claimed that it has been "applied in a manner which would constitute ... a disguised restriction on international trade".[44]

56. GATT practice has introduced very stringent tests for the application of Article XX(d). Canada's First Submission[45] drew attention to the *EEC Parts and Components* Panel,[46] which interpreted Article XX(d) in terms of enforceability as opposed to measures designed to ensure that the objectives of another measure are not undermined. Canada is not challenging the latter decision or its reasoning. It makes sense in the context of regulatory statutes with prohibitions or even tax statutes that are designed to raise revenue and prevent tax evasion. But in the case of a fiscal incentive whose sole purpose is to influence business decisions in a certain direction, compliance has to be judged in terms of effectiveness.

57. Another aspect of the test was elaborated in *United States - Section 337 of the Tariff Act 1930*[47] where the Panel held that the term "necessary" requires the use of the least trade-restrictive measure available. As noted at the hearing, Canada submits that there are no other measures, less restrictive or otherwise, that will accomplish the objective. If split-runs could be imported, with Canadian advertisements often placed by businesses for which

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[43] This passage addresses issues raised by the Panel in Question 13.

[44] This paragraph addresses issues raised by the Panel in Question 12.

[45] Paras. 101 and 102.

[46] *EEC - Regulation on Imports of Parts and Components* (Report of the Panel adopted on 16 May 1990), GATT Doc. L/6657, BISD 37S/132.

[47] Report of the Panel adopted on 7 November 1989, GATT Doc. L/6439, BISD 36S/345 at 392, paras. 5.25-5.27.

Canadian tax liability is irrelevant, the program will simply no longer work.[48]

58. The distinction is between formal compliance and real or substantial compliance, which in this case has nothing to do with whether deductions are properly claimed but with the policy behind this entire set of measures. Canada therefore reiterates its suggestion that the application of the exception in Article XX(d) should take account of the nature of the measures under consideration, and that the test in the *EEC Parts and Components* and the *U.S. Section 337* Panel decisions should not be rigidly applied without taking account of these circumstances. The Panel will recall that Code 9958 and the income tax provision have always been considered part of a single, indivisible package of complementary, indivisible measures and should be treated as such for the purposes of Article XX(d).

59. In its Oral Statement, the United States placed most of its emphasis on the second part of Code 9958, which places a five per cent limit on space devoted to advertising for the Canadian market in imported magazines. To the extent that the second part of Code 9958 goes beyond the coverage of section 19 of the *Income Tax Act*, and thus beyond the split-run phenomenon, the arguments made by Canada under Article XX(d) have no independent application. This assumes, however, that the Code can be broken down into independent components. In Canada's view, the Code should be regarded as an indivisible legislative prescription, all of which is closely linked in conception and application to the policy underlying the deductibility provision of section 19 of the *Income Tax Act*.

60. The United States claims that the Canadian legislation creates a "monopoly" for Canadian publishers of advertisements directed at the Canadian market. The existence of "spillover" advertising, whereby advertisements for generally-available products in wide-circulation U.S. magazines automatically reach the Canadian public, with very significant consequences for the competitiveness of the Canadian industry, suffices to cast doubt on this proposition. The "monopoly" effect complained of by the United States has nothing to do with the first part of the Code, dealing with split-runs, or with the *Excise Tax Act*. The *Pulp & Paper* magazine exhibited by the United States at the hearing is only relevant to the second part of Code 9958;[49] and is not relevant to the first part of that Code or to the *Excise Tax Act*.

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[48] This paragraph addresses issues raised by the Panel in Question 9.

[49] The provisions of Part 2 of Code 9958 apply to a very limited type of advertising. Advertisements that would not be allowed would have to indicate a source of availability in Canada to be considered as "directed at Canadians", such as addresses and telephone numbers. Any other references to availability in Canada, including, for example, 1-800 numbers and web-sites, would be acceptable under the Code and would not be counted within the 5 per cent.

III. CONCLUSIONS

61. In the light of the foregoing, Canada requests the Panel to conclude that:

1. Article III of the GATT 1994 does not apply to Part V.I of the *Excise Tax Act*.

2. If the Panel decides that Article III of the GATT 1994 does apply, Part V.I of the *Excise Tax Act* is compatible with Article III of the GATT 1994.

3. The national treatment obligation of Article III:4 of the GATT 1994 does not apply to the commercial rates charged by Canada Post.

4. The funds paid by the Department of Canadian Heritage to Canada Post in order to grant Canadian publishers of periodicals reduced postal rates are allowable subsidies pursuant to Article III:8(b) of the GATT 1994.

5. Code 9958 of Schedule VII to the *Customs Tariff* is justifiable under Article XX(d) of the GATT 1994.

TABLE OF EXHIBITS