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US CHALLENGE TO INDIAN EXPORT SUBSIDIES AT THE WTO: WHAT NEXT?

September 2018

Background

- US challenged the following Indian export subsidies before the WTO:
 - Special Economic Zones (“SEZ”)
 - Export Oriented Unit (“EOU”) and sector specific schemes including Electronic Hardware Technology Parks (“EHTP”)
 - Merchandise Exports from India Scheme (“MEIS”)
 - Export Promotion Capital Goods Scheme (“EPCG”)
 - Duty free imports for exporters program (Customs Notification No. 50/2017 dated 30 June 2017)



- Current position: Both India and US have filed their first written submissions; first hearing likely to be held in February 2019 and the order of the Panel expected in first half of 2019
- Challenge to India’s export subsidies under ASCM is limited to goods
 - Export subsidies provided for services will not be affected

What is at stake?

- Scheme-wise subsidy amounts during 2017-18

Name of Scheme	Total grant (in INR, Crores) 2017-18 (Ann.)
Export Oriented Units, and sector specific schemes such as Electronics Hardware Technology Parks Scheme and Biotechnology Parks	3,400
Merchandise Exports from India Scheme	13,937
Export Promotion Capital Goods Scheme	2,300
Special Economic Zones	3,567

Source: <https://www.indiabudget.gov.in/ub2018-19/rec/annex7.pdf>

Legal framework under ASCM

- Subsidy = ‘financial contribution’ + ‘benefit’ [Art. 1 of Agreement on Subsidies and Countervailing Measures (“ASCM”)]

- Types of subsidies under ASCM
 - Prohibited subsidies
 - Actionable subsidies

- Prohibited subsidies (Art. 3, ASCM):
 - subsidies contingent upon export performance including those illustrated in Annex I
 - subsidies contingent upon the use of domestic over imported goods

- Actionable subsidies are subject to challenge, either through multilateral dispute settlement or through countervailing action, in the event that they *inter alia* cause injury to the domestic industry of another WTO Member country
 - e.g. production subsidies which are contingent upon production of a particular product/group of products and not on export

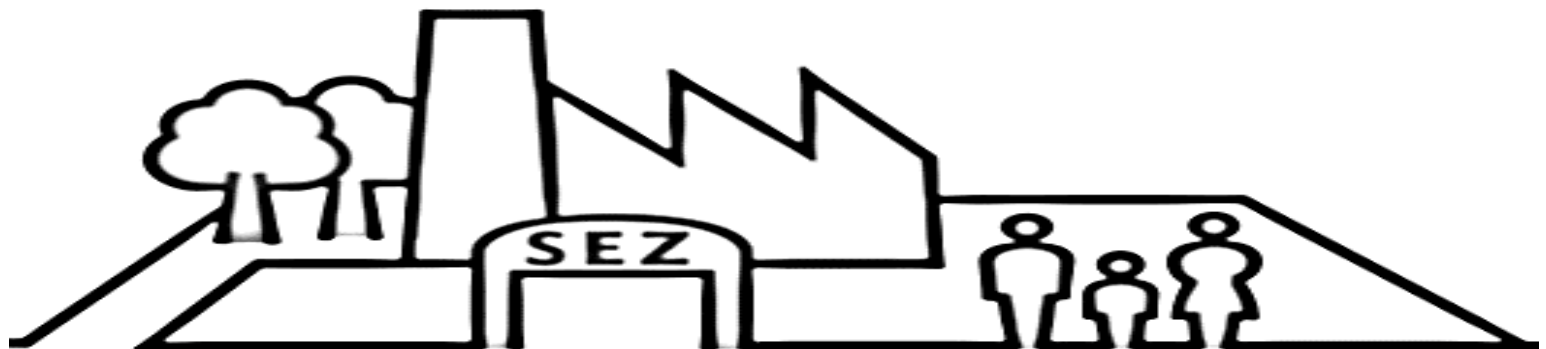
Exceptions under ASCM

- Notably Annex I recognizes the principle that “taxes may not be exported”
 - Based on this concept an exception is carved out for export subsidies
 - This exception is known as the **Excess Remission Principle**
- **Excess Remission Principle:** Any remission of indirect taxes or import charges on inputs in excess of those used for products for domestic consumption not permitted (Para (h) and (i) of Annex I).
 - Verification mechanism
 - Input - output norms (Annex II and III)
- Another exception is carved out in terms of the concept of **Specificity** (Art. 2, ASCM)
 - A subsidy must be specific to an enterprise, industry or region
 - Prohibited subsidies are by definition considered to be specific

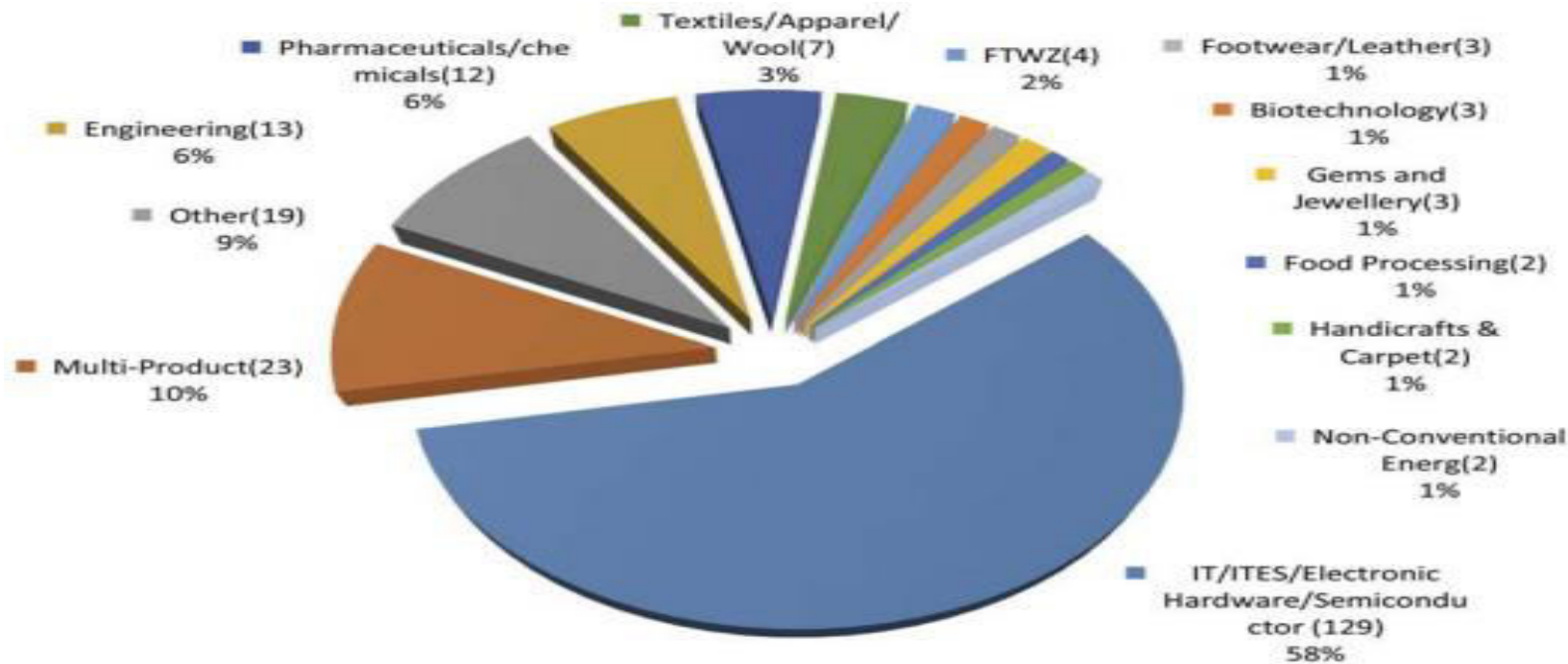
Key features of SEZs

- Benefits provided to SEZ units:
 - Indirect tax exemptions;
 - Income tax exemptions;
 - Other exemptions/concessions
 - Stamp duty, electricity duty

- Export contingency:
 - Positive NFE Benefits cumulatively for a period of 5 years from the commencement of production
 - Failure to achieve positive NFE attracts penal action under the FTDRA



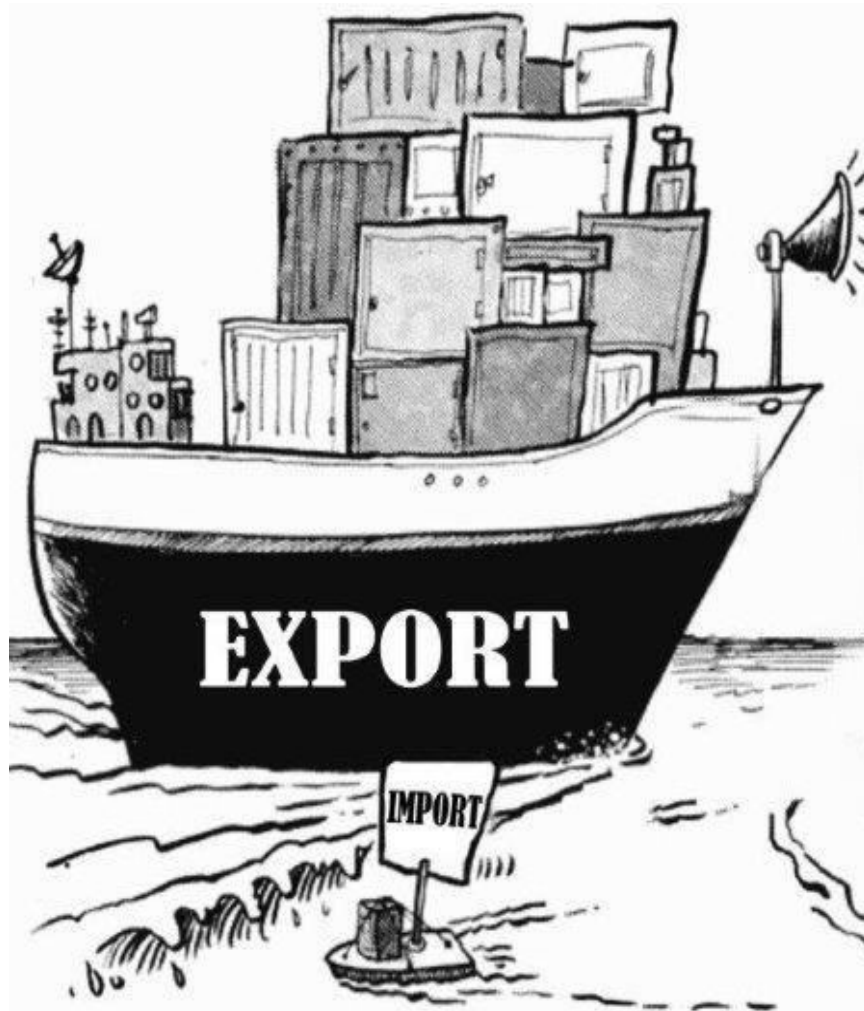
Top 5 SEZ sectors in India



Source: Ministry of Commerce, Annual Report (2017-18)

- Since the ASCM only sets out the framework of subsidies provided for goods, DS 541 will not affect the subsidies provided for services.

Key features of EOUs



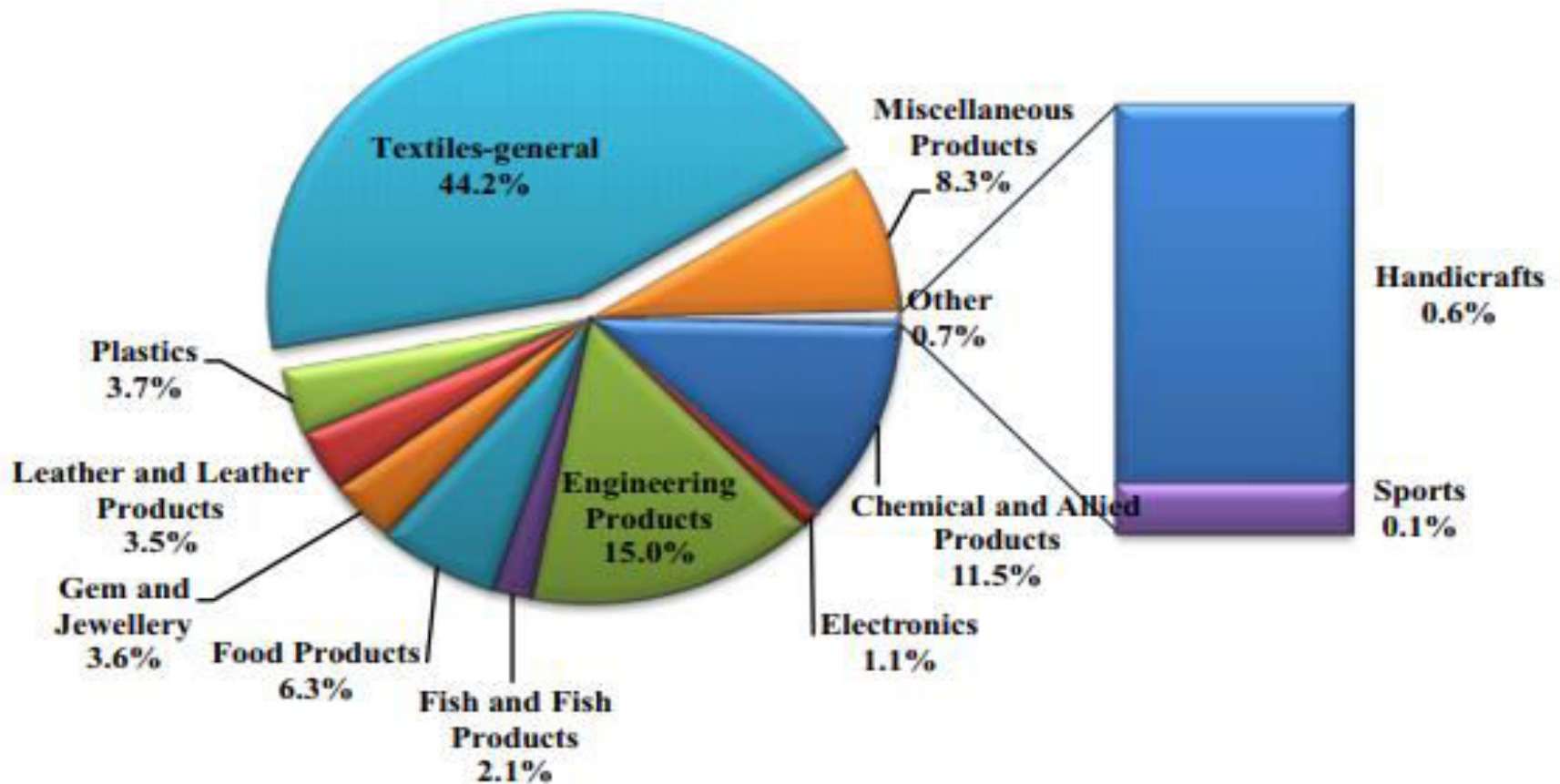
- EOUs must export their entire production except for certain permissible sales to DTA
- Like SEZs, EOUs have to achieve positive NFE (calculated cumulatively in block of 5 years, starting from commencement of production)
 - Failure to achieve positive NFE attracts penal action under the FTDR
- EOUs also receive certain tax exemptions wrt importation of inputs and capital goods
- Both EOUs and SEZs remain contingently liable for penalties until positive NFE is not achieved.

Key features of EPCG



- Two-fold objective of EPCG:
 - to facilitate import of capital goods for producing quality goods and services, and
 - enhance India's manufacturing competitiveness
- EPCG allows import of capital goods for pre-production, production and post-production at zero customs duty
- Import under EPCG is subject to an export obligation equivalent to 6 times of exemptions on capital goods, to be fulfilled in 6 years from date of issue

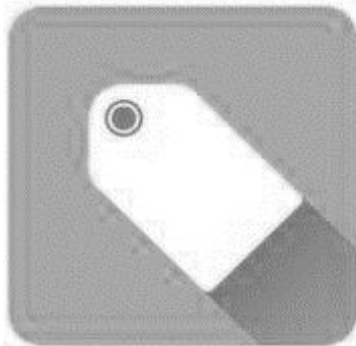
Percentage share of sectors in issuance of authorisations under EPCG during 2016-17



Source: DGFT's MIS Report of Export Promotion Schemes (2017)

Key features of MEIS

- Two -fold objective:
 - To promote the manufacture and export of notified products
 - To offset infrastructural inefficiencies and associated costs



- MEIS is provided in the form of duty credit scrips
- It can be used for payment of:
 - BCD and additional customs duty for import of inputs
 - Central excise duties on domestic procurement of inputs or goods
- The basis of calculation of the entitlement under MEIS would be on realised FOB value of exports

Duty free imports for exporters program (DFIE)



- US claims that the GoI through Customs Notification No. 50/2017 dated 30 June 2017 provides a duty free imports to exporters
- It sought to supersede an earlier notification and prescribe effective rates of customs duty and IGST for goods imported into India
- The notification provides for reduced or zero duty rates for imports of specified products subject to certain conditions:
 - specific conditions no. 10, 21, 28, 32, 33, 36, 60, 61 and 101
 - 8 relevant conditions are regarding use of imported products for use in products for exports
 - 2 conditions (60(i) and 61) are for import products of R&D, however do not specify that import should be related to exports
 - The 9 conditions also specify maximum limit of the value of goods imported, expressed as percentage of the FOB value of exports during the preceding financial year
 - All 9 relevant conditions require production of a certificate from a relevant authority certifying value of exports made and value and quantity of goods imported for the relevant financial year

US position on WTO incompatibility

Scheme	Benefits	Export contingency
SEZ	Indirect tax exemptions on imports of inputs and capital goods; Income tax exemptions; Other tax/duty exemption	Obligation to achieve NFE
EOU	Indirect tax exemptions on imports of inputs and capital goods	Obligation to achieve NFE
EPCG	Indirect tax exemption on import of capital goods	Export obligation
MEIS	Duty scrip	On FOB value of exports
Duty free imports for exports	Reduced or nil customs duty	Inputs to be used in exports

Possible defenses

Issue	Potential arguments to counter US claims	Remarks/Challenges
Exemption of duties on imports of inputs (i.e. raw materials)	Excess Remission Principle	<ul style="list-style-type: none"> • Burden and standard of proof • Verification mechanism • DS 486
Exemption of duties on import of capital goods	Only non-cenvatable component of duty (i.e. BCD + cess) may be considered as ‘benefit’	<i>Prima facie</i> capital goods not covered under ‘excess remission principle’
Income tax deductions and other duty exemptions	<ul style="list-style-type: none"> • SEZ outside the customs territory (i.e. all sales from SEZ even to DTA deemed as exports) and hence no liability to pay tax • No foregoing of revenue “otherwise due” • Treatment of certain similar FTZs in Vietnam, Oman etc. by USDOC 	<ul style="list-style-type: none"> • FTZs untested by WTO • US – FSC dispute report could pose a challenge • NFE obligation and contingency to pay tax

Treatment of free trade zones by USDOC



- US Department of Commerce (**USDOC**) has countervailed SEZs and EOUs in several anti-subsidy investigations against India for the following reasons:
 - SEZs and EOUs are subject to penalty if they don't meet the positive NFE requirement therefore, legally, they are **not treated as being outside the customs territory of India**
 - SEZs and EOUs **lack of a reasonable and effective system to confirm which inputs and in what amounts are actually consumed** in the production of the exported product after allowing for waste.

- USDOC did not countervail similar programs implemented by Vietnam and Indonesia for the following reasons:
 - Vietnamese customs authority examines every sale of scrap to ensure there are no leakages
 - Indonesian customs authority conducts physical inspections through customs officials assigned to each zone. It has in place a procedure for routine reporting requirements and periodic audits.

- **Non-countervailability does not imply compatibility with the ASCM**

GoI project on export subsidies

- The focus of GoI should be to defend its SEZ and EOU policies
- In a reaction to DS 541, the Commerce ministry set up a committee headed by Bharat Forge chairman Baba Kalyani to review its SEZ policy
- The GoI must consider doing away with the penalty provision for non-fulfilment of the positive NFE requirement
- Since India always gets called out for its verification mechanism by investigating authorities
 - GoI can use this opportunity to overhaul the system and introduce procedure for periodic audits and physical inspections
 - Such procedures should focus on monitoring every sale of scrap

How can GoI provide WTO compatible subsidies?



- Footnote 1 to the ASCM provides a special carve out in terms of the excess remission principle which takes away the prohibition against export subsidies
- Under the ASCM the subsidies to which the excess remission principle applies are:
 - exemption or remission of indirect taxes in respect of the production and distribution of exported products
 - exemption, remission or deferral of prior-stage cumulative indirect taxes on goods or services used in the production of exported products
 - remission or drawback of import charges levied on imported inputs that are consumed in the production of the exported product
- A strong and effective verification mechanism + a reasoned and transparent input-output norms necessary to apply excess remission principle
- Producer subsidies

Way forward

- Evaluate and quantify export incentive
- Industry representation to GoI
- Restructuring supply chain
- Phase wise action anticipated
- Future investment



THANK YOU



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