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SHOP TALK

Don't Bind the Supply Chain: Lessons from the Boeing Incentives WTO Panel Report

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While most state and local incentives professionals are at least aware of the potential constitutional constraints on state aid, a decision last autumn by a World Trade Organization (WTO) Panel[1] highlights another risk to an incentives package: international trade agreements. The Panel found that conditions attached to certain Washington State tax benefits for Boeing effectively created a preference for the use of domestic goods (i.e., wings) over imported goods, amounting to a prohibited subsidy under WTO rules.

When crafting incentives for large projects, professionals should weigh international trade risks and adjust the incentives package if needed. Additionally, businesses seeking a more level playing field should assess whether their domestic competitors are receiving subsidies that could expose the United States to a WTO challenge or whether the United States could challenge support granted to a foreign competitor.

Boeing's $8.7-billion deal to manufacture the 777X in Washington State

The Boeing 777X production facilities were the mega-project of 2013, with many states offering compelling incentives packages to try to win the aircraft assembly operations. Ultimately, Boeing's home state of Washington beat out the upstarts with an estimated $8.7 billion in tax breaks, supposedly the largest incentives package ever at that time, and perhaps still the largest to date.

The incentives were created in 2013 via special legislation[2] that both improved and extended through 2040 a suite of existing aerospace-related tax benefits that were otherwise scheduled to expire in 2024:

1. A special low rate of 0.2904% for manufacturing of commercial aircraft under the Business & Occupation (B&O) Tax.[3]
2. A sales and use tax exemption for construction services and materials.
3. A sales and use tax exemption for computer hardware and software.
4. B&O tax credits for aerospace product development.
5. B&O tax credits for property taxes and leasehold excise taxes paid.
6. Property tax and leasehold excise tax exemptions.

These incentives applied not only to production of the 777X but also to Boeing's other aircraft production activities in Washington. Effectively, this package was in part a retention incentive.

The incentives package came into effect in July 2014 upon a determination by the Washington State Department of Revenue that a significant commercial airplane manufacturing program had been sited in the state—the Boeing 777X program.[4] Additionally, the special low B&O tax rate of 0.2904% has a compliance clause that will terminate the preferential rate if the Department of Revenue were to determine that "any final assembly or wing assembly" of any version of the 777X had been sited outside of Washington.

The European Union's WTO challenge to Washington State's tax breaks

These developments in Washington State were being watched closely by officials in the European Union (EU), home to Boeing's leading rival, Airbus. In December 2014, the EU initiated a WTO dispute by requesting consultations with the U.S. under the WTO Agreement on Subsidies and Countervailing Measures (the "SCM Agreement"). The EU contended that Washington's tax breaks are "subsidies contingent . . . upon the use of domestic over imported goods" prohibited under Article 3 of the SCM Agreement.[5]

The consultations held in February 2015 did not resolve the dispute. A Panel was subsequently established to consider the dispute, and this Panel issued its report in November 2016.

State tax breaks classified as subsidies

The Panel's first consideration was the threshold issue of whether the tax breaks should be considered subsidies subject to review; it ultimately concluded that all of the tax incentives were subsidies. Under the

SCM Agreement, a subsidy is defined as (i) a financial contribution, (ii) by a government or any public body in a WTO Member's territory, (iii) that confers a benefit.[6] A financial contribution can take the form of a "direct transfer of funds" (e.g., grants or loans), the provision of non-infrastructure "goods or services," or, as most relevant here, "government revenue that is . . . forgone or not collected (e.g. fiscal incentives such as tax credits)."[7]

The Panel's analysis of the existence of a subsidy first focused on the "financial contribution" element. Since the tax incentives in large part would have been in effect until 2024 anyway, the Panel first had to determine whether it could consider the future foregone revenue (i.e., from after 2024) as a present subsidy. It concluded that it could do so because, by the tax measures "presently in effect," the state had already given up its right to the future revenue.[8]

The Panel then compared each of the specified tax benefits to the ordinary rates of the relevant taxes. For example, the special low 0.2904% B&O tax aerospace rate was compared against the ordinary manufacturing (0.484%), wholesale (0.484%), and retail (0.471%) rates, as well as the special tooling manufacturing and wholesale rate (0.471%). The special low rate was considered to be a subsidy,[9] as were the special credits to further reduce the B&O tax liability.

The Panel also found that the sales and use tax exemptions were subsidies. This is notable because, on their face, the exemptions—particularly the computers and software exemption—were anodyne industry-based exemptions. The Panel's analysis focused on the "organizing principle" of sales and use taxes being "a generally applicable tax that applies by default."[10] The Panel Report did not consider principles of anti-pyramiding in determining the relevant benchmark tax treatment for business exemptions.

The property tax and leasehold tax exemptions also were considered to be subsidies—they were complete exemptions from taxes otherwise due.

But are they prohibited subsidies contingent on use of domestic goods?

The SCM Agreement is not a blanket prohibition on subsidies. To be challengeable, a subsidy must be either "actionable," i.e., causing "serious prejudice" or other adverse effects,[11] or "prohibited," i.e., *per se* inconsistent with SCM rules. Two types of support are deemed "prohibited subsidies" given their significant potential to adversely impact trade and other WTO Members' interests—export subsidies and local content subsidies.

Export subsidies are "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance."[12] Local content subsidies are "subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."[13]

Here, the EU contended that the Washington tax incentives were prohibited local content subsidies. The essence of the EU's argument was that the aircraft wings were goods that could be imported for final assembly, as is the practice for Airbus aircraft and for some Boeing aircraft. Thus, in the EU's view, Washington's incentives package was illegally discouraging Boeing from using imported wings for the 777X.

The Panel first considered and rejected *de jure* arguments that the Washington incentives law on its face required use of in-state wings for producing completed 777X aircraft. A *de jure* analysis considers only the language of the relevant provisions. In this case, the initial enactment trigger upon the siting decision did require both aircraft assembly and wing assembly operations, but it did not expressly require that aircraft assembly use solely in-state wings. Even the compliance clause potentially terminating the preferential B&O tax rate, on its own or taken together with the initial enacting clause, was not considered to be *de jure* contingent on the use of domestic instead of imported goods, because it related to "siting" of operations rather than importation of wings.[14]

In a *de facto* analysis, however, that compliance clause was found to be contingent on the use of domestic instead of imported goods. The United States responses to the Panel's questions had indicated that any importation of completed 777X wings from outside of the country would likely be considered by the Washington State Department of Revenue to be an out-of-state siting that would trigger the compliance clause and raise the B&O tax rate.[15] Statements by Governor Inslee regarding the legislation's goal of requiring Boeing to keep all 777X wing assembly in the state also were noted.[16]

Taking these facts into account, the Panel determined that the preferential B&O tax rate was a prohibited subsidy because it effectively conditioned the tax rate incentive on not using imported goods (wings).[17] Since the compliance clause affected only the preferential B&O tax rate, the other subsidies were upheld.

Both parties are appealing this WTO Panel Report, and so it is unlikely to be the final word on whether Washington State's incentives constitute illegal subsidies.[18] If the Panel Report is upheld by the WTO Appellate Body, Washington State would need to withdraw the subsidy within a specified time period. If it fails to do so, then the EU could be authorized to take commensurate countermeasures.[19]

Implications of the Boeing incentives Panel Report for practitioners

For large incentives projects, a big part of the expected benefits to a state and its localities come from the use and development of local supply chains. Yet, as the Boeing Panel Report illustrates, legal provisions conditioning an incentives package on the use of local suppliers are problematic under the SCM Agreement if the relevant suppliers have competition from non-U.S. sources. State incentives for the location of vertically integrated manufacturing operations are also implicated by the WTO Panel's reasoning. Conceivably, any operations comprising two or more steps could be affected if an intermediate product being incentivized is a good that can be traded in international markets.

In many instances, if the WTO subsidy issue is identified, then the structure of the incentives could be changed to reduce the risks. For example, perhaps Washington could have adjusted the compliance clause to avoid the all-or-nothing question of whether *any* foreign production of 777X wings took place and thereby triggered termination of the preferred B&O tax rate. Or it could have drafted the compliance clause as an affirmative requirement for Boeing to maintain a given level of 777X wing production in Washington rather than as an effective disincentive for locating 777X wing production abroad and then importing the wings. Another approach would have been to use other levers to encourage supply chain localization, such as in-state employment incentives or R&D support. These incentives might still constitute actionable subsidies under the SCM Agreement, but the bar for mounting a WTO challenge would be higher; a complainant country would need to establish adverse effects.

The public narrative surrounding the incentives package also should be scrutinized for statements that could be construed as limiting trade. While use of local contractors and service providers is to be expected, statements about developing or retaining an in-state supply chain should be avoided if possible. While making for good politics, such pronouncements can give ammunition to an argument that a subsidy is de facto contingent on the use of domestic goods, as in the Boeing tax incentives dispute.

In dealing with big projects and customized incentives, a business involved in international markets needs to understand its WTO subsidy risks much as it would seek to understand other risks to the state's ability to hold up its side of the bargain (political risks, constitutional risks, fiscal risks, etc.) All of these risks are readily manageable if addressed in advance when designing the incentives package.

[1] Panel Report, *United States—Conditional Tax Incentives for Large Civil Aircraft*, WT/DS487/R (Nov. 28, 2016) (the "Panel Report").

[2] Engrossed Substitute Senate Bill 5952, 63 Wash. Leg., 2013 3d Spec. Sess.

[3] The legislation also extended through 2040 special B&O tax rates for other aerospace-related activities.

[4] *Special Notice: New and Extended Aerospace Tax Preferences,* Washington Department of Revenue (July 2014).

[5] SCM Agreement, art. 3.1(b).

[6] SCM Agreement, art. 1.1.

[7] SCM Agreement, art. 1.1(a)(1).

[8] Panel Report, ¶¶ 7.52-7.55.

[9] *See* Panel Report, ¶¶ 7.56-7.83.

[10] Panel Report, ¶ 7.125.

[11] SCM Agreement, art. 5.

[12] *Id.* art. 3.1(a).

[13] *Id.* art. 3.1(b).

[14] Panel Report, ¶¶ 7.298-7.317.

[15] Panel Report, ¶¶ 7.362-364.

[16] Panel Report, ¶ 7.366.

[17] Panel Report, ¶ 7.369.

[18] At the time of this writing, the WTO Appellate Body had notified the parties that it would not rule on the appeals within the 90-day timeframe specified by Article 17.5 of the WTO Dispute Settlement Understanding. No expected date of the Appellate Body Report has been announced.

[19] SCM Agreement, art. 4.7, 4.10.