

IN THE MATTER OF:

**Article 304 and the Definition
of Direct Cost of Processing
or Direct Cost of Assembling**

USA-92-1807-01

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)	
ARTICLE 304 AND THE DEFINITION)	SECRETARIAT CASE NUMBER
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OF DIRECT COST OF PROCESSING)	USA-92-1807-01
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OR DIRECT COST OF ASSEMBLING)	

FINAL REPORT OF THE PANEL

JUNE 8, 1992

Panel Members

Ian Binnie, Q.C.
James F. Grandy (Chair)
William B. Kelly, Jr.
Donald McRae
Phillip Trimble

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Final Report of the Panel**June 8, 1992*****I. Introduction***

1. The Panel was established by the Canada-United States Trade Commission under Article 1807 of the Free Trade Agreement between Canada and the United States (hereafter "FTA") in accordance with an exchange of letters between Canada's Minister for International Trade, Michael H. Wilson, and the United States Trade Representative, Carla A. Hills.

2. The Parties agreed on the following timetable:

January 6	Panel requested by Canada
February 6	Panel selection completed
February 18	Canada files written submissions
March 9	USA files written counter-submissions
March 31	Oral hearing in Washington, D.C.
April 7	Parties file supplementary briefs
May 6	Panel presents initial report
May 20	Parties file comments on initial report
June 8	Panel presents final report

3. The Parties further agreed that the Panel should be composed of Ian Binnie, Q.C.; James F. Grandy (Chairman); William B. Kelly, Jr.; Donald McRae; and Phillip Trimble. Sidney Rubinoff was appointed by the Chair as an assistant to the Panel.¹ A

¹Jack Weiss served as an assistant to Phillip Trimble, Anthony Van Duzer served as an assistant to Donald McRae, and Riyaz Dattu served as an assistant to Ian Binnie.

hearing was held in Washington, D.C. on March 31, 1992. At the beginning of the hearing the Chair was asked for a ruling as to the propriety of a Party making the written submissions available to, and having present at the hearing, an outside counsel engaged in the private practice of law. Under Article 1807(4) the Panel establishes its own rules of procedure, including those relating to the conduct of a hearing. The Chair ruled, on the basis of the Model Rules of Procedure, Part VI, para. 1, and after deliberation of the Panel, that outside counsel could be present at the hearing as long as the Party concerned assumed its responsibility to ensure confidentiality.

II. Background

4. On May 22, 1991, in response to an advice request dated November 7, 1989 from Toyota Motor Sales, U.S.A., Inc. respecting the treatment of interest as a direct cost of processing under Article 304 of the FTA, the United States Customs Service issued an administrative decision in relation to the following issues:

- "a. Is the 'mortgage interest' of Article 304 limited to interest associated with real property? Does the definition of 'direct cost of processing' in Article 304 include all interest associated with the manufacturing process, including loans used to finance tools and equipment, payroll, and factory inventory?
- b. Is there a requirement that the loan be secured by an asset in order for the interest expense to be considered as a direct cost of processing?
- c. Is there a requirement that interest be paid to an institution chartered in the territory of either party in order to be included in the value content calculation as part of the numerator?"

5. In respect of the first two issues the United States Customs Service held that interest expense which is not secured by a mortgage on real property used in production of the goods being exported would not be considered allowable as a direct cost of processing or direct cost of assembling for origin determination purposes. The actual text of the United States Customs Service holding was as follows:

"HOLDING: Mortgage interest, secured by real property, paid to an institution will be treated as a direct cost of processing or direct cost of assembling for the portion of the interest related to the real property used in the production of the goods being exported to the other party. Subsequent interest payments (accruals) related to the real property will be considered allowable as a direct cost of processing or direct cost of assembling for the portion of the interest related to the real property used in the production of the goods being exported to the other party. Interest expense which is not covered by a mortgage, i.e., unsecured loans, inter-company loans and lines of credit, etc., will not be considered allowable as a direct cost of processing or direct cost of assembling for origin determination purposes. Interest expense relating to loans for general and administrative purposes are specifically excluded as a direct cost of processing or direct cost of assembling under the Agreement."

6. Issue (c), which asked whether there is a requirement that the financial institution to which the interest is paid must be chartered in the territory of either party, was not addressed in the *holding* of the administrative decision of May 22, 1991 but was referred to by the United States Customs Service in the body of the *analysis* section as follows:

"The final opinion relating to what country such interest must be paid relates to the specific wording contained in the Agreement. In this regard we find the intent to allow such mortgage to be executed within or outside both territories

as long as such mortgage meets the criteria of Article 304 for direct cost of processing/assembling paragraph e) and the real property is located within the territory."

7. After the May 22, 1991 administrative decision was announced, Canada invoked the dispute settlement mechanism under Chapter 18 of the FTA. On January 6, 1992 Canada requested the establishment of a Panel under Article 1807 to consider the treatment of interest in the calculation of territorial content under the rules of origin. On January 22, 1992 the United States interpretation of Article 304 set out in the administrative decision dated May 22, 1991 was incorporated in United States Customs Regulations S.10.305 (a)(3)(iv).

III. Terms of Reference

8. The Parties agreed to the following terms of reference in an exchange of letters on February 7, 1992 and February 14, 1992:

"To determine whether the definition of 'direct cost of processing' or 'direct cost of assembling' set forth in Article 304 of the United States-Canada Free Trade Agreement ("Agreement") includes interest payments on debt of any form, secured or unsecured, undertaken to finance the acquisition of fixed assets such as:

- (i) real property
- (ii) a plant, and/or
- (iii) equipment,

used in the production of goods in the territory of a Party and that are subject to a determination based on the criteria specified in the Annex 301.2 to the Agreement.

In the context of this determination, it is agreed that the interpretation contained in the U.S.

Customs Service's administrative decision of May 22, 1991 (ENT-3-02-CO:RA:C, MS REF-04) will be examined by the Panel. It is further agreed that the question relating to the territory where interest is paid, contained in paragraph (c) of the Issues section of that administrative decision, is not before the Panel."

IV: Arguments of the Parties

9. Since there were no facts in dispute the Parties addressed the interpretation of Chapter 3 of the FTA, and in particular the definition of "direct cost of processing or direct cost of assembling." Article 304 provides as follows:

"direct cost of processing or direct cost of assembling means the costs directly incurred in, or that can reasonably be allocated to, the production of goods, including:

- a) the cost of all labor, including benefits and on-the-job training, labor provided in connection with supervision, quality control, shipping, receiving, storage, packaging, management at the location of the process or assembly, and other like labor, whether provided by employees or independent contractors;
- b) the cost of inspecting and testing the goods;
- c) the cost of energy, fuel, dies, molds, tooling, and the depreciation and maintenance of machinery and equipment, without regard to whether they originate within the territory of a Party;
- d) development, design, and engineering costs;
- e) rent, mortgage interest, depreciation on buildings,

property insurance premiums, maintenance, taxes and the cost of utilities for real property used in the production of the goods; and

- f) royalty, licensing, or other like payments for the right to the goods;

but not including:

- g) costs relating to the general expense of doing business, such as the cost of providing executive, financial, sales, advertising, marketing, accounting, and legal services, and insurance;
- h) brokerage charges relating to the importation and exportation of goods;
- i) costs for telephone, mail, and other means of communication;
- j) packing costs for exporting the goods;
- k) royalty payments related to a licensing agreement to distribute or sell the goods;
- l) rent, mortgage interest, depreciation on buildings, property insurance premiums, maintenance, taxes and the cost of utilities for real property used by personnel charged with administrative functions; or
- m) profit on the goods."

(a) Submissions of Canada

10. Canada argued that the text immediately following the word "means" at the commencement of the paragraph supplies the definition and that the subparagraphs that

follow, i.e. (a) to (f) and (g) to (m), simply provide illustrations of the general definition.² Canadian and United States legal precedents were cited to the effect that the use of the term "includes" is normally illustrative and enlarging rather than limiting or exhaustive.

11. Canada then submitted that, as the mention of mortgage interest in 304(e) is only an illustration of the type of interest cost that could be treated as a cost of production, other interest costs in respect of the acquisition of real property, plant and equipment used in production are equally costs of production. "They are much more closely associated with the costs in the included list than with those in the excluded list"³ Canada noted that the costs on the excluded list relate to the general costs of doing business such as advertising, marketing, accounting and legal expenses.⁴ It was argued that interest costs incurred in respect of the acquisition of real property, plant and equipment are not a general business expense in this sense. As to the question of form, it was Canada's view that it is the use to which the property is put, not the form of security given for the loan, that is decisive.⁵

12. To allow mortgage interest costs for real property used in production, while disallowing equivalent costs arising from non-mortgage financing, would be to prefer form over substance, would lead to anomalous results and would distort normal commercial practice. There often are good reasons for choosing other forms of debt. Canada did not believe the Parties intended to restrict the financing options of companies investing in either country.

²Canada First Submission, pp. 10-17.

³Canada First Submission, p. 17, para 45.

⁴Canada First Submission, p. 17, para. 46.

⁵Canada First Submission, p. 17, para. 47-48.

13. Canada cited examples of United States practice under the Generalized System of Preferences (GSP) and the Caribbean Basin Economic Recovery Act (CBI)⁶ where the Regulations made no express mention of interest costs, yet the United States Customs Service had consistently ruled that interest costs related to debt incurred to acquire equipment for the production of goods were included in the "direct costs of processing operations". Canada said that while these U.S. cases do not bear directly on the interpretation of the FTA, the Canadian negotiators were aware of them and had a "reasonable expectation" that interest on the acquisition costs of equipment would be regarded as a direct cost of processing for purposes of origin under the FTA.

14. Canada noted that the *Analysis* section of the United States Customs Service administrative decision of May 22, 1991, in discussing capital assets, stated that under Generally Accepted Accounting Principles (GAAP) interest payments could be capitalized in the cost of a capital asset up to the time it was placed in use and the capitalized cost of the asset would then be depreciated over its useful life and could be allocated to the cost of production of the goods.⁷ Canada said that according to the United States Customs, subsequent interest payments (accruals) related to that asset would be allowable as a cost of processing or assembly, based on a proper allocation between direct costs and general and administrative expenses. Canada contended that this accounting analysis favoured Canada's position but was not reflected in the *Holding* section of the May 22, 1991 administrative decision, and argued that the underlying rationale of the *Holding* section must have been that such interest was excluded only because of the erroneous view that the list of costs following the word "includes" in Article 304 is exhaustive.

15. In any event Canada considered that the May 22, 1991 administrative decision erred in its reliance on GAAP because the GAAP principles are designed to serve a

⁶Canada First Submission, pp. 20-22, para. 56-64.

⁷Canada First Submission, p. 25, para. 75.

completely different purpose than the FTA value test. GAAP are largely concerned with the integrity of the reporting of the financial results of a business enterprise. This objective is completely different from the objective of the FTA value test which is a measure of "value added".⁸

16. With respect to the negotiating history of the FTA, Canada argued that "the best evidence of the intent of the Parties is the text of the Agreement. More important still, the text is the only evidence of what they actually achieved jointly as distinct from what they might have desired individually".⁹

(b) Submissions of the United States

17. The United States submitted that the plain and ordinary meaning of Article 304 was that interest expenses and other costs of financial services were expressly excluded from the definition of direct cost of processing or assembling. This was the general rule of Article 304 stated in subparagraph (g). Only one exception was provided for, namely mortgage interest for real property used in the production of goods, a specific and carefully limited exception.¹⁰

18. The United States argued that the ordinary meaning of "financial services" in subparagraph (g) included the provision of credit. While Chapter 3 contained no definition of financial service, Article 1706 defined it as "a service of a financial nature offered by a financial institution excluding the underwriting and selling of insurance policies". While Article 1706 is not directly applicable to Article 304, it is evidence of what the drafters of

⁸Canada First Submission, p. 25, para. 72-73.

⁹Transcript of Oral Hearing, p. 39.

¹⁰United States First Submission, p. 9.

the FTA understood by the expression "financial services".¹¹ The United States also cited the definition of financial services in the *Draft Final Act of the Uruguay Round of Multilateral Trade Negotiations* which included "lending of all types including consumer credit, mortgage credit, factoring and financing of commercial transactions". Thus, in the view of the United States, the ordinary meaning of the term "financial services" was that it covered interest expenses on funds borrowed.¹²

19. The United States argued that the fact that a cost, such as interest, could be allocated to the production of a good did not in itself qualify that cost to be allowed as a direct cost of production or assembly of the good. In order to be allowed as a direct cost of processing a cost must not only be allocable to the cost of producing the good, it must also be a cost of production within the meaning of the FTA. Financial services costs, being expressly excluded from the definition of direct cost by subparagraph (g), may not be counted even if such costs could otherwise reasonably be allocated to the production of that good.¹³

20. The United States submitted that the narrow and exceptional circumstance in which interest could be an included cost is defined by three important limitations: it must be *mortgage* interest, for *real* property, used in the *production* of goods.¹⁴ Acceptance of the Canadian submission would wrongly allow this exception to swallow the rule. If subparagraph (e) had really been intended to suggest that all interest could be included, the Parties would not have burdened subparagraph (e) with three such specific limitations. In the United States view subparagraph (e) is only tangentially concerned with interest. Its true subject matter is real property and the various costs related to real property. These are

¹¹U.S. First Submission, pp. 10-11.

¹²U.S. First Submission, p. 11.

¹³U.S. First Submission, p. 14.

¹⁴U.S. First Submission, p. 14.

included in the direct cost of processing or the direct cost of assembly as a special "real property" exception to the general prohibition in subparagraph (g).

21. The United States did not concede that the lists are "illustrative" in the sense that the categories of enumerated items exemplify other categories of items. The United States argued that the Canadian submission ignored the list of exclusions and failed to consider what is the result when there are two conflicting "illustrative" examples, one general (exclusion of financial services) and one specific (inclusion of mortgage interest on real property used for the production of goods). In the United States view, an exception to a general rule must be construed narrowly.¹⁵

22. The United States said that the drafters of the FTA were determined to ensure that where goods were made in part from third-country materials there would be substantial input of Canadian or United States labor or materials, avoiding the so-called "bookkeeping input" that had been included in the value content calculation under the Automotive Products Trade Agreement ("the Autopact") between the United States and Canada. Hence profits were specifically excluded under the FTA in Article 304(m) although they were included as domestic content under the Autopact. The United States contended that the intent of the FTA was to promote the use of North American labor, materials and parts, referred to by the United States as "hard costs". Accordingly it was intended that, to the fullest extent possible, costs other than "hard costs" would be excluded.¹⁶

23. The United States argued that just as profits are the cost of equity capital, interest is the cost of debt capital. If the cost of one form of capital is excluded, the cost of the other form of capital should likewise be excluded. Moreover, to include interest costs as direct costs of production would involve double counting, that is, both the interest cost

¹⁵U.S. First Submission, p. 16.

¹⁶Transcript of Oral Hearing, pp. 83-84.

on money borrowed to acquire the plant and equipment and the depreciation expense on that plant and equipment would be counted.¹⁷

24. With respect to GAAP, and the reliance on GAAP by the United States Customs Service in its administrative decision of May 22, 1991, the United States contended that accounting theory and practice do support the conclusion that interest expenses are neither directly incurred in nor reasonably allocable to the cost of production, and that this is the same for financial accounting methodology as well as for cost accounting methodology. The United States noted that the Financial Accounting Standards Board (FASB) generally prohibits the capitalization of interest for inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis.¹⁸ It was not unreasonable for the Parties to have created an exception in Article 304 for mortgage interest on real property because accounting theory and practice do not treat land (as distinct from buildings and equipment) as a depreciable asset. Mortgage interest, in the United States submission, represents a proxy for the contribution of real property to the cost of production.¹⁹

25. The United States relied on the negotiating history of the FTA as evidence of the intent of the Parties. The United States chief negotiator for Article 304 in his presentation to the Panel during the oral hearing on March 31, 1992 explained that the Canadian negotiators had approached the United States negotiators late in the process, in October, 1987, with a request for the inclusion of mortgage interest on real property used in the production of goods together with depreciation on buildings, property insurance premiums and real property maintenance costs. Canada had not asked for a general reference to interest costs. Canada's request related only to *mortgage* interest on *real* property used in the *production* of goods. The United States had agreed to that request

¹⁷U.S. First Submission, pp. 25-26.

¹⁸U.S. Second Submission, pp. 32-35.

¹⁹U.S. First Submission, pp. 19-20.

because by the end of October 1987 "we were running out of time" and in light of the non-depreciation of land costs and "in the interest of consummating an agreement" the United States accepted the amendment.²⁰ If Canada had intended in October 1987 the broad inclusion of interest it now seeks in the present proceeding Canada would have asked for it in very different language.

V. The Panel's Analysis

(a) The meaning of Article 304

26. This brief summary of the arguments of the Parties is not intended to repeat their careful and extensive submissions in the written and oral proceedings, but it identifies the major contending lines of argument sufficiently for purposes of the Panel's own analysis of Article 304. The Panel will refer in greater detail to the Parties' arguments where appropriate in the following paragraphs.

27. Article 31 of the Vienna Convention on the Law of Treaties sets out the basic rule of interpretation which the Parties accept as applicable to the present dispute. Article 31 provides:

"A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose."

28. The relevant terms of Article 304 are "direct cost of processing or direct cost of assembling" and these are defined by Article 304 itself by a two-pronged test separated by the disjunctive "or", as follows:

²⁰Transcript of Oral Hearing, pp. 80-81.

"the costs directly incurred in or that can reasonably be allocated to, the production of goods."

(emphasis added)

29. The first branch of the test ["the costs directly incurred in ... the production of goods"] adds little to the terms themselves being defined i.e. the expression "*direct* cost" is defined as "the costs *directly* incurred ...", an elaboration that does not shed much light on what the Parties intended, in this context, by adoption of the concept of "directness". The first branch of the definition does however couple the ideas of "processing" and "assembling" as components of the more general activity of "production".

30. Traceability appears to the Panel to be the essence of the distinction between costs *directly* incurred in the production of goods, and other costs, under the first branch of the two-pronged test. This is borne out by the definition of "direct costs" set out in some of the standard accounting reference texts, for example:

- (a) Cooper & Ijiri - "Kohler's Dictionary For Accountants", (6th ed., New Jersey 1983)

"The cost of any good or service that contributes to and is readily ascribable to product or service output"

- (b) Barfield, Raiborn & Dalton - "Cost Accounting - Traditions and Innovations", (Minnesota 1991)

"A cost that is distinctly traceable to a particular cost object"

- (c) Rotch, Allen & Smith - "Executive Guide To Management Accounting and Control Systems", (4th ed., Texas 1991)

"*Direct* costs, strictly speaking, are only those costs that can readily be identified or measured by product. Allocated costs, whether fixed or variable, are excluded."

- (d) Horngren - "Cost Accounting - A Managerial Emphasis", (3rd ed., New Jersey 1972)

"The terms direct and indirect have no meaning unless they are related to an object of costing. Traceability is the essence of the distinction. The word direct refers to the practicable, obvious, physical tracing of cost as incurred to a given cost object."

31. The second branch of the test ["the costs ... that can reasonably be allocated to the production of goods"] does not use the word "directly". As some accounting definitions indicate, "allocated costs" are sometimes contrasted with "direct costs". It therefore appears that the Parties intended in the second branch of the definition of Article 304 to broaden the meaning that would otherwise flow from the first branch of the definition, and indeed to broaden from their ordinary signification the terms being defined, i.e. "*direct* cost of processing or *direct* cost of assembling".

32. The difficulty is that the outer limits of Article 304 are defined by reference to the concept of "reasonableness" without Article 304 ever explicitly indicating the *standard* by which "reasonableness" is to be assessed. An allocation that is reasonable for the purpose of evaluating the profitability of a product line, for example, may not be a reasonable allocation for the purpose of valuing inventory, or, for that matter, "reasonable" in the context of Article 304. Moreover, traceability, which is important in distinguishing direct and allocated costs, may also be important in establishing that an allocation of interest cost is "reasonable," especially in light of the fungibility of money.

33. Clearly reasonableness was intended by the Parties to be a meaningful limitation. As the United States points out, any cost is *capable* of being allocated. However, the Parties have provided that only those costs "that can *reasonably* be allocated for the production of goods" are to be included.

34. In light of the principle of interpretation expressed in the Vienna Convention, the Panel must find the scope of that limitation in the context in which the word "reasonably" has been used, as well as in the object and purpose of the Free Trade Agreement itself. Both Parties appreciated that their bargain would be expressed in the FTA. While the Panel does not deny that in some circumstances it may be helpful to go beyond the Agreement itself, as the Vienna Convention contemplates, this cannot be done for the purposes simply of taking account of the motivation or objectives of one of the Parties. Thus, the Panel does not accept Canada's arguments based on its understanding of earlier United States Customs rulings under various provisions including the Generalized System of Preferences (GSP). Similarly, the Panel is not able to accept the relevance of the domestic practice of the Parties under other agreements that are distinguishable from the FTA in both text and purpose. For this reason, the Panel does not find the practices under the GSP and the U.S. Caribbean Economic Recovery Act to be persuasive. Finally, unilateral explanations such as the Canadian Explanatory Notes to the Agreement or United States Executive Branch documents are not authoritative guides to interpretation.

35. The two-pronged definition in Article 304 is immediately followed by a list of thirteen items, the first six items introduced by the word "including", and the second seven items introduced by the words "but *not* including". In the view of the Panel the Parties intended the lists of inclusions and exclusions to serve as the primary raw material out of which the intended standard of "reasonableness" should emerge.

36. It is convenient to reproduce the lists of illustrations for purposes of comparison:

"including"

- a) the cost of all labor, including benefits and on-the-job-training, labor provided in connection with supervision, quality control, shipping, receiving, storage, packaging, management at the

"but not including"

- g) costs relating to the general expense of doing business, such as the cost of providing executive, financial, sales, advertising, marketing, accounting, and legal services, and insurance;

- | | |
|--|---|
| <p>location of the process or assembly, and other like labor, whether provided by employees or independent contractors;</p> <p>b) the cost of inspecting and testing the goods;</p> <p>c) the cost of energy, fuel, dies, molds, tooling, and the depreciation and maintenance of machinery and equipment, without regard to whether they originate within the territory of a Party;</p> <p>d) development, design, and engineering costs;</p> <p>e) rent, mortgage interest, depreciation on buildings, property insurance premiums, maintenance, taxes and the cost of utilities for real property used in the production of the goods; and</p> <p>f) royalty, licensing, or other like payments for the right to the goods;</p> | <p>h) brokerage charges relating to the importation and exportation of goods;</p> <p>i) costs for telephone, mail, and other means of communication;</p> <p>j) packing costs for exporting the goods;</p> <p>k) royalty payments related to a licensing agreement to distribute or sell the goods;</p> <p>l) rent, mortgage interest, depreciation on buildings, property insurance premiums, maintenance, taxes and the cost of utilities for real property used by personnel charged with administrative functions; or</p> <p>m) profit on the goods;</p> |
|--|---|

A comparison of the lists yields a number of important messages to those charged with the task of interpretation.

37. Firstly, those who drafted the illustrative lists created two sets of opposable pairs. The first pair relate to real property:

Real Property

including ...

- e) rent, mortgage interest, depreciation on buildings, property insurance premiums, maintenance, taxes and the cost of utilities for

but not including ...

- l) rent, mortgage interest, depreciation on buildings, property insurance premiums, maintenance, taxes and the cost of utilities for

real property used in the
production of the goods;

real property used by personnel
charged with administrative
functions;

The text of these opposable illustrations is identical except for a differentiation in the *use* to which the real property is put, a differentiation which contrasts use in *production* with use in *administration*. It is common ground between the Parties that the reference in subparagraphs (e) and (l) to mortgage interest was added along with depreciation, property insurance premiums and maintenance, all at the same time, in late October 1987. While this confirms the fact that in subparagraphs (e) and (l) the essential focus of the Parties was on real property as opposed to interest generally, in the view of the Panel the wording of a particular illustration, and the negotiating history of that wording, would not convert an illustration into anything more or less than an illustration of a definition already stated in general terms in the preceding text of Article 304.

38. The second opposable pair deals with royalties:

Royalties

including ...

but not including ...

f) royalty, licensing, or other like
payments for the right to the
goods;

k) royalty payments related to a
licensing agreement to distribute or
sell the goods;

The included royalties "for the right to the goods" is characterized by the United States as the cost of acquiring "any rights (normally intellectual property rights) that otherwise would preclude the *sale* of the goods in the open market".²¹ However, as (k) precludes royalties under licensing agreements for distribution or sale of the goods, the royalties included in (f) would appear to relate to the *production* of the goods rather than to their sale.

39. The Parties demonstrated by these two sets of opposable pairs that the same type of payment (mortgage interest, royalties) would *reasonably* be included or excluded,

²¹U.S. Second Submission, p. 16.

depending on its relationship (or the lack of it) to the production of goods. The first message, therefore, is that it is the relationship of the cost to production, rather than the form of the payment, or the security for the payment, that is the key to "reasonableness".

40. Secondly, the illustrations are not self sufficient, but must be related in each case back to the two-pronged definition in the opening words of Article 304. If, for example, subparagraph (e) were treated as a "stand alone" definition, money could be raised on the security of a mortgage and used for purposes other than the production of goods, and would be an "included" cost so long as the real property supplied as security for the loan were used for the production of goods. The text of the issue submitted to this Panel states that the mortgage money in question is used for *acquisition* of the real property mortgaged, but use of the money for acquisition is not a formal requirement set out in subparagraph (e). Nevertheless it is clear from the context of Article 304, read as a whole, that the Parties did not contemplate the inclusion of interest on money raised on the security of existing real estate (even where such real estate *is* used in the production of goods) if the proceeds of the loan are used for *non*-production purposes.

41. Thirdly, a comparison of the opposable pairs confirms that the lists are *not* intended to be exhaustive. No doubt those who drafted Article 304 recognized that real property could be used for purposes other than the two uses explicitly mentioned, i.e. production of goods or administrative functions. Real property could be used, for example, for the location of a sales outlet. Equally, subparagraph (f) specifically refers to "royalty, licensing *and other like payments*" whereas no such expansive language is used in subparagraph (k). Nevertheless, the Parties did not intend that the *only* type of royalty to be *excluded* under subparagraph (k) would be "royalty payments related to a licensing agreement to distribute or sell the goods". Royalties for the use of a corporate logo, for example, would clearly be excluded, yet such a use is not explicitly excluded in subparagraph (k). If the list of excluded costs was not intended to be exhaustive, there is no reason to believe the list of included costs was intended to be exhaustive. The common

denominator of both lists is the focus on the relationship of the cost, or the lack of it, to the production of the goods.

42. Quite apart from the fact that the enumerated lists in Article 304 are introduced by the words "including" and "but not including", and are thus *prima facie* illustrative rather than exhaustive, the drafting of the illustrations themselves thus refute any contention that the illustrations are to be treated as an exhaustive code.

43. Fourthly, the list of inclusions indicates an *extended* reading of the concept of "production", encompassing not only the cost of the means of production and labor but also the "development, design and engineering costs" under subparagraph (d). In the normal course of events development costs will largely predate commercial production. Labor costs are to be included, not only where the labor is consumed in the production of the goods, but also in such ancillary matters as the storage and shipping of the goods, and management at the *location* of the process or assembly, according to subparagraph (a).

(b) Interpretation of "interest"

44. Armed with these preliminary observations, we now turn to the text of the question submitted to the Panel, which for ease of reference is reproduced in part as follows:

"To determine ... [the inclusion or exclusion of]
interest payments on debt of any form, secured
or unsecured, undertaken to finance the
acquisition of fixed assets such as:

- (i) real property
- (ii) a plant, and/or
- (iii) equipment,

used in the production of goods ..."

45. The Panel approaches these terms of reference on the footing that "interest" is to be understood to mean *bona fide* interest incurred under a loan agreement entered into on arm's length terms in the ordinary course of business, (which of course includes the normal practices associated with the commencement of production as well as with subsequent stages of production). Transactions that do not satisfy these criteria create a particular set of problems that will be addressed later.

(c) *The treatment of mortgage interest*

46. The starting point for the Panel's analysis is the text of subparagraph (e) in which the Parties explicitly agreed that it would be "reasonable" to include

"e) rent, mortgage interest, depreciation on buildings, property insurance premiums, maintenance, taxes and the cost of utilities for real property used in the production of the goods"

(emphasis added)

In order to fully understand what the Parties meant by this illustration it is necessary to consider the content of what the Parties have compendiously described as "real property". The term has a well known significance under the law of both Canada and the United States as including more than land. In the United States, its meaning is readily ascertained in such widely available standard legal works as Corpus Juris Secundum (1985 edition) at volume 36A p. 587 which states:

**"1. Definition and Nature and Requisites
of Conversion into Realty in General**

The law recognizes that, under certain circumstances personal property becomes a part and parcel of real property and thereafter

assumes the status of real property. In fact it is an ancient maxim, which in the language of antiquity is expressed 'quicquid plantatur solo, solo cedit,' that whatsoever is fixed to the realty is thereby made a part of the realty to which it adheres, and partakes of all its incidents and properties."

(emphasis added)

47. At p. 620 of the same authority consideration is given to the status of buildings:

"Buildings. The character of a building and its adaptability to the purposes for which the land is used have been held to be factors to be considered in determining whether or not it constitutes a fixture. Ordinarily, however, buildings placed on the land have been regarded as part of the realty, occasionally without reference to any actual fastening to the ground, on the theory presumably that they are accessory to the realty as being necessarily, or at least presumptively, built for the purpose of improving it, although buildings of light construction, especially if not firmly attached to the land, have occasionally been regarded as personalty, as being evidently annexed for temporary purposes only."

(emphasis added)

It appears to the Panel that industrial and manufacturing plants would ordinarily meet this test to qualify as "real property".

48. As to machinery and equipment, Corpus Juris Secundum (1985 edition) vol. 36A at p. 620 goes on to state:

"Machinery or apparatus in buildings. The test of the character of the article annexed, as related to the use to which the realty is devoted, has been applied in connection with machinery or apparatus in a building, it often being said or held that when a building is erected for, or

permanently adapted or devoted to, a particular purpose, anything annexed to the building for the carrying out of that purpose may be considered as accessory to the realty itself, while such articles annexed merely for the purpose for which the building happens at the time to be used are not to be so regarded.

It has sometimes been said that the chief test in the determination is whether the machinery is permanent and essential to the purpose for which the building is occupied or employed. In this test no distinction is made between machinery placed in a factory erected for a specific manufacturing purpose and like machinery placed in a building constructed for an entirely different purpose, but thereafter converted to a use for which the machinery is essential."

(emphasis added)

Once again, to the extent machinery and equipment is "permanent and essential to the purpose for which the building is employed", and is attached in some way to the building or to the soil on which the building is erected, it becomes as much part of the "real property" as the land itself.

49. Canadian law is to the same effect. Generally available legal dictionaries include Dukelow and Nuse The Dictionary of Canadian Law (Carswell 1991) which states:

"REAL PROPERTY. 1. Includes messuages, lands, rents and hereditaments whether of freehold or any other tenure whatever and whether corporeal or incorporeal and any undivided share thereof and any estate, right or interest other than a chattel interest therein. 2. The ground or soil and everything annexed to it, and includes land covered by water, all quarries and substances in or under land other than mines or minerals and all buildings, fixtures, machinery, structures and things erected on or under or affixed to land. 3. Includes any estate, interest or right to or in land, but does

not include a mortgage secured by real property."

(emphasis added)

Support for the underlined words may be found in Haggert v. Town of Brampton (1897) 28 S.C.R. 174, at p. 182, where the Supreme Court of Canada held manufacturing machinery and equipment to be real property as between mortgagor and mortgagee in the circumstances there under consideration.

50. In light of the ordinary legal meaning of the term "real property" in both the United States and Canada, it must be accepted that a mortgage secured on "real property" would include not only the land, but plant and equipment sufficiently annexed to the land to become "fixtures", and that the Parties to the FTA have already expressly agreed that interest paid on the whole of the debt so secured would *reasonably* be included as an allowable cost under Article 304.

51. The United States made various arguments based on the different accounting treatment accorded in some circumstances to "land" as distinguished from buildings and other equipment. The Panel accepts the United States point that "land" as such is not depreciated. However, the Parties chose to employ in subparagraph (e) the concept of mortgaged "real property", which clearly includes manufacturing plants and fixed production equipment which *are* depreciated, as well as land which is *not* depreciated. These accounting arguments therefore do not provide any basis for differentiating non-mortgage interest from mortgage interest in respect of real property in its entirety.

(d) The treatment of non-mortgage interest

52. The task of the Panel is to apply the general words of definition in Article 304 (the two-pronged test) to the balance of our terms of reference by the simple process of reasoning from what the Parties have said is "reasonable" to the other matters on which the

Parties have sought our determination, but which are not referred to expressly in any of the illustrations. In particular,

- (a) if inclusion of mortgage interest on real property (land, plant and fixed production equipment) is expressly agreed to be reasonable, is it reasonable also to include *non*-mortgage interest on such real property?
- (b) if inclusion of interest incurred on the acquisition of real property used in the production of goods is reasonable, is it reasonable also to include interest incurred in the acquisition of other means of production?

53. The first question is whether interest should be "included" in respect of a loan to acquire real property in circumstances identical to subparagraph (e) except that the loan is not secured by a mortgage on the real property so acquired. The basis for inclusion, if any, must be found in the two-pronged definition in the opening words of Article 304. It does not emerge, at least explicitly, from any of the other illustrative subparagraphs.

54. Both Parties submitted references to statements by the United States Financial Accounting Standards Board (FASB). Canada relied on the FASB Statement of Financial Accounting Standards No. 34, paragraph 48 (October 1979) which reads in part:

"The cause and effect relationship between acquiring an asset and the incurrence of interest cost makes interest cost analogous to a direct cost that is readily and objectively assignable to the acquired asset."

In the Panel's view, a cost that is "analogous to a direct cost", and is "readily and objectively assignable to the acquired asset", exhibits the necessary relationship to the means of production required by Article 304 for inclusion in the value content calculation. The point is that interest must be "readily and objectively" assigned to acquisition of a production asset. This will give rise to questions of proof. In its first submission, Canada gave as an example the possibility that a loan agreement may require dedication of proceeds to

production assets.²² The Panel has not heard argument on what, if any, other factors or procedures may amount to a sufficient objectively established connection with production assets for an allocation of interest costs to be "reasonable."

55. The requirement to establish a relationship between use of loan proceeds and the production of goods is the same whether or not payment of the purchase price is secured by a mortgage on the acquired asset. The significance of the mortgage, after all, lies in the remedies it offers to the mortgagee in the event of a default on payment. The mortgage is an invisible web of rights and obligations that neither enhances nor impedes the work of the capital asset secured by it in the production of goods. Article 304 is concerned with the production of goods, not with the remedies of unpaid creditors. Nevertheless, it is the view of the United States that even if non-mortgage interest costs incurred in the acquisition of land, plant and equipment used in the production of goods could *reasonably* be allocated to the production of goods, the Parties have nevertheless agreed that such non-mortgage interest should be excluded from the value content calculation.

56. The United States submitted that subparagraph (g) is a complete answer to the Canadian position. For ease of reference we repeat the wording of (g) here:

"g) costs relating to the general expense of doing business, such as the cost of providing executive, financial, sales, advertising, marketing, accounting, and legal services, and insurance;"

(emphasis added)

57. In the United States view, the provision of credit is a "financial service" and the cost of credit is therefore a cost relating to the provision of a financial service. Accordingly, it is argued, interest costs have been characterised by the Parties themselves in (g) as a "general expense of doing business", and interest therefore must be *excluded* from

²²Canada First Submission, p. 19, para. 51.

the "direct cost of processing or direct cost of assembling" unless it can be brought within the "narrow exception" of *mortgage* interest in subparagraph (e). This exclusion, the United States says, must be given effect even if such costs are "reasonably allocable" to the production of particular goods because they are "explicitly disallowed" by Article 304.

58. The Panel cannot accept that subparagraph (g) has either the meaning or the paramountcy which the United States Submission attributes to it.

59. Firstly, for the reasons already given, the Panel has concluded that the enumerated lists are merely illustrative, and do not establish amongst themselves any hierarchy of importance or paramountcy. Even if the expression "financial services" were intended to cover interest cost, it would not by the fact achieve the superior status of "a general rule" within the overall framework of Article 304, to which other subparagraphs would operate only as narrow exceptions. The United States in its Second Submission²³ states that its overall analysis of Article 304

"... is buttressed by Paragraph (g), which provides the general rule that, except as otherwise specifically provided (e.g., in Paragraph (e)), general expenses, such as the costs of financial services, are excluded from the definition."

If subparagraph (g) were expressed in these words, of course, the United States' argument would stand on somewhat stronger footing, but that is not the language chosen by the Parties in the Free Trade Agreement. The Panel is bound to respect the language that the Parties have in fact employed.

60. Secondly, the financial services referred to in (g) are grouped with other types of services including advertising, accounting and legal services. Interest represents the cost of money, not the cost of service. The United States itself defined interest as "the cost of

²³U.S. Second Submission, p. 14.

money borrowed" and "the value, or cost of money over time."²⁴ In the Panel's view, it would distort the "ordinary meaning" of words to characterize the cost of money as the cost of a service. The principle of treaty interpretation set out in Article 31 of the Vienna Convention on the Law of Treaties and accepted by the Parties as appropriate requires us to interpret Article 304 in accordance with the "ordinary meaning to be given to [its] terms." A financial institution may offer a wide variety of financial services for which fees are paid that may have nothing to do with interest charged on the balance of outstanding loans. The chief financial officer of a manufacturing company and his/her staff also provide a variety of financial services. In this regard the Panel agrees with the arguments made by Canada.²⁵ The Panel also regards the definition and use of the term "financial services" in the Draft Final Act of the Uruguay Round as not being relevant to the issue before the Panel, in light of the dissimilar contexts in which the terms appear.

61. Thirdly, if the submission advanced by the United States were correct, all interest would be excluded under the "general rule" established by subparagraph (g) except such mortgage interest as is specifically permitted under subparagraph (e). The Parties apparently did not share this view, because they did not treat subparagraph (g) as a general exclusion but went on to provide specifically for a type of "excluded" mortgage interest in subparagraph (l) in respect of real property used for administrative purposes.

62. The United States chief negotiator for Article 304 told the Panel that a mutual objective of the Parties in the FTA was to tighten up the value content calculations permitted under the Autopact. However he could recall no discussion with Canadian negotiators to the effect that subparagraph (g) was to be regarded as a general prohibition against allowance of interest.²⁶ Moreover, he could not recall any discussion about the meaning to be

²⁴U.S. First Submission, p. 25.

²⁵Transcript of Oral Hearing, pp. 26-27.

²⁶Transcript of Oral Hearing, p. 96.

attributed to the expression "financial services" in subparagraph (g). The FTA on its face does not disclose any mutually agreed upon hierarchy of "illustrations", or any mutually agreed upon *expanded* meaning of the term "financial services". It is true, as the United States points out, that if real property mortgage interest was already included in Article 304 prior to Canada's request to mention it expressly in October 1987, Canada's request was superfluous. It is also true, as Canada points out, that while efforts to "tighten up" the value content rules in the Autopact resulted in the FTA's express disallowance of such items as profit and advertising expense, there was no such express disallowance in the case of interest. The "negotiating history", such as it is, does not offer a solution to the impasse.

63. In summary, the Panel does not accept the reference to "financial services" in subparagraph (g) as a proxy for an express disallowance of interest. In the Panel's view subparagraph (g) does not provide any significant assistance in the resolution of the questions submitted. We believe the test of "reasonableness" in connection with interest should focus on the juxtaposition of subparagraphs (e) and (l), not (e) and (g). The subject matter of subparagraphs (e) and (l) is identical whereas the subject matter of subparagraphs (e) and (g) is quite different.

(e) *The form of the loan transaction*

64. The terms of reference require the Panel to evaluate the importance of the legal *form* of the transaction giving rise to the interest obligation. The Panel was asked to determine whether

"the definition of 'direct cost of processing' or 'direct cost of assembling' set forth in Article 304 ... includes interest payments on debt of any form, secured or unsecured, undertaken to finance the acquisition of fixed assets such as:

- (i) real property
- (ii) a plant, and/or
- (iii) equipment,

used in the production of goods."

(emphasis added)

65. The Panel fully recognizes that mortgage interest is paid pursuant to a formal document whose terms can be easily ascertained. Although the mortgage document will not ordinarily explain the use to which the proceeds of the mortgage were put, the accompanying loan documentation may well do so. Such documentation would help establish an objective basis on which "reasonably" to allocate that interest to production. The negotiators of Article 304 may have considered that an independent bank or other financial institution, as opposed to a related corporation would be more likely to take mortgage security. Loan transactions with independent banks and other financial institutions would normally be concluded on arms-length terms. Government authorities could readily verify the interest cost, identify the real property included as security, and verify whether in fact the proceeds of the loan secured by the mortgage are used for the production of goods.

66. There are thus a number of features of a mortgage which may have led the negotiators to single out mortgage financing for special mention. It does not follow, however, that these features should determine what is "reasonable" for the purpose of an Article 304 allocation.

67. Firstly, the same features apply equally to a chattel mortgage of personal property, yet the list of illustrations refers only to mortgages of real property.

68. Secondly, and more generally, difficulties of proof in particular cases should not artificially restrict the meaning to be applied to the general words of Article 304. The words of the two-pronged test must, according to the Vienna Convention on the Law of Treaties, be given their "ordinary meaning".

69. If mortgage interest on all of the fixed means of production is considered by the Parties to be a "reasonable" allocation to the "direct cost of processing or the direct cost of assembling", the Panel cannot find anything in the text or context of Article 304 to suggest that the Parties considered *the form* of the security (if any) or other aspect of the *form* of the financing, whether by mortgage or otherwise, to be of controlling importance. While mortgage financing may present advantages in terms of verification, it cannot be contended that mortgage financing is the *only* method of financing for which such verification is possible. The Free Trade Agreement, taken as a whole, suggests no compelling reason to require producers to finance the acquisition of the means of production by mortgages rather than other methods of financing which may, in particular circumstances, be more commercially appropriate. The Parties to the Free Trade Agreement have no particular vested interest in mortgage financing, and producers should not be required to make financing decisions based on governmental convenience in the verification or audit in the absence of some express agreement to that effect in the FTA itself.

70. In its submissions, the United States drew attention to the potential for abuse if non-mortgage interest were to be included:

"equipment used in transplant operations is normally purchased and imported from the foreign parent corporation, so that any interest expense is essentially an intercompany transfer of funds."²⁷

This, the United States implied, does not involve interest at all. Rather it involves a transfer of profit from a parent corporation to a subsidiary. Article 304(m) makes it clear that a transfer of *profit* may not "reasonably" be allocated to the production of goods. While some producers may seek to accomplish this indirectly (e.g. by dressing up profit as interest to try to qualify it as an included cost), the potential for such an abuse exists whether or not the abusive "loan" is secured by a mortgage on real property. The problem arises generally from the fungible nature of money and the difficulty of unequivocally associating the proceeds of a loan with the acquisition of specific property. But this problem applies even

²⁷U.S. Second Submission, p. 7.

when the loan is secured by a mortgage on real property. The proceeds of a mortgage on real estate may be diverted to an ineligible purpose. The interest rate on a mortgage on real property may be inflated in a non-arms length transaction to strip profit out of a subsidiary.

71. In the Panel's view, this potential for abuse should be dealt with in the same way whether a loan is secured or unsecured, whether for the purchase of real property or for the purchase of other production assets. The interest must be bona fide, the transaction must be on terms that are at arms length and the borrowing must be in the ordinary course of business to finance the production of goods. These requirements are implicit in Article 304 itself, for if they are not met then it could not be said that the interest cost, "can reasonably be allocated" to the production of those goods.²⁸

72. It follows that in the opinion of the Panel, in light of the fact that the Parties considered inclusion of mortgage interest in respect of the acquisition cost of production-related real property to be reasonable, inclusion of *non-mortgage* interest in respect of the acquisition cost of such real property is also reasonable.

(f) *Interest on machinery and equipment*

73. The United States submits that interest should not be permitted on *any* machinery and equipment used in the production of the goods because of a negative inference that the United States believes should be drawn from subparagraph (c) of Article 304, which reads as follows:

"(c) The cost of energy, fuel, dies, molds, tooling, and the *depreciation and maintenance of machinery and equipment*, without regard to

²⁸Although the question relating to the situs of the lending institution has been excluded from consideration by the Panel, one member felt that the situs of the lender could form an additional requirement for the inclusion of non-mortgage interest for purposes of Article 304.

whether they originate within the territory of a Party."

(emphasis added)

74. The United States points out that the Parties saw fit specifically to mention depreciation and maintenance of machinery and equipment, and suggests that had it been the intention of the Parties to permit the deduction of *interest* in respect of machinery and equipment the Parties would have said so in clear language.

75. There is some appeal in this argument. Clearly the Parties went to some trouble to make some of the illustrations quite comprehensive. Interest is mentioned in combination with maintenance and depreciation in subparagraphs (e) and (l), and its absence from subparagraph (c) is notable. The question, however, is whether this fact justifies drawing a *negative inference* that interest on machinery and equipment should be excluded despite the existence of circumstances that would call for their inclusion under the two-pronged definition in the opening words of Article 304.

76. In the case of machinery and equipment fixed to the soil or to a plant, of course, any negative inference would be refuted by the inclusion of fixtures as "real property" under subparagraph (e). If interest may be included in respect of "fixed" machinery and equipment, there seems no basis on which to draw a *selective* negative inference from subparagraph (c) in respect of *unfixed* machinery and equipment, because subparagraph (c) makes no distinction as to whether the machinery and equipment is fixed or unfixed.

77. Adoption of the "negative inference" approach would produce some clearly undesirable effects elsewhere in Article 304. Some of these have already been noted. For example, subparagraph (l) excludes mortgage interest on real property used by personnel charged with "administrative functions", but does not explicitly exclude mortgage interest on real property used by personnel charged with sales, advertising or marketing functions

(or, for that matter, *non-mortgage* loans whose proceeds are used for administrative purposes). Subparagraph (k) excludes royalties related to "a licensing agreement to distribute or sell the goods" but does not expressly exclude such royalties payable otherwise than by a licensing agreement. Neither of the Parties have suggested, or would be likely to accept, an application of the "negative inference" approach in such cases.

78. In subparagraph (a) mention is made of the inclusion of various labor costs "whether provided by employees or independent contractors". A "negative inference" approach would suggest that where this qualification is not specifically mentioned only the cost of services provided by employees of the producer are to be taken into consideration. Such a "negative inference", however, would drastically truncate the obviously intended scope of subparagraph (g) so that for example only advertising, marketing, accounting, legal and financial services rendered by the producer's *employees* would be addressed. The United States points out that such an interpretation:

"would be absurd, however, as applied to a manufacturer of goods, which generally would not be engaged in the provision of financial services".²⁹

In short, the Panel does not accept the "negative inference" approach to Article 304, and concludes that the absence of any reference to "interest" in subparagraph (c), while curious, does not exclude interest that would otherwise be included on the basis of the general division between "production" uses and non-production uses evident from a reading of Article 304 as a whole.

79. It follows that the issue of interest on the acquisition cost of machinery and equipment must be addressed on a broader basis of principle. In the Panel's view, this broader basis is to be found in the general demarcation between production uses and non-production uses. In our view subparagraph (e) contemplates as reasonable the inclusion of interest on the cost of acquisition of real property used in the production of goods not

²⁹U.S. Second Submission, p. 14, footnote 6.

because it is real property *but because the acquired asset is used in the production of goods*. On that basis there seems no reason to differentiate between real property means of production and other means of production.

(g) *The object and purpose of the FTA*

80. As stated earlier, while the text and context of Article 304 call for detailed examination in the process of interpretation, other compelling sources of interpretive assistance are to be found in the object and purpose of the FTA and its rules of origin, of which Article 304 forms an important part.

81. It is clear from the Preamble of the FTA, and from the Objectives and Scope of the FTA set out in Chapter 1, that the Parties sought to create a trading arrangement whose benefits would accrue primarily but not exclusively to the goods and producers of the Parties, and to enhance employment and income opportunities primarily but not exclusively for persons living within the territories of Canada and the United States.

82. The question put to the Panel deals specifically with interest on debt incurred for the acquisition of fixed assets. As already stated, we recognize that money is fungible, and it is therefore especially difficult to connect the proceeds of debt unequivocally with any particular good or function. Nevertheless, Article 304 expressly allows mortgage interest on real property, notwithstanding the fact that the funds raised by a mortgage are fungible and may be traceable to the production process only in a formal sense. It must therefore have been the view of the Parties that the inclusion of interest, as such, is not inconsistent with the larger objects and purposes of the FTA. Once this basic policy is established, the Panel does not believe that the form of security (if any) securing the debt in respect of which interest is payable is determinative, and accordingly we conclude that unsecured debt to acquire fixed production assets should also be counted. However, as we have emphasized, our determination that in a given case interest can "reasonably" be allocated to production presupposes that a producer can demonstrate to the relevant government authorities, if

required to do so, that the interest is *bona fide* (for example that it is not incurred as part of a sham intracorporate loan transaction); that the interest is payable on arm's length terms (for example the interest rate has not been inflated artificially to increase the costs of production); that the loan has been undertaken in the ordinary course of business; and that the proceeds of the loan are objectively assignable to the production of goods.

83. The question submitted to the Panel focuses on the legal *form* of the transaction giving rise to the interest obligation. It follows from our analysis that the *form* of the debt is not a controlling circumstance. The relationship of the debt in respect of which interest is claimed to the production of goods is the key to the interpretation of Article 304.

VI: Determination

84. Accordingly, the Panel DETERMINES that:

- (i) *bona fide* interest payments on debt of any form, secured or unsecured, undertaken on arm's length terms in the ordinary course of business to finance the acquisition of fixed assets such as real property, a plant, and/or equipment used in the production of goods in the territory of a Party, and that are subject to a determination based on the criteria specified in FTA Annex 301.2, are includable in the 'direct cost of processing' or 'direct cost of assembling' set forth in Article 304 of the FTA;
- (ii) the U.S. interpretation of Article 304 contained in administrative decision ENT-3-02-CO:RA:C MS REF 04 and Customs Regulations S.10.305 (a)(3)(iv) published on January 22, 1992 as they relate to interest

other than mortgage interest on funds used to acquire real property, equipment and other fixed assets used in the production of the goods is inconsistent with the provisions of the FTA.

VII: Recommendation

85. The Panel RECOMMENDS that the Parties resolve the dispute by the adoption of such regulations and internal administrative procedures as may be necessary to implement the Panel's determination. The Parties may wish to consider the adoption of regulations and procedures that would address the particular problems of establishing an objective, traceable connection between a loan and production assets, the scrutiny of intracorporate loans, and the ascertainment of ordinary business practice.

SIGNED IN THE ORIGINAL BY:

JUNE 8, 1992
Date

JAMES F. GRANDY
James F. Grandy (Chair)

JUNE 8, 1992
Date

IAN BINNIE
Ian Binnie, Q.C.

JUNE 8, 1992
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WILLIAM B. KELLY, JR.
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DONALD MCRAE
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