# Korea – Taxes On Alcoholic Beverages

**(WT/DS75/AB/R)**

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| **Participants:**  Korea, *Appellant* European Communities, *Appellee* United States, *Appellee*  Mexico, *Third Participant* | **Appellate Body Division:**  Matsushita, *Presiding Member* Ehlermann, *Member* Feliciano, *Member* |

**Dispute Timeline**

Panel Request……………………………………………………………………April 2nd 1997  
Panel Establishment…………………………………………………………October 16th 1997  
Panel Report Circulation………………………………………………….September 17th 1998  
AB Report Circulation……………………………………………………….January 18th 1999  
Adoption……………………………………………………………………February 17th 1999

***Measures at issue:***Korean Liquor Tax Law of 1949; Korean Education Tax Law of 1982;as well as any amendments, related measures, or implementing measures.

***Legal basis of Complaint:*** Article III:2 of GATT 1994

## Relevant Facts of the Dispute

This is an appeal by Korea from certain issues of law and legal interpretation developed in the  
Panel Report, *Korea – Taxes on Alcoholic Beverages*. That Panel was established by the DisputeSettlement Body (the "DSB") to examine the consistency of two Korean tax laws: the Korean LiquorTax Law of 1949 and the Korean Education Tax Law of 1982, both as amended (the "measures"),with Article III:2 of the GATT 1994. The Liquor Tax Law imposed an *ad valorem* tax on all distilledspirits. The rate of that tax depends on which of the eleven fiscal categories a particular alcoholicbeverage falls within. The Education Tax Law imposed a surtax on the sale of most distilled spirits,the rate of the surtax being a percentage of the liquor tax rate applied to the spirit in question.

The Panel considered claims made by the European Communities and the United States that  
the contested measures were inconsistent with Article III:2 of the GATT 1994 because they accordedpreferential tax treatment to soju, a traditional Korean alcoholic beverage, as compared with certainimported "western-style" alcoholic beverages. The Panel Report was circulated to the Members of theWorld Trade Organization (the "WTO") on 17 September 1998. The Panel reached the conclusion that soju (diluted and distilled), whiskies, brandies, cognac, rum, gin, tequila, liqueurs and admixturesare directly competitive or substitutable products. The Panel also concluded that Korea has taxedthe imported products in a dissimilar manner and the tax differential is more than *de minimis* andthat the dissimilar taxation is applied in a manner so as to afford protection to domestic production.

The Panel recommended that the Dispute Settlement Body request Korea to bring the Liquor Tax Law and the Education Tax Law into conformity with its obligations under the General Agreement on Tariffs and Trade 1994.

## Issues raised before Appellate Body

Korea raised the following issues against the report of the Panel before the Appellate Body:

A. whether the Panel erred in its interpretation and application of the term "directly competitive or substitutable product" which appears in the *Ad* Article to Article III:2, second sentence, of the GATT 1994;

B. whether the Panel erred in its interpretation and application of the term "so as to afford protection", which is incorporated into Article III:2, second sentence, by specific reference to the "principles set forth in paragraph 1" of Article III of the GATT 1994;

C. whether the Panel erred in its application of the rules on the allocation of the burden of proof;

D. whether the Panel failed to make an objective assessment of the matter as required by Article 11 of the DSU;

E.whether the Panel failed to set out the basic rationale behind its findings and recommendations as required by Article 12.7 of the DSU.

## Decision of the Appellate Body

### "Directly Competitive or Substitutable Products"

In Report in *Japan - Alcoholic Beverages*, we stated that three separate issues must beaddressed when assessing the consistency of an internal tax measure with Article III:2, second sentence, of the GATT 1994:

##### the imported products and the domestic products *are* "*directly competitive or substitutable products*" *which are in competition with each other*;

##### the directly competitive or substitutable imported and domestic products *are* "*not similarly taxed*"; and

##### the dissimilar taxation of the directly competitive or substitutable imported and domestic products *is* "*applied …so as to afford protection to domestic production*".

Korea claimed that the Panel misinterpreted the term "directly competitive or substitutableproduct" by, *inter alia*, "relying on 'potential' competition, comparing the Korean market to theJapanese market and undertaking the wrong product comparisons."

#### Potential Competition

Contrary to Korea's assertions, the Panel had not relied on potential competition toovercome the then absence of a current "directly competitive or substitutable" relationship between the domestic and imported products on the basis that such a relationship might develop in the future. Rather, the Panel had concluded that "there is sufficient unrebutted evidence in the existing case to show *present* direct competition between the products”. This legal finding is not a speculative one concerning the future, but instead is based firmly in the present. Therefore, their reference to "a strong potentially direct competitive relationship" only buttresses the Panel's finding of "present direct competition".

The term "directly competitive or substitutable" describes a particular type of relationship  
between two products, one imported and the other domestic. Consequently, essence of that relationship is that the products are in competition. The word "competitive" means "characterized by competition", and from the word "substitutable" meant "able to be substituted". The context of such a competitive relationship is necessarily the marketplace since this is the forum where consumers will have to choose between different products. Competition in the market place is a dynamic, evolving process. Accordingly, the wording of the term "directly competitive or substitutable" implies that the competitive relationship between products is*not* to be analyzed *exclusively* by reference to *current* consumer preferences. Thethe word "substitutable" indicates that the requisite relationship *may* exist between products that are not, at a given moment, considered by consumers to be substitutes but which are, nonetheless, *capable* of being substituted for one another.

The words "competitive or substitutable" are qualified in the *Ad* Article by the term  
"directly". In the context of Article III:2, second sentence, the word "directly" suggests a degree of proximity in the competitive relationship between the domestic and the imported products. The word "directly" does not, however, prevent a panel from considering both latent and extant demand.

This interpretation of the ordinary meaning of the term "directly competitive or substitutable" issupported by its context as well as its object and purpose. As part of the context, the *Ad* Article provides that the second sentence of Article III:2 isapplicable "only in cases where competition *was* involved". The first part of the clause is cast in the conditional mood ("would") and the use of the past indicativesimply follows from the use of the word "would". It does not place any limitations on the temporaldimension of the word "competition". The first sentence of Article III:2 also forms part of the context of the term. "Like" productsare a subset of directly competitive or substitutable products: all like products are, by definition,directly competitive or substitutable products, whereas not all "directly competitive or substitutable" products are "like".The notion is to construe like products narrowly but the very category of directly competitive or substitutable products is broader. While perfectly substitutable products fall within Article III:2, first sentence, imperfectly substitutable products can be assessed under Article III:2, second sentence.

The context of Article III:2, second sentence, also includes Article III:1 of the GATT 1994.  
In *Japan - Alcoholic Beverages*, we stated that Article III:1 informed Article III:2 through specific reference. The broad and fundamental purpose of Article III is to *avoid protectionism* in the application of internal tax and regulatory measures. Toward this end, Article III obliges Members of the WTO to *provide equality of competitive conditions* for imported products in relation to domestic products. Moreover, it is irrelevant that the "trade effects" of the tax differential between imported and domestic products, as reflected in the volumes of imports, is insignificant or even non-existent; Article III *protects expectations* not of any particular trade volume but rather of the *equal competitive relationship* between imported and domestic products.

With the objectives of avoiding protectionism, requiring equality of competitiveconditions and protecting expectations of equal competitive relationships, we decline to take a static view of the term "directly competitive or substitutable." The object and purpose of Article III confirms that the scope of the term "directly competitive or substitutable" cannot be limited to situations where consumers *already* regard products as alternatives. If reliance can be placed only on current instances of substitution, the object and purpose of Article III:2 can be defeated by the protective taxation that the provision aims to prohibit. Accordingly, in some cases, it may be highly relevant to examine latent demand.

We, however, also note that the actual consumer demand may be influenced by measures other thaninternal taxation. Thus, demand may be influenced by, *inter alia*, earlier protectionist taxation, previous import prohibitions or quantitative restrictions. Latent demand can be a particular problem in the case of "experience goods", such as food and beverages, which consumerstend to purchase because they are familiar with them and with which consumers experiment only reluctantly.We, therefore, conclude that the term "directly competitive or substitutable" does not prevent a panel from taking account of evidence of latent consumer demand as one of a range of factors to be considered when assessing the competitive relationship between imported and domestic products under Article III:2, second sentence, of the GATT 1994.

Therefore, the Panel committed no error of law in buttressing its finding of "present direct competition" by referring to a "strong potentially direct competitive relationship".

#### Expectations

In the course of its reasoning on potential competition, the Panel referred to the "settled law  
that competitive expectations and opportunities are protected" and noted our statement in  
*Japan - Alcoholic Beverages* that "Article III protects expectations not of any particular trade volumebut rather of the equal competitive relationship between imported and domestic products".

As we stated earlier, the object and purpose of Article III is the maintenance of equality of  
competitive conditions for imported and domestic products. It is, therefore, not only legitimate, buteven necessary, to take account expectations regarding products that are not currently "directly competitive or substitutable",but which may become so in the near future in interpreting the term "directly competitive orsubstitutable product".

#### “Trade Effects” Test

The Panel had expressed concern that focus on the quantitative extent of competition instead ofthe nature of it could result in a type of trade effects test being written into Article III cases. In our view, when the Panel referred to a "type of trade effects test", it was simply expressing its skepticism aboutthe consequences of placing undue emphasis on quantitative analyses of the competitive relationshipbetween products.

The Panel’s reasoning that if a particular degree of competition had to be shown inquantitative terms, that would have been similar to requiring proof that a tax measure had a particular impact on trade. Such an approach, consequently,could be considered akin to a type of trade effects test.We do not consider the Panel's reasoning on this point to be flawed.

#### Nature of Competition

The Panel made numerous references to the "nature of competition". We believe that the Panel used the term "*nature* of competition" as a synonym for *quality* of competition, as opposed to *quantity* of competition. The Panel considered that in analyzing whether products are "directly competitive or substitutable", the focus should be on the *nature* of competition and not on its *quantity*.

In our view,the approach proposed by Korea that focused solely on the quantitative overlap of competition will, in essence, make cross-price elasticity *the* decisive criterion in determining whether products are "directly competitive or substitutable". Therefore, we consider that the Panel's use of the term "nature of competition" is not questionable.

#### Evidence From Japanese Market

The Panel consideredappropriate to look at "the nature of competition in other countries in assessing whether products were directly competitive or substitutable.

A "directly competitive or substitutable" relationship is deemed to have been present in the market at issue(Korean market). We accept that while the consumerresponsiveness to products may vary from country to country, it does not precludeconsideration of consumer behaviour in a country other than the one at issue. The evidence from other markets may be pertinent to the examination of the market at issue, particularlywhen demand on that market has been influenced by regulatory barriers to trade or to competition.Consequently, while every other market will be relevant to the market at issue,evidence of consumer demand in another market displaying characteristics similar to the market at issue, may be of some relevance to the market at issue. This, however, can only be determined on a case-by-case basis, taking account of all relevant facts. Therefore,we hold that the Panel did not err in referring to the Japanese market in its reasoning.

#### Grouping of the Products

Korea argued that the Panel erred in failing to examine distilled soju and diluted soju  
separately and also in examining all of the imported products together.

In our view, some grouping is almost always necessary in cases arising under Article III:2,  
second sentence, since generic categories commonly includes products with *some* variation in  
composition, quality, function and price, and thus commonly gives rise to sub-categories. We also note that "grouping" of products involves at least a preliminarycharacterization by the treaty interpreter that certain products are*sufficiently similar* as to, for  
instance, composition, quality, function and price, to warrant treating them as a group for conveniencein analysis. We agree with Korea's concern that, in certaincircumstances, such "grouping" of products *might* result in individual product characteristics beingignored, and that, in turn, *might* affect the outcome of a case.

We looked into the Panel's analysis of the physical characteristics, end-uses, channels of distribution and prices of the importedproducts and confirm the correctness of its decision to group the products for analytical purposes.Weconsequently uphold the Panel's grouping of imported products, complemented whereappropriate, by individual product examination, and state that such groupingproduces the same outcome that individualexamination of each imported product would have produced.

### "So As To Afford Protection"

We stated in the *Japan Alcoholic Beverages* casethatthe focus of such a portion of the inquiry should have been on the objectivefactors underlying the tax measure in question including its design,architecture and the revealing structure. Examination of whether a tax  
regime affords protection to domestic production is an issue of how the measure in question is*applied*, and that such an examination requires a comprehensive and objective analysis.

According to Korea, the Panel committed several errors in applying the third element of  
Article III:2, second sentence, such as ignoring Korea's explanations for the structure of the tax and making"much" of the virtual absence of imported soju.

We note that in finding that the Korean measures afford protection todomestic production, the Panel had relied, first, on the fact that "the Korean tax law … has very largedifferences in levels of taxation." Although it considered that the magnitude of the tax differenceswas sufficiently large to support a finding that the contested measures afforded protection to domesticproduction, the Panel also considered the structure and design of the measures. In addition, thePanel also found that, in practice there was virtually no imported soju so the beneficiaries of this structureare almost exclusively domestic producers.Consequently, the tax operated in such a way that thelower tax brackets covered almost exclusively domestic production, whereas the higher tax bracketsembraced almost exclusively imported products. In such circumstances, the reasons given by Korea asto *why* the tax was structured in a particular way did not call into question the conclusion that themeasures are applied so as to afford protection to domestic production. Likewise, the reason behind whythere is very little imported soju in Korea did not change the pattern of application of the contestedmeasures. We consider the Panel’s reasoning to be correct in this matter.

Korea argued that a finding that a measure afforded protection must have been  
supported by proof that the tax difference had some identifiable trade effect. However, Article III is not concerned with trade volumes and, therefore, it isnot incumbent on acomplaining party to prove that tax measures are capable of producing any particular trade effect.Consequently, we holdthat the Panel did not err in its application of the term "so as toafford protection".

### Allocation of the Burden of Proof

Korea argued that the Panel misapplied the burden of proof and that it applied a "double  
standard" when assessing the evidence. We note that although the Panel did not actually articulate therules on allocation of the burden of proof, it made specific reference to passages of our earlier Report in*United States – Shirts and Blouses* where such rules were enunciated.

Weupholdthe Panel’sapplication of the rules on allocation of the burden of proof. First, the Panel insisted thatit could have made findings under Article III:2, second sentence, only with respect to products for which a*prima facie* case had been made out on the basis of evidence presented. Second, it declined toestablish a presumption concerning all alcoholic beverages within HS 2208. Such a presumptionwould be inconsistent with the rules on the burden of proof because it would have prematurely shifted theburden of proof to the defending party. The Panel, therefore, did not consider alleged violations ofArticle III:2, second sentence, concerning products for which evidence was not presented. Thus,the Panel examined tequila because evidence was presented for it, but did not examine mescal andcertain other alcoholic beverages included in HS 2208 for which no evidence was presented. Third,contrary to Korea's assertions, the Panel did indeed consider the evidence presented by Korea in rebuttal,but had nevertheless concluded that there was "sufficient *unrebutted* evidence" for it to make findings ofinconsistency.

### Article 11 of the DSU

Korea claimed that the Panel failed to make an objective assessment of the matter before it and  
failed to apply the appropriate standard of review under Article 11 of the DSU. Korea contends thatthe Panel did not have sufficient evidence before it to enable it to conduct an objective assessment ofthe matter, and that, as regards the evidence that was, in fact, before it, the Panel made a series of"manifest and/or egregious errors of assessment".

The Panel's examination and weighing of the evidence submitted falls, in principle, within thescope of the Panel's discretion as the trier of facts and, accordingly, outside the scope of appellatereview. We cannot second-guess the Panel in appreciating either theevidentiary value of the presented studies or the consequences, if any, of alleged defects in those studies.Furthermore, we cannot review the relative weight ascribed to evidence on such matters asmarketing studies, methods of production, taste, colour, places of consumption, consumption with"meals" or with "snacks", and prices.

We note that a panel's discretion as trier of facts is not unlimited, but rather such discretion is alwayssubject to, and is circumscribed by, among other things, the panel's duty to render an objectiveassessment of the matter before it.

In *European Communities - Hormones*, we had dealt with allegationsthat the panel had "disregarded", "distorted" and "misrepresented" the evidence before it and held that not every error in the appreciation of the evidence(although it might have given rise to a question of law) may be characterizedas a failure to make an objective assessment of the facts. Only a deliberatedisregard of, or refusal to consider, the evidence submitted to a panelis incompatible with a panel's duty to make an objective assessment ofthe facts.

In our view, Korea has not shown that the Panel had committed any egregious errors that could have been characterized as a failure to make an objective assessmentof the matter before it. It is not an error, let alone an egregious error,for the Panel to fail to accord the weight to the evidence that one of the parties believe should be accorded to it. Consequently, the Panel had not failed to make an objectiveassessment of the matter before it within the meaning of Article 11 of the DSU.

### Article 12.7 of the DSU

Korea claimed that the Panel has failed to fulfil its obligation under Article 12.7 of the DSU to set out the basic rationale behind its findings and recommendations.We do not consider it necessary or desirable to attempt to define the scopeof the obligation provided for in Article 12.7 of the DSU.

It suffices to state the Panel has set outa detailed and thorough rationale for its findings and recommendations in this case by taking account of competing considerations and explaining why it made the findings and recommendations that it did. While the rationale set out by the Panel might not have been the one thatKorea agreed with, but it is adequate to satisfy the requirements ofArticle 12.7 of the DSU.

## Findings and Conclusions

For the reasons set out in the Report, the Appellate Body:

A. **upholds the Panel's interpretation and application** of the term "directly competitive or substitutable product" which appears in the Ad Article to Article III:2, second sentence, of the GATT 1994;

B.**upholds the Panel's interpretation and application of the term** "so as to afford protection", which is incorporated into Article III:2, second sentence, by specific reference to the "principles set forth in paragraph 1" of Article III of the GATT 1994;

C.**upholds the Panel's application** of the rules on the allocation of the burden of proof;

D. **concludes that the Panel did not fail** to make an objective assessment of the matteras required by Article 11 of the DSU; and

E.**concludes that the Panel did not fail** to set out the basic rationale behind its findingsand recommendations as required by Article 12.7 of the DSU.

The Appellate Body *recommends* that the Dispute Settlement Body request Korea to bringthe Liquor Tax Law and the Education Tax Law into conformity with its obligations under theGeneral Agreement on Tariffs and Trade 1994.