NOTES

FOREIGN SALES CORPORATIONS: A VIABLE SOLUTION TO THE DISC CONTROVERSY?

I. INTRODUCTION

The Foreign Sales Corporation Act of 1983 (FSC)[1] was introduced in Congress on August 4, 1983 as a replacement for the embattled ten year old tax export aid, the Domestic International Sales Corporation (DISC).[2] Given the criticism which has plagued DISC since its inception in 1971, this year's enactment of FSC is indeed a welcome change. However, as a solution to the DISC controversy under the General Agreement on Tariffs and Trade (GATT),[3] or as a comparable incentive to DISC, FSC is arguably somewhat lacking.

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1. The Foreign Sales Corporation Act of 1983, H.R. 3810, was originally introduced in the House of Messers. Rostenkowski and Conable on August 4, 1983. H.R. 3810, 98th Cong., 1st Sess., 129 CONG. REC. H6606 (daily ed. Aug. 4, 1983). An identical Senate bill, S. 1804, was introduced the same day by Senator Dole. S. 1804, 98th Cong., 1st Sess., 129 CONG. REC. S11762 (daily ed. Aug. 4, 1983 pt. II). Neither version received consideration during the 98th Congress 1st session. On March 21, 1984, however, FSC was reported out of the Senate Committee on Finance as a part of the Deficit Reduction Act of 1984, H.R. 4170. *See Summary of Deficit Reduction Act of 1984, reprinted in* 23 TAX NOTES (CCH) No. 2, at 178 (Apr. 9, 1984). Although not made a part of the House tax act, FSC was passed by the Senate on May 17, 1984. 130 CONG. REC. S5973 (daily ed. May 17, 1984). In conference, FSC was adopted by both Senate and House conferees on Saturday, June 23, 1984, and the Conference Report was passed by both houses on June 27, 1984. 130 CONG. REC. D902, D905 (daily ed. June 27, 1984). President Reagan signed the tax bill into law on July 18, 1984. 20 WEEKLY COMP. PRES. DOC. 1037 (July 23, 1984).

2. A Domestic International Sales Corporation is a tax incentive to export. *See* 26 U.S.C. §§ 991-997 (1982). As a long term direct tax deferral, DISC works by lowering the effective tax rate on export transactions. In 1976, the DISC provisions were challenged and found incompatible with the General Agreement of Tariffs and Trade (GATT), *done* Oct. 30, 1947, 61 Stat. A3 (1947), T.I.A.S. No. 1700, 55-61 U.N.T.S. 194 (1948). *See* Report of the GATT Panel, United States Tax Legislation (DISC), GATT DOC L./4422 (2 Nov. 1976), *reprinted in* 23 BISD 98 (1975-76).

3. GATT, *supra* note 2. The concern in the debate over DISC compliance with GATT centered on whether DISC violated GATT article XVI on subsidies. GATT, *supra* note 2, at A51, as then interpreted by the Working Party Report on Subsidies. *See* Report on Subsidies, Provisions of article XVI:4, *reprinted in* 9 BISD 185 (1961). The EC alleged that DISC was a "remission of direct taxes, . . . calculated in relation to exports" that was specifically defined as a subsidy under items (c) and (d) of the Working Party Report. Report on Subsidies, 9 BISD at 186-187. The United States argued DISC was not an exemption or remission, but rather only a deferral and therefore GATT legal. In relation to FSC, then, one issue is whether FSC is a subsidy under the now official Subsidies Code, the successor to

Under certain circumstances, to be discussed, FSC may conform to the legal standards of GATT.[4] These circumstances, however, are not the majority of cases. Perhaps even more troublesome is that Congressional approval of FSC publicly signifies a retreat from longstanding U.S. efforts to combat the trade distorting tax practices of the European Community (EC).[5] Not only does FSC concede the direct-indirect exemption conflict to European logic,[6] but it represents a unilateral effort at enforced arm's-length pricing currently unmatched in the EC.[7]

As an export incentive to producers, FSC offers a net level of benefit lower than that under DISC[8] with more inherently costly requirements.[9] Because of this added cost, the proposal may well be out of reach of many of the businesses it was intended to aid.[10] Moreover, with such low or negative levels of would-be benefits

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the Working Party Report. *See* GATT: Agreement on Interpretation of Articles VI, XVI and XXIII, *done*, Apr. 12, 1979 (1979) 1 U.S.T. 573, T.I.A.S. No. 9619, *reprinted in* 26 BISD 56 (1979) [hereinafter cited to BISD]. For reasons discussed herein, FSC has the potential to be a subsidy. *See infra* text accompanying notes 163-85a.

4. *See infra* text accompanying notes 163-85a. Under the model derived in footnotes 174-84, for FSC to be consistent with the GATT foreign economic processes exemption, *see infra* text accompanying notes 87-88, it would have to be assumed that the disposition and overhead costs incurred by an FSC represented 64% of the export price of the product. Clearly, if the FSC does not produce the product itself, but rather must purchase it at arm's-length from its parent, a mere 36% of the export price being allocable to the product itself is somewhat unrealistic. Moreover, given the "watered down" foreign process and presence requirements under the FSC proposal, it is equally unrealistic that the costs for these processes would amount to 64% of the export selling price. However, these are the assumptions arguably made by the drafters of H.R. 3810.

5. Reference is made to the longstanding U.S. policy of promoting free, undistorted trade patterns based on comparative advantage. FSC arguably does not further this policy because of its questionable GATT legality. Moreover, FSC represents both an abandonment of the U.S. fight to win recognition of indirect tax exemptions as trade distorting practices within the meaning of the GATT, as well as a move toward arm's-length transfer pricing which is currently unmatched in Europe. Thus, not only do indirect exemptions remain GATT legal, but EC transfer price rules have yet to match U.S. arm's-length standards—both trade distorting results. *See infra* text accompanying notes 208-32.

6. *See supra* note 4 and *infra* text accompanying notes 208-32.

7. *See supra* note 4 and *infra* text accompanying notes 73-86.

8. While DISC and FSC, in the large exporter case, offer the same level of tax benefit, with the costly foreign presence and process requirements of FSC, the net level of benefit under FSC is lower. *See infra* text accompanying notes 232-47.

9. These more costly requirements are called the foreign presence and foreign economic processes requirements. *See infra* text accompanying notes 109-25.

10. This conclusion is drawn from the fact that because the effective level of tax benefit is lower under FSC than under DISC, those firms operating at the margin under DISC would find it too costly to continue to produce in the United States and export through a foreign subsidiary. *See infra* text accompanying notes 242-47.

in some cases, FSC may be a force in granting marginal DISC users an incentive to once again invest and produce abroad.[11]

FSC may buy a short term peace with the EC in the GATT Council. The long run effect, however, is a net disadvantage to U.S. exporters in relation to their European counterparts and a further entrenchment of the trade distorting practices of the EC's own tax export aids. It appears, therefore, that while United States' efforts may be commendable, there is something indeed ironic about calling FSC a real "solution" to anything.

An analysis of the arguments presented above is the subject of this Note. Section II will deal with the DISC legislation, its technical and theoretical description, and the history of the DISC controversy within GATT.[11a] Particular emphasis will be placed on the justification for DISC the United States offered and then abandoned before the GATT Council.[11b] Section III will deal with the FSC Proposal.[11c] Section IV is an analysis of FSC legality under GATT and its acceptability to business as an alternative incentive to DISC.[11d]

II. DOMESTIC INTERNATIONAL SALES CORPORATIONS

A. A Technical/Theoretical Description

A Domestic International Sales Corporation (DISC) is an exporting firm located in the United States that is exempt from federal income taxation.[12] Enacted as a part of the Revenue Act of 1971,[13] DISC is designed to give parent corporations with DISC subsidiaries a lower effective tax rate on the export income from domestically produced goods.[14] The purpose of the lower rate is to

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11. Reference is made to one of the policies for which DISC was created: to keep taxes from creating an incentive to produce goods for foreign markets in foreign countries rather than in the United States. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, 98TH CONG., 1ST SESS., REPLACEMENT OF DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISCs)—DESCRIPTION OF S. 1804 (FOREIGN SALES CORPORATION ACT) 34 (J. Comm. Print 1983) [hereinafter cited as Joint Committee Print]. Whereas FSC does not provide the same net level of benefit as DISC, those firms at the margin will find a net advantage in producing abroad rather than in the United States.

11a. *See infra* notes 12-100 and accompanying text.

11b. *See infra* notes 73-86 and accompanying text.

11c. *See infra* notes 101-62 and accompanying text.

11d. *See infra* notes 163-263 and accompanying text.

12. 26 U.S.C. §§ 991-92 (1982).

13. The Revenue Act of 1971, Pub. L. No. 92-178, Title V, § 501, 85 Stat. 535 (1971).

14. Joint Committee Print, *supra* note 11, at 9.

The lower effective tax rate on the export income earned through DISCs is based on the assumption of permanent DISC deferral. If, for instance, all deferred income needed counter existing corporate tax incentives for producing abroad such as paying no U.S. tax until the foreign income is repatriated.[15] By producing at home, it was hoped that there would be a positive effect on U.S. balance of payments and the level of domestic employment.[16]

In theory, the desired effects of the DISC legislation are achieved by lowering the effective income tax rate to give the DISC exporter the opportunity to lower prices, expend more funds on export promotion, and thereby increase the demand for exports.[17] With the increased profitability of exporting, there would then be a shift of firms and their resources to the exporting industry, which in turn would result in a higher number of exports.[18] By making

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to be set aside for future tax liability, the isolation of these funds and their lack of productivity in the production process would arguably make up for any lower effective tax rate. In reality, firms behave with the deferred income tax dollars as if they were the result of a tax exemption. Accordingly, the Accounting Principles Board advises that, "the contingent tax liability [related to DISC tax-deferred income] is so remote that it need not even be considered in the compilation of annual earnings." Statement of Accounting Principles Board, *reprinted in* Anninger, *DISC and GATT: International Trade Aspects of Bringing Deferral Home*, 13 HARV. INT'L L.J. 391, 404 (1972).

15. The Committee analyzed the effect of the disparate tax treatment given U.S. companies which exported goods abroad and U.S. companies which manufactured goods abroad in foreign subsidiaries, as follows: The exporter was discriminated against because he paid full U.S. taxes on a current basis; the U.S. company which manufactured abroad through a foreign subsidiary, on the other hand, generally was required to pay only the foreign taxes on its income on a current basis. Foreign taxes were found by the committee to average about 10 percentage points less than the regular U.S. corporate income tax. The committee also found that the existing tax structure encouraged the reinvestment of foreign earnings of foreign subsidiaries in plants or selling organizations located abroad, since this enabled the parent corporation to postpone the payment of the U.S. tax which would result if the foreign earnings were remitted to the United States. The DISC provisions of the bill were designed to remove the U.S. exporter's disadvantage by freeing him from U.S. tax as long as he continued to use export income in production facilities, to the extent the facilities were used to produce goods in the U.S. for sales abroad.

Joint Committee Print, *supra* note 11, at 9.

16. *Id.*

17. Comment, *The DISC Legislation as a Violation of the General Agreement on Tariffs and Trade*, 41 MO. L. REV. 180, 185 (1976).

18. *Id.* at 186. Traditional microeconomic theory predicts that in industries where short run influences create excess economic profits, firms in industries facing long run equilibrium and zero economic profits will be drawn to investing resources at the higher return. Once a greater number of firms develop in the industry with the higher asset returns, output will expand, prices will fall, and excess profits will dissipate in the long run thereby limiting the expanding industry's growth. The result, therefore, is the long run expansion of the targeted industry.

In the DISC case, the lower effective tax rate creates excess economic profits which it as profitable to have a manufacturing subsidiary based in the United States as abroad, the tax deferral increases the demand for the domestically produced product.[19]

To qualify as a DISC and receive this favorable tax treatment, a corporation must meet several requirements: (1) the DISC must be incorporated in the United States;[20] (2) it must have issued only one class of stock with a stated value of at least $2,500.00;[21] (3) it must have elected to be treated as a DISC;[22] (4) ninety-five percent of its gross receipts must be derived from exports;[23] and (5) ninety-five percent of its assets must be export related.[24]

A DISC may act as a principal or as an agent with respect to export property.[25] Its activities can be performed for or on behalf of related or unrelated parties.[26] There is also no requirement for

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attract entry into the targeted export sector. This creates a greater output of the export good, a new lower price for the export good, and an expansion in the quantity of exports demanded. Under competitive market conditions, this is an export tax incentive. For further explanation, see W. NICHOLSON, MICRO ECONOMIC THEORY: BASIC PRINCIPLES AND EXTENSIONS 291-307 (2d ed. 1978).

19. Comment, *supra* note 15, at 186. The reference to making production "just as profitable" at home as abroad is in reference to tax incidence alone. The analysis in the text accompanying notes 17-19 is one which holds all other factors besides tax rate constant for the predicted result. Under DISC, the "just as profitable" language refers to the existence of a U.S. based export firm which is itself tax exempt and whose dividends are only taxed to the parent stock owner when distributed. This immediate tax scheme is that which is currently in place for export firms based abroad, owned by U.S. based corporations.

20. 26 U.S.C. § 992(a)(1) (1982).

21. *Id.* § 992(a)(1)(c).

22. *Id.* § 992(a)(1)(D).

23. *Id.* § 992(a)(1)(A). The gross receipts test requires that at least 95% of the corporation's gross receipts consist of qualified export receipts. In general, qualified export receipts are receipts, including commission receipts, derived from the sale or lease for use outside of the United States of export property, *Id.* § 993(a)(1)(A), or from the furnishing of services related or subsidiary to the sale or lease of export property. *Id.* § 993(a)(1)(C). Dividends on stock of related foreign export corporations and interest on any obligation which is a qualified export asset are also considered qualified export receipts. *Id.* § 993(a)(1)(E). Export property must be manufactured, produced, grown, or extracted in the United States. Exports subsidized by the U.S. government or exports intended for ultimate use in the United States do not qualify as export property. *Id.* § 993(a)(2). A DISC may not engage in manufacturing, producing, growing or extracting export property. *Id.* § 993(c)(1)(A).

24. Qualified export related assets include inventories of export property, necessary operational equipment and supplies, trade receivables from export sales (including commissions receivable), producer's loans, working capital, investments in related foreign export corporations, obligations of domestic corporations organized solely to finance export sales under guaranty agreements with the Export-Import Bank, and obligations issued, guaranteed or insured by the Export-Import Bank or the Foreign Credit Association. *Id.* § 992(a)(1)(B).

25. *Statement by Reagan Administration, General Explanation of Current Law—DISC, reprinted in* 20 TAX NOTES (CCH) No. 3, at 240 (June 18, 1983).

26. *Id.*

a DISC to have employees or real operation.[27] Conversely, the DISC itself is prohibited from producing the exports it sells.[28]

The size of the DISC benefit a parent corporation or shareholder receives is dependent in major part upon two factors: the amount of export income allocated to the tax exempt entity from the parent;[29] and the portion of the taxable DISC income that is required to be distributed back to the parent.[30] DISC income allocation is determined either on an "arm's-length"[31] basis or under one of two special pricing rules.[32] Specifically, an allocation can be made allowing the DISC to earn taxable income not exceeding the greater of:

> a. taxable income based upon the price actually charged the DISC by its supplier, if that price is justifiable under section 482 pricing regulations;[33]
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> b. four percent of the qualified export receipts attributable to the sale of export property plus 10% of the related export promotion expenses, which are the ordinary and necessary expenses incurred to obtain qualified export receipts;[34] or
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> c. fifty percent of the combined taxable income of the DISC and its related supplier attributable to qualified export receipts plus 10% of the related export promotion expenses.[35]

In terms of the portion of DISC income that is distributed, the Internal Revenue Service (IRS) determines the parent's tax liability in the following manner. Using the DISC's average gross receipts

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27. *Id.*

28. *Id. See* 26 U.S.C. § 993(c)(1)(A) (1982). *See also* Anninger, *DISC and GATT: International Trade Aspects of Bringing Deferral Home*, 13 HARV. INT'L L.J. 391 (1972).

29. This is the intercompany transfer provision defined at 26 U.S.C. § 994 (1982). Theoretically, the parent desires to allocate as much income as possible to the DISC in order to decrease its own tax base and increase the DISC's. This is achieved by charging as low a price as possible to the DISC for goods to be sold for export. Under the DISC provisions, this occurs through the choice of the transfer price rule which allocates the greatest amount of total export receipts to the DISC.

30. This is the distribution requirement for DISC shareholders defined at 26 U.S.C. § 995 (1982). *See infra* text accompanying notes 36-38.

31. "Arm's-length" refers to a transfer price between two related entities which is theoretically equal to that price which would be charged for the same good between unrelated parties. It is a standard which related U.S. tax payers are required to follow or else face reallocation by the IRS under § 482. 26 U.S.C. § 482 (1982).

32. *Id.* § 994(a)(1) & (a)(2).

33. *Id.* § 994(a)(3).

34. *Id.* § 994(a)(1).

35. *Id.* § 994(a)(2).

over a four year base period, the excess of the current year's receipts over 67% of the average gross is calculated.[36] Fifty-seven and a half percent of the excess is deemed distributed to the DISC's shareholders and is taxed to the parent corporation or individual at the normal rate.[37] The remaining 42.5% is retained by the DISC and is exempt from taxation.[38]

Since 1971, the DISC provisions have been altered by the Tax Reduction Act of 1975,[39] the Tax Reform Act of 1976[40] and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[41] The Tax Reduction Act denied DISC benefits to profits arising from exports of products in short domestic supply.[42] The 1975 Act also removed DISC benefits from exports of natural resource products, such as oil, gas, and minerals, subject to the percentage depletion allowance.[43] The Tax Reform Act excluded renewable resources,

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36. *Id.* § 995(e)(3).

37. *Id.* § 291(a)(4).

38. *Id.* These provisions for the calculation of DISC income distribution and deferral are appropriately referred to as the "incremental provisions." *See infra* text accompanying notes 45-46. Their purpose is to ensure that only by *increasing* exports will firms *increase* their DISC benefits past the first year of election.

To understand this incremental concept, the use of a simplifying example is perhaps best. If a DISC, in operation, say, since 1971 were to calculate its distribution and deferral for 1980, it would first calculate an average base period figure using the fourth, fifth, sixth and seventh calendar years preceding 1980. Thus, the base period figure would be the average of export receipts for years 1974 through 1977. For simplicity, this amount will be $162 ($75 + $150 + $200 + $225 / 4).

Using this figure of $162 as the average gross receipts base, the excess of the 1980 figure over 67% of the base is calculated. For 1980, a gross receipts amount of $400 will be chosen to provide a contrast for our example. Thus, for the hypothetical DISC in 1980, receipts in excess of 67% of the base are $291. Under the distribution rules, $167 ($291 x .575) would be deemed distributed to the parent (provided the DISC is a wholly owned subsidiary) and $124 ($291 x .425) would be income retained by the DISC as tax exempt deferred income.

Suppose, however, this DISC had a higher base average, reflecting a lesser export receipts increase for 1980. Using a base of $294 ($225 + $275 + $325 + $350), the receipts in excess of 67% of the base would be $203. Distribution would then be $117 to the parent with only $86 for the DISC tax free as a deferral. Clearly, the example illustrates that the absolute level of DISC receipts is not as significant as the relationship of gross receipts to the base period average. Thus, the conclusion is consistent with the incremental rule's purpose: only by *increasing* current export receipts can DISC benefits increase. As parent corporations wish to increase DISC benefits, they must not maintain their current level of exports, they must increase it. From the firm's viewpoint, this is the incentive to export.

39. Tax Reduction Act of 1975, Pub. L. No. 94-12, Title VI, § 603, 89 Stat. 26, 64 (1975).

40. Tax Reform Act of 1976, Pub. L. No. 94-455, Title XI, § 1101, 90 Stat. 1520, 1655 (1976).

41. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Title II, § 204(a), 96 Stat. 324, 423 (1982).

42. 26 U.S.C. § 993(c)(3) (1982).

43. *Id.* § 993(c)(2)(C).

such as timber, from the natural resource products ineligible for DISC benefits.[44] The 1976 Act also included incremental provisions limiting DISC benefits to increases in exports above a certain base period.[45] The incremental provisions were enacted in order to ensure DISC benefits were perpetuated only as a result of increased exports.[46] In 1982, TEFRA increased the deemed distribution rate from a DISC to a corporate shareholder from 50% to 57.5% of taxable income.[47]

Based on the foregoing, the real value of DISC benefits is perhaps somewhat hidden.[48] Clearly, regardless whether income becomes tax exempt when retained by the DISC, it is still of little use to the parent or stockholder if it is taxed at the full rate when distributed.[49] Moreover, if the income cannot be used for production by the DISC, even the DISC's tax exempt status is arguably of little value.[50] The law, however, permits the DISC to loan its tax exempt profits to the parent or related firm if such firm is itself substantially engaged in export activities.[51] Herein lies the mechanism by which the parent firm can productively utilize the tax benefits so seemingly valueless to the DISC itself as a paper corporation.[52] Very simply, the more income allocated to the DISC, the greater the amount of tax exempt DISC income available for low interest "producer loans" to the parent, and the greater the incentive to produce and sell abroad.

B. DISC and GATT: A History of Controversy

Ever since its conception in 1970, DISC has been the topic of heated debate.[53] Of primary concern in this debate have been the

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44. Tax Reform Act of 1976, *supra* note 40, at 60.

45. Tax Reform Act of 1976, *supra* note 40, at 1655.

46. Joint Committee Print, *supra* note 11, at 13-14. Under the incremental approach, deferral is only granted to the extent of 42.5% of a company's current income attributable to increases in its exports over 67% of a 4 year average base amount. *See also* note 38.

47. 26 U.S.C. § 291(a)(4) (1982).

48. *See generally*, Brumbaugh, *DISC: Effects, Issues, and Proposed Replacements*, Congressional Research Service, Apr. 5, 1983, Rpt. No. 83-69E, 5-6.

49. Outside of deemed distributions, any declared dividends by DISCs are also subject to full taxation for the shareholder. 26 U.S.C. § 995(a) (1982).

50. Recall discussion of § 993(c)(1)(A), *supra* text accompanying notes 27-28.

51. 26 U.S.C. § 993(d) (1982).

52. Brumbaugh, *supra* note 48, at 5.

53. *See* Summary of arguments against DISC proposed by S. Surrey, *Hearings on Amendments 925 and 1009 to H.R. 175520 Before the Senate Committee on Finance*, 91st Cong., 2d Sess., pt. I, 37, 43-44 (1970). *See also* Brown, *Slipped DISC*, FORBES, Oct. 10, 1983, 158; J.H. Jackson, *The Jurisprudence of International Trade: The DISC Case in Gatt*, 72(4) AM. J. INT'L L. 747, 750-51 (1978); T. Kwako, *Tax Incentives for Exports, Permissible and Proscribed:*

repeated allegations of Canada and the EC that DISC is an export subsidy illegal under GATT.[54] In response, the United States has consistently argued that DISC is not an illegal subsidy under GATT but merely a tax deferral which is justifiable as a provision to neutralize the export subsidies inherent in certain European tax systems.[55]

An Analysis of the Corporate Income Tax Implications of the MTA Subsidies Code, 12(3) LAW & POL'Y INT'L BUS. 677, 686-714 (1980).

54. *See* United States Tax Legislation (DISC), Report of the Panel, *supra* note 2, at 102.

55. *Id.* For a clear picture of the U.S. position before the GATT Council, the following excerpt from a letter by Roy T. Englert, Acting General Counsel, U.S. Department of State, to Hon. Wilbur D. Mills, Chairman, House Committee on Ways and Means is representative:

> Dear Mr. Chairman: At the presentation before the Ways and Means Committee by the Treasury of its proposal for a domestic international sales corporation (DISC) on May 12, 1970, it was requested that the Committee be furnished with an opinion as to the compatibility of the DISC proposal with the obligations of the United States under the General Agreement on Tariffs and Trade (GATT).
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> The pertinent provision of the GATT is Article XVI:4. That Article provides in part as follows:
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> ". . . from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. . . ."
>
> Thus, the DISC proposal would be inconsistent with the obligations of the United States under the GATT only if that proposal involved the granting of a subsidy and the subsidy would result in the sale of products for export at a price lower than the comparable price in the domestic market.
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> The GATT working Party on Subsidies of November 19, 1960 (BISD, 9th Supp., Geneva, 1961) issued a report which, at page 185, sets forth a list of practices which would constitute a subsidy within the meaning of Article XVI:4, including the "exemption in respect to exported goods, of charges or taxes, other than . . . indirect taxes" and the "remission, calculated in relation to exports, of direct taxes . . . on industrial or commercial enterprises."
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> The DISC proposal involves neither the direct granting of a subsidy, the remission of direct taxes, nor an exemption from direct taxes. The essence of the DISC proposal is that United States tax on the export income derived through such a corporation, like the United States tax on income of a foreign subsidiary, would be deferred until distribution to shareholders, at which time the distribution would be taxed at regular rates.
>
> Therefore, after having considered the provisions of Article XVI:4, official statements and reports regarding that Article, the internationally accepted past and present practices of various countries which are also bound by the provisions of that Article, and having considered in addition the provisions of the United States Internal Revenue Code for the taxation of income of foreign corporations, and having regard also for other relevant factors, I am pleased to advise you that, in my opinion, the DISC proposal, as presented to the Committee, is consistent with the obligations of the United States under the General Agreement on Tariffs and Trade.

Anninger, *supra* note 28 at, 393-95 n.12.

See also Jackson, *supra* note 53, at 760-73; Kwako, *International Tax Rules*, in U.S. INTERNATIONAL ECONOMIC POLICY 1981: A DRAFT REPORT 6-28 (G. Hufbauer ed. 1982); L. GOMES,

1. *The European Position*

a. *DISC as a subsidy under GATT*

Established in 1946, GATT is a multilateral set of agreements designed to advance the principles of free trade.[56] While much of the free trade thrust of GATT has been in the direction of lowering tariffs, more recent emphasis has been on the removal of nontariff barriers such as subsidies.[57] It is in the context of subsidies that the DISC controversy arises.

In theory, subsidies such as DISC divert international trade flows from their normal pattern and distort producer incentives from those determined by comparative advantage.[58] Thus, although DISC may be beneficial to American interests in isolation, by distorting trade flows in favor of U.S. interests, DISC denies the benefits of an objective market mechanism to U.S. trading partners—benefits to which they are entitled under GATT.[59]

The GATT language prohibiting subsidies is found in article XVI, section 4, and comes into play through the fulfillment of two conditions: (1) the governmental program must be an export subsidy of a nonprimary product;[60] and, (2) the export subsidy must be found to result in the export sale of such product for a price lower than that charged in the exporter's domestic market.[61] While the criterion are indeed specific, no definition of subsidy was ever included in GATT.[62] What had been outlined, however, in 1960,

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INTERNATIONAL ECONOMIC PROBLEMS, 22-23 (1979). The administration also justified the 1971 DISC legislation to Congress as a response to European border tax adjustment actions. *Hearings on the Nomination of John B. Connally to be Secretary of the Treasury Before the Senate Comm. on Finance*, 92d Cong., 1st Sess. 40 (1971).

56. Comment, *The DISC Legislation as a Violation of the General Agreement on Tariffs and Trade, supra* note 17, at 180. *See* J. JACKSON, WORLD TRADE AND THE LAW OF THE GATT—A LEGAL ANALYSIS OF THE GENERAL AGREEMENT ON TARIFFS AND TRADE (1969).

57. Comment, *supra* note 17.

58. Comment, *supra* note 17, at 181.

59. Comment, *supra* note 17, at 181-83. *See also* the text of GATT article XVI, section A:

> If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory, it shall notify the CONTRACTING PARTIES in writing of the extent and nature of the subsidization, of the estimated effect of the subsidization on the quantity of the affected product or products imported into or exported from its territory and of the circumstances making the subsidization necessary.

GATT, article XVI, *supra* note 2, at 30.

60. GATT, article XVI, para. 4, *supra* note 2, at 31.

61. *Id.*

62. E. MCGOVERN, INTERNATIONAL TRADE REGULATION: GATT, THE UNITED STATES AND THE EUROPEAN COMMUNITY 251 (1982). The usual reason given for the lack of any definition

was a list of specific practices which were generally agreed upon to represent subsidies, the existence of which would set up a prima facie violation of article XVI.[63]

b. Sections (c) and (d) of the 1960 Working Party Agreement on Subsidies[64]

In 1973, a GATT panel was formally initiated to investigate whether sections (c) and (d) of the Working Party Agreement on Subsidies prohibited direct tax deferrals such as DISC.[65] Prompted by the complaints of Canada and the EC, the panel sought to determine whether DISC, which is technically a tax deferral, was of such unlimited duration as to amount to a direct tax exemption.[66] Upon concluding its investigation, the GATT panel agreed with the EC and Canada and recommended the GATT Council declare that the United States had nullified or impaired the GATT benefits of the petitioners.[67]

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of a subsidy in GATT centers around a recognition that subsidies can come in a greater variety of forms than are readily describable by a single definition. By defining subsidy, the drafters feared not only that the loopholes created by any definition would be greater than the prohibition of the definition itself, but that contracting parties would strictly construe any criterion given in order to severely limit the scope of Article XVI. Instead of a definition, the drafters settled for the general language of Article XVI, and the interpretive sections of the GATT Code on Subsidies. *See* GATT: Agreement on Interpretation of Articles VI, XVI and XXIII, *supra* note 3, at 67-70, 81-83.

63. *See* Report on Subsidies, Provisions of Article XVI:4, *supra* note 3, at 186.

64. *Id.* Items (c) and (d) refer respectively to "the remission, calculated in relation to exports, of direct taxes . . . on industrial or commercial enterprises," and "the exemption, in respect of exported goods, of charges or taxes, other than charges in connection with importation or indirect taxes levied at one or several stages on the same goods if sold for internal consumption." *Id.*

65.
> 28. The representative of the European Communities referred to the illustrative list of measures which governments prepared to accept the Declaration giving effect to Article XVI:4—including the United States Government—considered in general to be subsidies within the meaning of Article XVI:4 and in particular to items (c) and (d) of that list, which referred respectively to "the remission, calculated in relation to exports, of direct taxes . . . on industrial or commercial enterprises," and "the exemption, in respect of exported goods, of charges or taxes, other than charges in connection with importation or indirect taxes levied at one or several stages on the same goods if sold for internal consumption."

Report of the GATT Panel, United States Tax Legislation (DISC), *supra* note 2, at 103.

66.
> An unlimited deferral of taxes was, according to the European Communities, equivalent in economic terms to an exemption since the deferral granted by the DISC legislation was unlimited. . . . The system, therefore, afforded not a limited advantage but total exemption from direct federal corporation taxes for one half of the profits of a DISC accruing from exports.

Report of the GATT Panel, United States Tax Legislation (DISC), *supra* note 2, at 103.

67. Report of the GATT Panel, United States Tax Legislation (DISC), *supra* note 2, at 112-14 §§ 67-80.

Specifically, the GATT panel argued that because of DISC's unlimited existence and potential for indefinite deferral, the tax incentive was *potentially* a partial tax exemption.[68] Without reaching a conclusion as to this "broader" exemption issue, however, the panel chose to base its primary objection to DISC on a narrower finding that because no interest was charged on the deferred tax, this interest forgiveness was itself a subsidy.[69] The panel also faulted the DISC program's deduction for export promotion expenses[70] and the less than strict adherence to arm's-length pricing with the 4% and 50% rules discussed earlier.[71] On this latter ground, the panel concluded that given the various options under the DISC legislation for the allocation of profits from export sales between manufacturers and DISC's, there was too much leeway for abuse in measuring the amount of the DISC incentive.[72]

2. The U.S. Position

From the U.S. perspective, DISC is technically a deferral and therefore not simultaneously an exemption.[73] Moreover, DISC is equally justifiable as a countermeasure to EC tax export incentives.[74] This section will focus on the justification the United States presented for DISC to the GATT Council.

a. DISC as a means of removing an existing distortion rather than creating a new distortion in international trade

The DISC panel was one of four GATT panels commissioned in 1973 to investigate the issue of tax export aids.[75] While the DISC panel was instigated by the EC and Canada, the United States similarly won an examination of the French, Belgian and Dutch taxation systems on charges they also provided export incentives illegal

68. *Id.* at 113 § 71.
69. *Id.* at 113 § 69.
70. *Id.* at 114 § 76.
71. *Id.* at 114 § 79.
72. *Id.*
73. *Id.* at 104 § 31. *See supra* note 55.
74. Report of the Panel, United States Tax Legislation (DISC), *supra* note 2, at 106 §§ 39-42.
75. The other three GATT panels were, by title of final report: Income Tax Practices Maintained by France, Report of the Panel, GATT Doc. L/4423 (12 Nov. 1976); Income Tax Practices Maintained by Belgium, Report of the Panel, GATT Doc. L/4424 (12 Nov. 1976); Income Tax Practices Maintained by the Netherlands, Report of the Panel, GATT Doc. L/4425 (12 Nov. 1976).

under GATT.[76] From the U.S. perspective, the territorial systems of these major EC nations were designed to allow parent corporations to shift large amounts of domestic source income to foreign subsidiaries which were both untaxed domestically and often incorporated in low tax countries.[77] Whereas the EC systems allowed such profits to be repatriated almost tax free, the systems guaranteed the parent the fruits of any allocation of domestic profits to the foreign entity.[78] The root of the problem, the United States argued, was the nonenforcement of arm's-length intercompany pricing rules to ensure only profits derived abroad would receive preferential tax treatment.[79]

As a result of the inherent nature of the EC tax systems to promote exports, and the flexibility of EC intercompany pricing rules, the United States alleged it was justified in maintaining DISC.[80] With "approximate" arm's-length pricing standards, DISC merely brings U.S. intercompany pricing rules closer in line with those in effect in Europe.[81] Therefore, as a U.S. tax export aid, DISC is justifiable as a means of neutralizing already existing tax breaks

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76. *Id. See* E. McGovern, *supra* note 62, at 254.

77. Report of the Panel, United States Tax Legislation (DISC), *supra* note 2, at 106 § 40.

78. *Id.* In clear contrast to the relaxed nature of European corporate tax practices are those of many states within the United States. Unlike the European territorial systems which promote overseas transactions and investment, many states within the United States have adopted "unitary business/formula apportionment" methods of taxation aimed at taxing the multinational income of instate corporations. This is a very direct method of discouraging overseas operation because of the added tax burden and fears of double taxation. In contrast to this state practice is the Federal Internal Revenue Code which taxes income from foreign subsidiaries only to the extent it is remitted to the United States in the form of corporate dividends. For further background into the contrast of United States and European taxation of multinational income see the recent U.S. Supreme Court case of Container Corp. v. Franchise Tax Board, 456 U.S. 960, *rehearing denied*, 104 S.Ct. 365 (1983), in which a unitary method, like that just described, was upheld against a constitutional challenge.

79. Report of the GATT Panel, United States Tax Legislation (DISC), *supra* note 2, at 106 § 40. The use of arm's-length pricing is important to undistorted trade flows under a territorial tax system because of the incentive to export which can arise through its absence. If a producer knows that profits repatriated from overseas subsidiaries are tax free, while those from domestic transactions are taxed at a normal rate, clearly the effect is to promote export transactions through the foreign subsidiary. With the aid of intercompany price manipulation, the parent can maximize the favorable result of the foreign tax rules by charging the subsidiary an at cost price for the good produced at home, so that no taxable profits accrue to the parent. Then, when the foreign subsidiary resells for export, its low cost basis in the transaction yields an amount equal to not only its normal profit, but the parent's as well. The subsidiary then repatriates the parent's portion, which is tax free to both itself and the parent.

80. *Id.*

81. *Id.* at 105 § 38.

provided to EC producers through intercompany pricing rules and territorial taxation.[82]

The panels found that arm's-length pricing would indeed be a logical solution, and that EC practices clearly strayed from this standard in many instances.[83] There was not, however, an inherent flaw in territorial tax systems which would render them GATT illegal.[84] On the contrary, as long as arm's-length standards are observed, territorial systems are a GATT legal means for avoiding international double taxation.[85] As for the U.S. justification, the panels concluded any alleged EC distortions were better remedied by a GATT standard of arm's-length pricing, rather than a posture of mutually offsetting distortions on both sides of the Atlantic.[86]

3. The Current Status of the Controversy

In adopting the panel findings discussed above, the GATT Council issued a statement of understanding reached between the opposing parties which set out three criteria for judging the legality of tax export aids.[87] Briefly, the council concluded that (1) the GATT treaty will not be interpreted to require signatories to tax economic processes taking place outside the territorial limits of an exporting country;[88] (2) article XVI (4) will be interpreted to require arm's-length prices in connection with the taxation of export transactions;[89] and, (3) GATT will not be interpreted as a prohibition on the adoption of measures designed to prevent the double taxation of export earnings.[90]

Since 1981, the GATT Council's findings have been interpreted to conclude DISC is a violation of the General Agreement.[91] The United States, however, has consistently maintained that DISC is GATT legal, mainly in light of the Council's ruling that foreign

82. *Id.* at 105 § 38, 106-07 §§ 39-42.

83. *See* GATT panel reports on European tax systems, *supra* note 75. *See also* E. McGovern, *supra* note 62, at 255.

84. E. McGovern, *supra* note 62, at 255.

85. *Id.*

86. Report of the Panel, United States Tax Legislation, (DISC) *supra* note 2, at 114 § 79.

87. *December 1981 Statement of Understanding, Report accompanying adoption of the GATT panel reports, reprinted in* 16 Tax Notes (CCH) No. 3, at 269 (July 19, 1982).

88. *Id.*

89. *Id.*

90. *Id.*

91. *DISC Again Under Attack Before the GATT Council*, 16 Tax Notes (CCH) No. 1, at 81 (July 5, 1982).

source income need not be taxed directly to comply with GATT.[92] Despite the consistent denial of GATT illegality, the United States acknowledged in October 1982 that due to the height of the DISC controversy, an attempt would be made to develop a DISC substitute.[93] In defense of the decision to seek a DISC substitute, Treasury Secretary Regan wrote the GATT Council that the U.S. initiative was taken because "the view held by many of the GATT members that the U.S. is not abiding by GATT rules seriously compromises the ability of the United States to use the GATT to defend its trade interests."[94]

The U.S. initiative came into public view in August 1983 with the introduction of H.R. 3810, the Foreign Sales Corporation Act of 1983.[95] The proposal, however, received scant consideration in the Senate and none in the House before the end of the first ses-

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92. Statement of the Deputy U.S. Trade Representative, David R. McDonald, before the GATT Council, June 29, 1982, *reprinted in* 16 TAX NOTES (CCH) No. 3, at 269 (July 19, 1982). Specifically, the United States argued that although the question whether the tax deferral equalled a GATT illegal exemption was originally the issue, with the release granted by the GATT Council allowing tax exemptions for foreign source income, DISC, which did no more than this, was legitimized. DISC, the United States stressed, did no more than defer tax on foreign source income, as such income is defined under applicable United States law.

The Europeans rejected this analysis outright as a clear manipulation of terms. To the EC, foreign source income was not synonomous with all monies received from abroad. Rather, foreign source income was income derived from foreign economic processes—processes which a DISC, as a domestic corporation, could not perform. Therefore, from the European perspective, the foreign economic processes requirement exempting foreign source income from mandatory direct taxation did little to help defend the United States' position.

93. Over the past several years, the General Agreement on Tariffs and Trade (GATT) has undertaken a detailed examination of the provisions designed to promote exports through DISCs to determine if they are in conformity with the GATT rules governing export subsidies. Although the United States has vigorously defended DISC, a general consensus has developed among GATT member countries that the DISC is inconsistent with the GATT and that the United States should bring its tax practices into compliance with these rules. The view held by many of the GATT members that the United States is not abiding by GATT rules seriously compromises the ability of the United States to use the GATT to defend its trade interests. Accordingly, the Administration believes that the United States should respect the GATT consensus and attempt to comply with it.

> The Treasury Department is now examining various alternatives to the DISC. Any alternative must be GATT legal and promote sound international economic policy. A specific legislative proposal will be developed in the context of the fiscal year 1984 budget process.

Letter from U.S. Treasury Secretary Donald T. Regan to the GATT Council, *reprinted in* 17 TAX NOTES (CCH) No. 9, at 708 (Nov. 29, 1982).

94. *Id.*

95. H.R. 3810, 98th Cong., 1st Sess., 129 CONG. REC. H6580-81 (1983). *See supra* note 1.

sion of the 98th Congress.[96] During the second session, S.1804 was the topic of a Senate Finance Committee hearing on February 3, 1984.[97] At that time, Senator Dole declared FSC would be a part of the omnibus tax bill expected to be reported out of the Finance Committee on or before April 1, 1984.[98]

On March 21, 1984, FSC was reported out of the Senate Committee on Finance as a part of the Deficit Reduction Act of 1984.[98a] Although not a part of the House tax bill for 1984, FSC was maintained as part of the Deficit Reduction Act when passed by the Senate on May 17, 1984.[98b] Amended slightly in conference,[98c] FSC was finally adopted by both Senate and House Conferees on Saturday, June 23, 1984, and passed by both houses on June 27, 1984.[98d] The complete 1984 tax bill, including FSC and repeal of DISC, was signed into law by President Reagan on July 18, 1984.[98e]

While responses to FSC have been mixed, the EC has yet to stop its calls for a GATT working party to assess monetary damages for the EC countries allegedly injured as a result of DISC.[99] The United States has repeatedly denounced such attempts to force a monetary settlement for DISC and has warned that such attacks are counterproductive and likely to result

96. The only consideration FSC received before the end of the 98th Congress, 1st Session, was a brief hearing on Friday, November 18, 1983. Hearing reprint is yet unavailable. Witnesses at the hearing included: The Honorable Juan Luis, Governor U.S. Virgin Islands; Evan A. Werling, Vice President, Finance, French Oil Mill Machinery Company, Piqua, Ohio, on Behalf of the Chamber of Commerce of the United States, Washington, D.C.; Glen W. White, Director of Taxes, Dow Chemical Company, on Behalf of Chemical Manufacturers Association, Washington, D.C.; Michael Fayhee, McDermott, Will & Emery, Chicago, Ill., accompanied by Alfred DeGregory, Vice President, Finance, California Almond Growers Exchange, Sacramento, Calif., on Behalf of the National Council of Farm Cooperatives, Washington, D.C.; Ron Joranko, Director of Taxes, TRW, Incorporated, Arlington, Va., accompanied by Robert Ragland, Director of Taxation, National Association of Manufacturers, Washington, D.C.

97. *Finance Panel to Include FSC Proposal in Tax Bill,* DAILY TAX REPORT (BNA) No. 24, at LL-1 (Feb. 6, 1984).

98. *Id.*

98a. *See supra* note 1.

98b. *Id.*

98c. *Id.*

98d. Washington Post, June 28, 1984, at A1, col. 5.

98e. *See supra* note 1.

99. Prior to enactment see, *European Community Renews its Call for DISC Damages Study at the GATT*, 19 U.S. EXPORT WEEKLY (BNA) No. 10, at 363 (June 7, 1983); *U.S. Takes Strong Defensive Stance Against EC Attack on DISC at GATT* 20 U.S. EXPORT WEEKLY (BNA) No. 2, at 50 (Oct. 11, 1983). Subsequent to enactment see, Washington Post, July 12, 1984, at D6, col. 6.

in turning Congress away from dealing objectively with the DISC situation.[100]

III. THE FOREIGN SALES CORPORATION ACT OF 1983 (FSC)

A. A Technical/Theoretical Description

As a GATT legal substitute for DISC, FSC is conceptually grounded on the GATT Council's pronouncement releasing signatories from any obligation to tax the foreign economic processes of domestic firms.[101] In form, therefore, FSC is to be incorporated abroad and actually possess the presence with which to generate the income receiving U.S. tax exemption.[102] In this way, the proposal conforms the alleged propensity of DISC to subsidize U.S. producers through a potentially indefinite deferral on certain domestic source income.[103]

Like DISC, FSC is a tax incentive to export. Unlike DISC, however, FSC works through a 100% repatriated dividends deduction for FSC corporate parents[104] and a limited corporate income tax exemption for the FSC itself.[105] For dividends declared from a portion of the FSC income also exempted from U.S. direct taxation,[106] the dividends received deduction ensures that no level of U.S. corporate tax is imposed on a portion of FSC income.[107] Therefore, within the limits set by the proposal, the more exporting a parent does through an FSC, the more tax exempt income, and the lower the combined effective tax rate on export transactions.

To qualify as an FSC, a corporation must have its shares held by no more than twenty-five persons,[108] and satisfy both the foreign presence and foreign economic processes requirements. In terms of foreign presence, an FSC must (1) maintain an office outside U.S. territory;[109] (2) maintain a summary of its permanent books of

100. *See* 19, 20 U.S. Export Weekly (BNA), *supra* note 99.

101. Reference is to criteria (1) for judging the GATT legality of tax export aids promulgated by the GATT Council upon the adoption of the DISC panel report. *See* Report on Acceptance of Panel Reports, *supra* note 87.

102. 26 U.S.C. §§ 923, 924 (West Supp. 1985).

103. *See supra* text accompanying notes 64-69.

104. 26 U.S.C. § 245(c) (West Supp. 1985).

105. *Id.* § 923.

106. *Id.* § 926.

107. Joint Committee Print, *supra* note 11, at 26.

108. 26 U.S.C. § 922(a)(1)(B) (West Supp. 1985).

109. *Id.* § 922(a)(1)(D)(i). The specific requirement is to maintain an office, and under

account at its foreign office;[110] (3) have at least one director who is resident outside the United States;[111] and, (5) be incorporated outside the United States.[112]

In connection with income earned by an FSC, the following foreign economic processes must be evidenced by the FSC itself. First, the FSC must participate in the solicitation, the registration or the making of any contract related to a transaction from which an FSC will be assigned income.[113] This test is met if either the FSC, or anyone under contract with it, performs one or more of these three activities *outside* the United States.[114]

Second, the FSC must fulfill the foreign direct cost—total direct cost ratio.[115] Under this test, the foreign direct costs of an FSC, attributable to any transaction from which an FSC will be assigned income, must meet the 50%[116] or 85% foreign direct cost requirement.[117]

Under both ratios, direct costs are related to the costs incurred for: (1) advertising and sales promotion;[118] (2) the processing of customer orders and the arranging for delivery of the export property;[119] (3) transportation from the time of acquisition by the FSC to the delivery to the customers;[120] (4) the determination and transmittal of a final invoice or statement of account and the receipt of payment;[121] and, (5) the assumption of credit risk.[122]

§ 922(a)(1)(A)(i) to be incorporated, *see infra* note 113, in a country which has either an exchange of information treaty pursuant to § 274(h)(6)(C), or an income tax treaty with the United States. 26 U.S.C. §§ 922(a)(1)(A)(i), 274(h)(6)(C) (West Supp. 1985). *See also Id.* § 927(e)(3).

110. A complete set of books and records must also be kept available in the United States for U.S. tax administration and enforcement. 26 U.S.C. § 922(a)(1)(D)(ii-iii) (West Supp. 1985).

111. *Id.* § 922(a)(1)(E).

112. Incorporation in either Guam, the Virgin Islands, the Commonwealth of the Northern Marianas or American Samoa is also acceptable. *Id.* § 927(d)(5). As discussed in note 109 *supra*, the intention is that a foreign country, to be eligible for FSC incorporation, not be a country that has a law denying U.S. officials access to the corporate records of companies owned by U.S. citizens. This explains the need for an exchange of information or tax treaty pursuant to § 927(e)(3). *Id.* § 927(e)(3). For further discussion see, 130 CONG. REC. 46636 pt. II (daily ed. June 22, 1984) [hereinafter cited as 1984 Tax Conference Report].

113. 26 U.S.C. § 924(d)(1), (d)(1)(A) (West Supp. 1985).

114. *Id. See* Joint Committee Print, *supra* note 11, at 29.

115. 26 U.S.C. § 924(d)(1)(B), & (2) (West Supp. 1985).

116. *Id.* § 924(d)(1)(B).

117. *Id.* § 924(d)(2).

118. *Id.* § 924(e)(1).

119. *Id.* § 924(e)(2).

120. *Id.* § 924(e)(3).

121. *Id.* § 924(e)(4).

122. *Id.* § 924(e)(5).

In relation to the 50% requirement, the ratio of direct costs incurred abroad to the total direct costs for the transaction must be at least 50%.[123] In relation to the 85% requirement, the ratio of any two of the direct costs outlined above, when performed abroad, to the total direct costs for the transaction must be at least 85%.[124]

For an FSC that satisfies the above requirements, both the FSC and its U.S. parent are eligible for a limited U.S. tax exemption on a portion of their income from export sales. The calculation of this benefit is the result of a two step process. First, the FSC's net export earnings[125] are calculated based on either (a) the arm's-length cost of the export good;[126] (b) a portion of the FSC's foreign trading gross receipts;[127] or, (c) an allocation of the FSC's and the parent's combined export income.[128] Second, the FSC's tax exempt income[129] is calculated to correspond to that income which is directly traceable to the FSC's foreign economic processes.[130] The former figure is the primary basis upon which tax exempt dividends are declared and repatriated to the U.S. parent.[131] Only after exhausting this source can the FSC distribute its own tax exempt earnings.[132]

The FSC's net export earnings, or foreign trading income,[133] is the income generated from the FSC's foreign trading gross receipts.[134] Generally, foreign trading gross receipts are gross receipts from the sale or lease of property outside the United States.[135] From this gross receipts figure, FSC net export earnings

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123. *Id.* § 924(d)(1)(B).

124. *Id.* § 924(d)(2).

125. These net export earnings correspond to the FSC's foreign trade income from foreign trading gross receipts. *Id.* §§ 923(b), 924.

126. *Id.* § 925(a)(3).

127. Foreign trading gross receipts are defined at *Id.* § 924; transfer-price-income-allocation rules are defined at *Id.* § 925(a)(1).

128. *Id.* § 925(a)(2).

129. This figure corresponds to *Id.* § 923 entitled "exempt foreign trading income."

130. *Id.* § 921.

131. *Id.* § 927(c).

132. *Id.* § 926(a).

133. *Id.* § 923(b).

134. *Id.*

135. Foreign trading gross receipts are gross receipts from:

(a) the sale, exchange, or other disposition of export property;

(b) the lease or rental of export property that is used by the lessee outside the United States;

(c) the performance of services that are related and subsidiary to the sale, exchange, lease, rental or other disposition of export property by the FSC;

are calculated as either (a) the balance left after subtracting an arm's-length transfer price for the export goods bought from the parent;[136] (b) 23% of the combined taxable income of the FSC and its parent;[137] or, (c) 1.83% of the FSC's foreign trading gross receipts,[138a] but not more than 46% of the combined taxable income of the FSC and the parent.[138b]

Method (a) represents the conforming section to the GATT pronouncement on arm's-length pricing between related parties.[139] Methods (b) and (c), however, are administrative pricing rules designed to approximate an arm's-length transaction where one is not easily distinguished.[140]

Once the FSC's net export earnings are calculated, the second step, as outlined above,[141] is to calculate that portion of the FSC's net export earnings which is directly traceable to the FSC's foreign economic processes. This portion of the net export earnings is called tax exempt foreign trading income,[142] and is calculated by a method dependent upon the transfer pricing method used to calculate the net earnings figure. If an arm's-length price was used, 32% of the net earnings become tax exempt.[143] If an administrative pricing rule was used, the tax exempt net earnings are either 16% of the com-

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(d) the performance of engineering or architectural services for construction projects located outside the United States; and

(e) the performance of managerial services in furtherance of the production of foreign export trading gross receipts.

Id. § 924. The provision for managerial services, § 924(a)(5), was qualified in Conference to include the following limitation: "Paragraph (5) [related to managerial services] shall not apply to a FSC for any taxable year unless at least 50 percent of its gross receipts for such taxable year is from activities described in paragraph (1), (2) or (3) [(a), (b) and (c) above]." Although the intent of this change from the original Act is not expressly written in the conference report, the impact is clearly to add greater substance to the FSC foreign presence. In this way, the Conference amendment acts to bring FSC more closely in line with the GATT foreign economic processes requirement. *See supra* note 87 and text accompanying *supra* note 89.

136. *Id.* § 925(a)(3).

137. *Id.* § 925(a)(2).

138a. *Id.* § 925(a)(1).

138b. *Id.* § 925(d).

139. Joint Committee Print, *supra* note 11, at 30.

140. *Id.* In order to use the administrative pricing rules, an FSC must meet two requirements. First, all of the activities which fall into the category of direct costs under § 924(e) must be performed abroad by the FSC. Second, all the activities related to the negotiating and making the contract for the export sale must be performed abroad by the FSC. 26 U.S.C. §§ 924, 925 (West Supp. 1985).

141. *See supra* text accompanying notes 133-38b.

142. 26 U.S.C. § 923 (West Supp. 1985).

143. *Id.* § 923(a)(2).

bined income of the parent and the FSC[144] or 1.27% of the FSC's gross sales up to 3% of FSC income.[145]

Finally, the parent's benefit comes through the repatriation of FSC net earnings in the form of tax exempt dividends.[146] While the FSC is free to declare dividends from all net export earnings—those possessing as well as those lacking tax exempt status on the FSC level—distributions are treated as being made first out of the nonexempt earnings and then out of the exempt category.[147] Thus, there is no corporate level tax on exempt FSC net earnings whether retained or distributed, and only a single-level corporate tax on net earnings other than the exempt variety.[148]

B. *Small Business Exceptions*

In order to provide relief for small businesses who may find the foreign presence and economic process requirements burdensome, the DISC replacement legislation provides two alternatives to FSC: the interest charge DISC[149] and the small FSC.[150] The premise of each option is that for small exporters, the benefits of FSC are outweighed by the costly foreign presence requirements. Thus, without these alternatives, such exporters would curtail export promotion.[150a]

1. *The Interest Charge DISC*

Any previously or newly qualified DISC[151] with ten million dollars or less in qualified export receipts[152] may continue, under the DISC replacement legislation, to operate as a DISC and defer tax liability on that limited portion of its income.[153] Three major

144. *Id.* § 923(a)(3).
145. *Id. See* 1984 Tax Conference Report, *supra* note 113, at H6636.
146. 26 U.S.C. § 926 (West Supp. 1985).
147. *Id.* § 926(a).
148. Joint Committee Print, *supra* note 11, at 32.
149. 26 U.S.C. § 995(f) (West Supp. 1985).
150. *Id.* § 924(b)(2).
150a. *See* 1984 Tax Conference Report, *supra* note 113, at H6636.
151. Interest charge DISCs will be administered under the same sections of the IRC, with minor amendments, as are current DISCs. 26 U.S.C. §§ 991-996 (West Supp. 1985). Thus, qualification as an interest charge DISC is primarily the same as qualification as a DISC today. The GATT legality of the DISC is technically provided for with the interest charge. In reality, however, because concern over DISC is centered mainly around large corporate exporters, small DISCs with $10,000 or less in qualified exports receipts are expected to be ignored for purposes of the debate over a GATT legal substitute for DISC.
152. *Id.* § 995(b)(1)(E).
153. *Id.*

changes, however, accompany this new DISC. First, all deemed distributions relating to base period exports (the incremental rule) and to one-half of the DISC's income have been eliminated.[154] Second, an interest charge on the DISC shareholders' deferred tax liability will now be collected on an annual basis.[155] The rate to be charged is to be based on the average investment yield of fifty-two week T-bills.[156] Third, any qualified export receipts in excess of the ten million dollar limit will be deemed distributed to DISC shareholders and fully taxed.[157]

2. The Small FSC

A small FSC is identical to the FSC described above with two exceptions. First, it may only receive favorable tax treatment on five million dollars or less of its foreign trading gross receipts.[158] Second, it will be exempt from the foreign management and foreign economic process requirements.[159] Any income above the five million dollar limit does not qualify as foreign trading gross receipts and is directly included in the FSC's U.S. tax base.[160]

C. Currently Deferred DISC Income

A simple but major provision of the FSC proposal is a tax forgiveness provision for previously deferred DISC income.[161] As of January 1, 1985, any accumulated DISC income will be treated as previously taxed income for purposes of any future tax liability.[162]

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154. 1984 Tax Conference Report, *supra* note 113, at H6512, section 802(a)(1).

155. 26 U.S.C. § 995(f) (West Supp. 1985).

156. *Id.*

157. *Id.* § 995(b)(1)(E).

158. *Id.* § 924(b)(2)(B)(i).

159. *Id.* § 924(b)(2)(A).

160. *Id.* § 921(d).

161. 1984 Tax Conference Report, *supra* note 113, at H6513, section 804(5)(2).

162. *Id.* The international and domestic legal implications of DISC deferred tax forgiveness are arguably much more significant than the practical effects. As stated in the text accompanying notes 196-202, the inclusion of a deferred tax forgiveness provision is arguably an admission that DISC was an export subsidy all along. This is not the most favorable conclusion considering the United States consistently defended DISC and as a GATT legal temporary deferral.

To the current DISC user, the forgiveness provision, while absolutely essential, is nonetheless what had been expected—not to mention what DISC users had been led to believe by the Treasury Department all along. While there is no question the very large accumulated deferrals of some major corporations, such as Boeing Corp., could cause bankruptcies if they were deemed currently due, DISC users were led to believe this would never occur.

First, no interest charge on the deferred amount is contrary to usual IRS procedure concerning deferral or currently non-recognized tax liability. One could argue that the lack

IV. ANALYSIS

A. FSC AND GATT

The basic question of an FSC's GATT legality is best studied from two inter-related perspectives. One is strict GATT legality: does FSC comply with the strict legal rules of GATT? The other is "GATT-ability": will FSC buy peace with our European trading partners?[163] These two terms often co-exist, but with the EC majority in GATT, the second is arguably the most telling.[164] In fact, given the structure of GATT investigatory procedures, if a contracting party does not actually challenge a DISC substitute, no investigation of it would be made.[165] Thus, under a standard of

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of diligence shown by Congress and the IRS to keep track of deferred income in constant dollars and save the present value revenue loss through interest payments is strong evidence Congress had already written off deferred DISC income. Second, the accepted accounting practice of not taking deferred DISC tax liability into account for computing current net income is misleading to investors, as well as overstates income, if that liability were not understood by corporate directors and accountants to be as good as forgiven. Finally, and most persuasive, is the existence of such huge accumulated corporate deferrals in and amongst themselves. If Congress expected to end the DISC program anytime soon without a forgiveness provision, it is highly unlikely these amounts would have been allowed to accrue. Declaring them suddenly due would be tantamount to declaring bankruptcy for many DISC users, if not serious financial ruin. Certainly it is easy to say these entities brought this on themselves, but the reality still exists and no Congress could ignore the implications of such an action.

Thus, while DISC deferred tax forgiveness is a thorn in future U.S./GATT relations with the EC and Canada, the reaction of domestic producers is clearly one of less than complete surprise.

163. The terms "GATT legal" and "GATT-able" are those used by the author in Field, *Administration Proposes DISC Replacement Plan*, 18 TAX NOTES (CCH) No. 11, at 977-78 (Mar. 14, 1983). They are particularly relevant because they describe the unique forces at work within the GATT Council. While there are clear standards of GATT legality, the United States must also be aware of the sensitivities of the European based majority. No doubt GATT legality is an avowed precedent—but there is clear evidence within the DISC controversy that portrays the EC as particularly preoccupied with defeating DISC regardless of the reasonableness of any U.S. justification put forth. *See e.g., U.S. Defense of DISC Before GATT*, 16 TAX NOTES (CCH) No. 3, at 269 (July 19, 1982), contrasted with the initial EC response found in *DISC Again Under Attack Before GATT Council*, 16 TAX NOTES (CCH) No. 1, at 81 (July 5, 1982). This theme of the need for both GATT legality and GATT-ability is developed further in the text following this note.

164. To see the extent to which the United States has gone to appease the Europeans on the DISC issue, and similarly to restore U.S. credibility before the GATT Council, *see supra* note 93, and the letter by Secretary Regan to the GATT Council.

165. As it relates to subsidies and the GATT, Article XVI declares that only "upon request" will discussions with the alleged subsidizing government take place. They do not automatically occur through an ongoing monitoring of CONTRACTING PARTY practices. *See* GATT, article XVI, *supra* note 2, at A60. For further explanation of the GATT dispute resolution procedures, *see* K. DAM, THE GATT: LAW AND INTERNATIONAL ECONOMIC ORGANIZATION (1970).

"GATT-ability," it should not be surprising that what is GATT illegal may be able to pass GATT muster—if it is acceptable from the European perspective.[166]

1. The Foreign Economic Processes Requirement[167]

Conceptually, a system which offers domestic income tax exemptions in proportion to the level of a firm's foreign economic processes is clearly both GATT legal and GATT-able.[168] An FSC, therefore, with its foreign economic processes and presence requirements, is conceptually unassailable. Whether the level and breadth of the foreign activity required, however, is proportional to the proposal's alleged net foreign source income component, is another question entirely.[169]

It is difficult to accurately generalize the active ingredients of one percentage of income generation. It is a task, however, which must be satisfactorily accomplished in order to determine the GATT legality of FSC.[170] Under an FSC transaction at arm's-length,

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166. Here the scenario would involve an EC practice that was arguably GATT illegal but to which the U.S. response was retaliation in a non-GATT-sensitive manner instead of a complaint before the GATT Council. The reverse situation is also possible, of course. It is worth adding at this point that while reference here is made primarily to the EC, the EC majority, and to the United States, the conclusion to be drawn is not that these are the only parties to the GATT. However, from the perspective of the DISC controversy, these, as well as Canada, are the primary players.

167. "Requirement" refers to the GATT pronouncement on giving direct tax exemptions only in proportion to the level of foreign economic processes. This requirement is derived from the first criteria adopted by the GATT Council upon the acceptance of the GATT panel reports: The GATT treaty will not be interpreted to require signatories to tax economic processes taking place outside the territorial limits of an exporting country. *See GATT Acts on Export Aid Panel Reports*, 13 TAX NOTES (CCH) No. 24, at 1485 (Dec. 14, 1981). *See also* E. MCGOVERN, *supra* note 62, at 255. Thus, if the United States wishes to give direct tax exemptions to stimulate exports in the form of FSC, there must be a foreign economic process requirement to comply with GATT.

168. This conclusion is drawn from the first criteria adopted by the GATT Council upon the acceptance of the DISC panel report. Acceptance of the DISC panel report was given conditionally upon:

> the understanding that with respect to these cases (DISC, etc. . . .) and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI(4) of the General Agreement.

Statement of GATT Council, December 1, 1981, *reprinted in* E. MCGOVERN, *supra* note 62, at 255.

169. The contrast here is between what is conceptually required for direct tax exemptions to be used as tax exports aids and what the physical manifestations of these conceptual requirements are within the DISC replacement legislation.

170. *See supra* notes 168-69.

the proposal exempts 32% of the net foreign trade income from U.S. direct taxation. The issue, therefore, is whether an over one-third profit allocation for an FSC's "watered-down" disposition function is a justifiable proportion.[171]

While no definitive answer to this question is offered, a reasonable starting point might be to say that the question is contingent upon the type of operation to which such a scheme is applied. Take, for example, a fully integrated parent corporation, which exports exclusively through a foreign subsidiary.[172] Based on an arm's-length transaction,[173] the parent receives its full domestic mark-up, through the sale to the subsidiary, before the product hits the foreign market.[174] The domestic source side of the transaction is complete.

Similarly, for the foreign subsidiary which has paid the arm's-length price for the product it will sell abroad, any "resale" mark-up the subsidiary attaches must be equated to some value *it* has added for the transaction to clear under competitive market conditions.[175] Such is the origin of a foreign source income component.

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171. The one third profit allocation alluded to here refers to the 32% tax exemption for FSC foreign trade income based on an arm's-length transaction. 26 U.S.C. § 923(a)(2) (West Supp. 1985). In terms of disposition functions, the label "watered-down" is applied because only either the 50% or 85% rules for foreign direct costs associated with disposition need to be followed to claim the 32% exemption. *Id.* § 924(d). For further detailed explanation *see infra* text accompanying notes 101-48.

172. A fully integrated parent would be one where all vertical levels of production are operated by the parent itself. In other words, from collection of resources to packaging for shipping, the parent operates as one unit and performs all functions.

173. For definition *see supra* note 31.

174. The following example will illustrate this type of transaction. As an integrated producer, the parent produces a good at cost X. X represents almost a pure input cost as all levels of production are internal to the parent. In other words, X does not contain any profit-taking by outside intermediate producers. On top of X, the parent adds, say, a 20% mark-up. The cost, therefore, on an arm's-length basis for the foreign sales subsidiary, is $X + .2X = Y$. Domestic source profits equal the parent's net income $(Y - X) = .2X$. The cost basis for the subsidiary becomes Y. Bear in mind that this is somewhat simplified in terms of actual cost breakdown.

175. The concept here is much simpler than it appears. Based on the example, *supra* note 174, if the foreign sales subsidiary has cost Y, which is an arm's-length transfer price, that will be the open market price for the good's resale unless the value of the product is increased by the subsidiary. "Increasing the product's value" means that for a foreign consumer, the good is worth more than the domestic transfer price Y. This is due to many factors such as unavailability except by export, transportation and distribution costs, as well as foreign office overhead. Export goods consumers, therefore, perceive the good's price in relation to these added costs. For the foreign sales subsidiary, the new or resale cost is $Y + Z$, where Z is transportation and disposition costs, including foreign office overhead.

What complicates any analogy from this conceptually simple scenario to the working of an FSC is that an FSC is not technically equivalent to a strict independent foreign subsidiary. In a strict parent/independent-subsidiary transaction, it is likely no substantive activity to complete the foreign sale occurs from the domestic side once the parent releases ownership of the good to the subsidiary.[176] With an FSC, however, this assumption is somewhat altered. Under the 50% and 85% rules,[177] only those percentages of what would be 100% foreign disposition costs for a strict independent subsidiary are the actual FSC costs incurred abroad. In other words, where all the costs attributable to a foreign subsidiary's resale are undertaken abroad in the strict independent subsidiary example, under FSC, the same profits accrue, with only an effective 50% foreign disposition cost requirement.[178] It is, therefore, only from this 50% foreign-incurred disposition cost that foreign source income can be derived.[179] Those percentages of income from

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Add to this the subsidiary's mark-up, say 5%, then final foreign consumer cost is (Y + Z) + .05 (Y + Z), or P_x (export price). Under competitive market conditions, P_x is the cost to foreign consumers. The foreign source net income component, or that derived from foreign economic processes, is .05Z. Remember that since Y is the price paid for a good produced in the U.S., it yields domestic source income. The figure .05Y, however, is still net income to the foreign sales subsidiary.

176. Such a relationship would be where the foreign subsidiary performed 100% of the disposition function abroad and incurred all such costs after paying the arm's-length price. Referring again to the scenario described *supra* notes 174-75, the point is that Z represents costs incurred abroad solely by the foreign subsidiary.

177. For explanation *see supra* text accompanying notes 115-24.

178. Again, referring to the example, *supra* notes 174-76, where the foreign source net income component is .05Z, the assumption was that the foreign subsidiary would incur cost Z completely as a foreign direct cost. Thus the 5% mark-up was attributable to foreign incurred costs up to the fraction of total cost: Z / (Y + Z). Under FSC, however, Z is not 100% foreign direct costs, but rather only 50%. Thus, .05 (.5Z) is the real foreign source net income component. The essential point being that .05 (.5Z), the residual, is a further domestic source component because up to that percentage of Z can be performed from the United States. In complete form, our example yields the following results: $P_x = (Y_d + Z_f + Z_d) + .05\,(Y_d + Z_f + Z_d)$, where Z_f and Z_d represent costs incurred abroad and in the United States, respectively, both chargeable to the FSC and equal to .5Z.

179. *See supra* note 178. It is important before proceeding, that the GATT interpretation of the terms domestic and foreign source net income are clearly understood. Under the FSC proposal and the GATT pronouncement on foreign economic processes, *see supra* notes 168-69, domestic source income, which is not eligible for direct tax exemption under the GATT, is that which is derived from domestic economic processes. Foreign source income is that which is derived from foreign economic processes. The critical point of understanding is that costs paid with monies from abroad are not costs of foreign economic processes unless the *activity* actually occurs abroad. Thus, even though a good is sold abroad and paid for with monies from abroad, that is not foreign source income unless the income is derived in connection with some sort of foreign value added.

the export sale attributable to the cost of the domestically produced product and the parent's disposition functions are not considered derived from foreign economic processes.[180]

Based on the 50% figure derived above, if the cost breakdown of the product being sold is 85% for the product itself and 15% for disposition, transportation and overhead, the net per transaction FSC foreign source income component is 7.5%, while the domestic source component is 92.5%.[181]

Returning, then, to the question of an FSC's exemption in relation to the substance of the required foreign economic processes, the GATT requirement of proportionality is clearly violated in cases such as those illustrated above. If the 32% exemption is compared to the 7.5% foreign source net income component, the proposal can arguably result in an exemption which is at the least 77% domestic source income.[182] Under a set of operating circumstances like those described above, it appears that FSC can produce an exemption which is out of line with the GATT foreign economic processes requirement.

Perhaps even more troublesome, though, to the GATT legality of FSC is the calculation of the cost breakdown that would be required to render a particular parent—FSC relationship GATT legal. For the FSC 32% direct tax exemption to be 100%, as opposed to 23% foreign source, foreign disposition costs under the 50% direct cost election would have to be a least 64% of the export sales

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180. *See supra* note 179.

181. Adding a final step to the example derived *supra* notes 174-78, if we substitute 85% for Y and 15% for Z (7.5%Z_d and 7.5%Z_f), the result is that 92.5% (85% + 7.5%) of the .05 mark-up figure is derived from domestic economic processes and 7.5% is derived from foreign economic processes.

Recapping the complete example with the terminology of the FSC, the corresponding figures evolve. Foreign trading income is calculated to be .05 (Y_d + Z_f + Z_d), while exempt foreign trading income equals 32% of this figure. In foreign and domestic source terms, and using the 85% / 15% split outlined above, at most 23% of the 32% exemption is really an exemption based on foreign economic processes, while at least 77% is an exemption based on domestic economic processes (23% = .05(Z_f) / .32 [.05 (Y_d + Z_f + Z_d)]).

The results of this example are based on a 1:1 cost-profit generation ratio. Given cost accounting assumptions, this is not an erroneous figure. Also, the example assumes that Z, which is intended to correspond to 26 U.S.C. § 924(e) (West Supp. 1985) activities, is representative of the only costs of the FSC. Clearly there are foreign presence costs which are not subject to the 50% split. Even if they were to be included in the example, however, at most the results would be changed to an 80% / 20% cost split and an exemption made of 31% (.05(10) /.32 [.05 (80 + 10 + 10)]) foreign source and 69% domestic source income—still way out of proportion.

182. *See supra* note 181.

price.[183] Such a scenario would then allow the parent's transfer price to represent no more than 36% of the export price.[184] While this may be possible in the absence of an arm's-length standard, it appears highly unlikely that with arm's-length pricing the price or value of the good sold would be less than half the amount of the final export price[185]—particularly given the limited foreign disposition cost component called for under the FSC proposal.[185a]

While FSC is not *per se* GATT illegal, the situations under which the economic processes requirement are met appear remote at best. While FSC is clearly conceptually GATT legal, the practical consequences of the proposal appear to strain any notion of strict GATT legality or GATT-ability.

2. The Interest Charge DISC and Small FSC Exceptions

a. Interest Charge DISC[186]

The findings of the GATT panel on DISC pointed directly to the lack of any interest charge on a DISC shareholder's deferred tax liability as a form of illegal subsidy.[187] It would seem reasonable to conclude, therefore, that an interest charge DISC would appease European concerns. While the logic of such a conclusion is clear, it is still doubtful that an interest charge DISC is either GATT legal or, more importantly, GATT-able.

The GATT panel on DISC, while resting its decree of noncompliance on the absence of an interest charge, set out to investigate the legality of DISC's potentially unlimited tax

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183. Using the formula outlined in note 182 *supra*, the value of Z_f needed to make the 32% exemption 100% foreign source is 32%. If this is not intuitively correct, 100% = .05(32) / .32[.05(36 + 32 + 32)]. Then, given the 50% foreign direct cost proportion requirement explained in note 178 *supra*, total foreign direct cost must account for 64% of the export profit or net income (.05(36 + 64) = 1.8 + 3.2 = 5; 3.2 / 5 = 64%).

184. If $Z_f + Z_d$ = 64%, then Y_d must equal 36% where 100% of the profit equals .05 ($Y_d + Z_f + Z_d$). See notes 174-83 *supra* for any lost steps in this analysis.

185. *See supra* text accompanying notes 116-25.

185a. As described in note 79 *supra*, under a system which allows transfer price manipulation, a parent could charge a sufficiently low transfer price to the foreign subsidiary so that a disproportionately large amount of the final export price appears to correspond to a foreign source component. Under such a system, it would be possible to have a 64% foreign source component on *paper*. For the reasons outlined in note 79 *supra* and accompanying text, under an arm's-length standard and the FSC foreign cost requirement, it is not likely.

186. 26 U.S.C. § 995(b)(1)(E) (West Supp. 1985).

187. *See supra* notes 68-69 and accompanying text.

deferral.[188] On this latter ground, the EC had alleged the unlimited deferral to be equivalent to a permanent direct tax exemption.[189] Direct tax exemptions, calculated in relation to exports, are illegal subsidies under GATT.[190] The issue necessarily arises, therefore, that given the tax forgiveness provision for past DISC deferrals under FSC,[191] what is the chance interest charge DISCs are also destined to be direct tax exemptions?

While no one knows whether future DISC forgiveness is in the offing, a logical European concern would be that while technically a deferral, the odds favor interest charge DISCs someday becoming exemptions. Moreover, looking to the demonstrated reality of DISC utilization, producers who set up DISCs operate undeniably on the assumption that deferrals will never be recognized.[192] A single look at the balance sheets of corporations such as Boeing do not reveal their multi-million dollar deferrals listed as payables.[193]

The conclusion, therefore, is that while the United States may have been previously able to redesign DISC as a legitimate tax deferral, now, with the forgiveness provision, no country is going to reject what it always "knew" to be true: DISC is and always will be an exemption. While the United States may downplay the interest charge DISC as an insignificant exception, the anger of the EC over the FSC forgiveness provision is likely to carry over to any attempt by the United States to create a GATT legal DISC. In terms of GATT-ability, if not GATT legality, DISC is a dirty word.

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188. *Id.*

189. *Id.*

190. *See* Report of Working Party on Provisions of Article XVI:4, *supra* note 3, at 50. *See also* Agreement on Interpretation and Application of Articles VI, XVI and XXIII, *supra* note 3, at 70.

191. 1984 Tax Conference Report, *supra* note 113, at H6513, section 804.

192. *See* Statement of Accounting Principles Board, *reprinted in* Anninger, *supra* note 28, at 404: "the contingent tax liability (related to DISC tax-deferred income) is so remote that it need not even be considered in the compilation of annual earnings."

In a letter of May 8, 1984 from 18 Washington Trade associations to Rep. Rostenkowski (D-Ill.), Chairman, House Committee on Ways and Means, it was stated that:

> DISC-generated investments were made on the basis of assurances by successive administrations that the DISC deferrals were intended to continue indefinitely so long as invested in export assets. . . . To tax these deferrals retroactively would unjustifiably penalize U.S. exporters who in good faith have followed the requirement of the DISC statute over the years.

Prospects Uncertain on Foreign Sales Corporation Provision, 23 TAX NOTES (CCH) No. 4, at 823 (May 21, 1984).

193. BOEING CORPORATION, 1982 ANNUAL REPORT 10 (1983).

b. The Small FSC

One possible explanation for allowing this blatantly GATT illegal exception centers on the likely low volume of trade it will foster in relation to the vast number of producers for which it will be unavailable. To paraphrase one source, because the EC only complained about the large exporters using DISCs, the little-man's exception should be acceptable.[194] Why then the exception? Such statements belie the small-FSC-supporters argument. If it is such an inconsequential addition, why risk acceptance of the proposal to include a small FSC?

Clearly, the existence of strong support for the small FSC stems from the not so inconsequential lobby that won its inclusion. There may be, therefore, a well placed group waiting in the wings to utilize this provision. A pre-emptive challenge may be made to the small FSC unless the United States can convince the EC of the insignificance of this provision. GATT legality no; in this case, however, if the United States can win GATT-ability, it may be enough.

3. The DISC Deferred Tax Forgiveness Provision

Besides the strictly GATT legal issues of the FSC transfer pricing[195] and foreign activities requirements,[196] there is one issue of GATT-ability which could create a problem potentially more significant than any of the GATT legal issues already anticipated: What to do with the deferred taxes on existing DISCs.[197] To the EC, treating this deferred tax as forgiven, as FSC does, would be an admission that DISC was a subsidy all along.[198] United States' credibility would be severely tarnished.[199] Even if FSC is found acceptable, there may be an attempt by the EC in the GATT Council to collect the entire amount as compensation to injured EC producers.[200] Thus, the United States could be inviting an even more

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194. *See supra* note 192.

195. *See supra* text accompanying notes 87-90.

196. *Id.*

197. Tax deferred income on existing DISCs is estimated for 1981, the latest year available, to be $3.6 billion. 1983 TREASURY REPORT ON DISC 21.

198. Brown, *supra* note 53, at 158.

199. *Id.*

200. EC members in GATT are already attempting to create a working party just to access damages to their domestic producers due to DISC. Given this hotly debated issue, a move to redirect that cry toward forgiven DISC income would not be an unexpected step. *See supra* notes 100-01.

bitter debate than it presently faces over the legality of DISC. The move toward forgiveness might even stall future debate of U.S. proposals aimed at protecting American markets from any degree of EC subsidy. Ironically, avoiding such a situation was the very reason the United States compromised and decided to present a DISC alternative.[201]

B. *FSC AS A MEANS OF OFFSETTING EXISTING EC TRANSFER PRICE PRACTICES*

During the discussion on DISC above, it was stated that because of DISC's "approximate" arm's-length pricing rules, DISC was a justifiable countermeasure to the lack of rigor with which arm's-length pricing is enforced and practiced in the EC.[202] It is arguable, therefore, that unless FSC can similarly aid in neutralizing the preferential treatment of EC intercompany pricing, without DISC, there will be a net export incentive advantage in favor of the EC.[203] Is FSC an effective neutralizer in the sense just described?

The answer to this question is an unqualified "no." FSC is based squarely on arm's-length principles.[204] The administrative pricing rules contain an upper limit which is below what could conceivably pass under a strict arm's-length standard.[205] In terms of enforcement, the U.S. Internal Revenue Service is ready, willing and specifically empowered to set aside transactions which fail to comly with section 482.[206] It seems doubtful, then, that FSC is capable of hiding domestic profits in transfer prices so as to make them part of FSC income. Without DISC, therefore, the EC retains an unmet export incentive advantage.

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201. *See* letter from Treasury Secretary Regan to the GATT Council, *supra* note 93.

202. *See supra* text accompanying notes 73-86.

203. *Id.*

204. Joint Committee Print, *supra* note 11, at 30.

205. 26 U.S.C. § 925 (West Supp. 1985). This is due to the heightened cost of using these rules. *See id.* § 925(c).

206. *Id.* § 482. Section 482 reads as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses.

Id. § 482.

C. *The Real Issue in Controversy: DISC As A Means of Offsetting Discriminatory Border Tax Adjustments*

Border tax adjustments are tools of fiscal policy which operate to influence trade patterns on the basis of destination rather than origin.[207] This "destination principle" is a rule of taxation whereby goods are taxed according to the destination of the final consumer as opposed to the location of the producer.[208] To understand the significance of this distinction, it is important to realize that GATT has been interpreted to *allow* the collection and exemption of indirect taxes on a destination basis but to *disallow* the exemption of direct income taxes on an origin basis.[209] Thus, for countries that impose indirect value added taxes (VAT),[210] as in the EC, there exists the possibility of using indirect tax exemptions to provide export incentives on the basis of destination.[211] Conversely, in the United States, where only direct producer taxes are paid,[212] a direct tax exemption used to stimulate exports would be clearly illegal under GATT.[213]

The justification provided by the GATT Council for allowing indirect tax exemptions and disallowing direct tax exemptions is the belief that the former are not equivalent to subsidies while the latter are.[214] The usual rationale is that indirect taxes are allegedly neutral in international trade as they are paid by consumers after the price of the good has been determined competitively by the market.[215] Therefore, they neither favor nor disadvantage producers whose product prices have been competitively determined on the world market.[216]

Direct tax exemptions, on the other hand, are benefits which

207. Anninger, *supra* note 28, at 415.

208. *Id.*

209. *Id.* at 415-16.

210. VAT taxes are indirect taxes on consumption paid by the consumer, as opposed to direct taxes which are paid on income by producers. The countries of the EC have long used VAT taxes, along with other direct schemes.

211. By exempting certain export transactions from VAT taxes, consumers pay less for the good and thereby will demand more.

212. Direct producer taxes are those paid on gross income.

213. Direct tax exemptions given to stimulate exports are illegal under GATT Article XVI, as interpreted by The Working Party Agreement on Subsidies, *supra* note 62, unless they are in proportion to income generated from foreign economic processes.

214. Anninger, *supra* note 28, at 416.

215. *Id.* at 416-18.

216. *Id.*

accrue directly to the producer.[217] Direct tax exemptions are disallowed because they allow producers to offer goods to the market at a price lower than that which would be observed in the absence of the exemption.[218] In effect, direct tax exemptions distort market forces to favor not the most naturally competitive product, but the product which has been rendered more competitive by means of an artificial price reduction.[219] The conclusion, therefore, is that banning a direct exemption and allowing a neutral indirect exemption is consistent with the overall free trade policy of GATT.[220] Not all theorists, however, agree with this analysis.

It is now generally accepted by economists, that both direct and indirect taxes have cost shifting effects which influence both consumers and producers.[221] Neither operates in an isolated fashion.[222] VAT exemptions are partially absorbed by price increases to give exporters an added return on export sales as well as a lower price in the world market.[223] Direct tax costs are actually shifted forward to increase producer prices.[224] Why a distinction based on the relative distorting effects of indirect and direct tax exemptions has been allowed to persist in GATT—to the disadvantage of the United States—is the real issue of significance raised by the United States in challenging the alleged GATT *il*legality of DISC.[225]

It is important not to mistake this justification for DISC as an argument that DISC is legal under GATT. GATT accepts the indirect-direct distinction in form.[226] As an allegedly permanent deferral, DISC is arguably GATT illegal. DISC, however, remains justifiable because contrary to the accepted norm that only direct and not indirect taxes are trade distorting, EC VAT exemptions produce similar benefits for producers and similar trade distorting

217. *Id.* at 416.
218. *Id.*
219. *Id.* at 418.
220. *Id.*
221. *Id.* at 416-18.
222. *Id.*
223. *Id.*
224. *Id.*
225. *See* Letter from P.S. Peter, Vice President of the General Electric Company in Washington, D.C. to Secretary Regan, *reprinted in* 17 TAX NOTES (CCH) No. 10, at 770-71 (Dec. 6, 1982).
226. Reference is to the fact that GATT has been interpreted to allow indirect tax exemptions and not direct tax exemptions. *See supra* notes 210-16 and accompanying text.

effects on world trade as DISCs.[227] DISC, as a domestic corporation, is in effect theoretically equivalent to an indirect border tax exemption scheme whereby the producer attempts to shift the indirect exemption partially inward instead of passing it completely on to the purchaser.[228] This type of exemption allows the producer the discretion to sell at a lower price while simultaneously realizing a greater per dollar input return than without the exemption.[229]

This is the very same discretion afforded under DISC.[230] Had the United States forced recognition of this issue within the GATT Council, instead of abandoning it and DISC, the United States would have had the perfect ammunition to gain either an approval of the direct or an abandonment of the indirect exemption. The longstanding advantage of the EC could have been neutralized. Instead, with the abandonment of DISC, any leverage the United States ever had over a resolution of the indirect-direct controversy is currently dissipated.

The thrust of this argument is that the GATT indirect-direct tax exemption distinction is one of form over substance. Moreover, it is a distinction which has been used by the EC in the GATT Council to cancel a U.S. incentive which was not a new distortion to trade, but rather a countermeasure to already existing EC practices.[231] Without the U.S. DISC, but with the EC VAT exemption system, the EC receives a plus to trade unshared by U.S. exporters. Furthermore, by abandoning DISC, the United States has publicly relinquished a significant point of contention with the EC. In so doing, the United States has signaled a clear retreat from longstanding efforts to combat trade distorting practices in the EC. Thus, although FSC may help to mend U.S. relations with the GATT Council, it is the U.S. abandonment of DISC itself which is perhaps the most significant signal to come from the controversy.

D. FSC and American Business

A major debate in the U.S. business community over the enactment of FSC is the size of the actual credit under FSC as compared

227. Letter from Peter to Regan, *supra* note 225.

228. Anninger, *supra* note 28, at 416-18.

229. *Id.*

230. Because DISC is a tax incentive to producers which operates in the first instance to lower the effective tax rate on export transactions, producers can either lower prices by the amount of the subsidy, increase per dollar return by the amount of the subsidy or any combination of the two. This is the same result as when a producer receives a VAT exemption or rebate.

231. *See* letter from Peter to Regan, *supra* note 225.

to DISC. In this regard, because FSC is designed to accommodate large and small exporters differently, the analysis below will take a similar tact.

1. Probable Effects of FSC on Large Exporters

Under DISC and FSC, the actual size of a firm's benefit depends on the fraction of its total income that can be allocated to the subsidiary,[232] as well as the fraction of export income that is exempt from federal taxation.[233] Under DISC, it is estimated that a firm can defer the payment of federal taxes on somewhere between 17% and 33% of its income.[234] If the rate of taxation is assumed to be 46%, this range of estimates translates into a maximum effective tax rate of 38.2% to a minimum of 30.8%.[235] Considering FSC, on the other hand, it can be estimated that an individual firm with an FSC could exempt a minimum of 17% and a maximum of 74% of its income from U.S. taxation.[236]

It is likely, however, that few firms will fall within the upper portion of this range of estimates.[237] Under the FSC rules, only firms with very low profit margins would be able to exempt a portion of income in the upper end of this range.[238] Indeed, judging by the average profit margin reported for DISC-utilizing manufacturing firms in 1981,[239] most firms using FSCs would probably be in the lower end of this range.[240] This is the portion of the range that coincides with parallel figures calculated for the DISC provisions.[240a] It appears, then, that while some firms with FSCs might be able to receive larger tax exemptions under FSC, for most larger firms the tax benefit should be the same.

The equality of benefit under both systems, however, is only guaranteed where the FSC is located in a low tax country.[241] Due

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232. *See supra* text accompanying notes 29-30; 125-32.

233. *Id.*

234. Brumbaugh, *Effect of Administration FSC Proposal on Export Firms*, Congressional Research Service, *reprinted in* 21 TAX NOTES (CCH) No. 3, at 255 (Oct. 17, 1983).

235. *Id.*

236. *Id.*

237. *Id.*

238. *Id.*

239. 1983 TREASURY REPORT ON DISC, *supra* note 198.

240. Brumbaugh, *supra* note 234.

240a. *See supra* note 234 and accompanying text.

241. The argument here is that while DISC is incorporated in the United States and pays no taxes itself, FSC is incorporated abroad and pays foreign taxes. Thus any net benefit would have to include foreign tax liability. A move to increase the level of benefit under FSC, therefore, would be to incorporate in a country with a low corporate income tax rate.

to foreign incorporation,[242] foreign taxes become a major force in dampening the benefits under this proposal as compared with DISC.[243] Moreover, without the foreign tax credit, all foreign taxes are fully borne by the FSC and its parent, and cannot be offset against a firm's U.S. tax liability.[244] In cases of high foreign tax rates, it may be more profitable to set up shop abroad and receive the 100% tax deferral accorded foreign subsidiaries. Similarly, those businesses which can feasibly set up FSCs in tax haven countries will be inclined to do so, rekindling flames under this hotly debated issue.

Administrative costs of setting up offshore are a second dampening effect which will eat into the benefit an FSC can effectively provide compared to DISC.[245] In a high volume, low profit business, even slight administrative costs may be too much for the corporation to afford in relation to the benefits of FSC.[246] Production abroad may be the only answer in such cases—with a resulting loss of jobs and investment at home.

Thus, although the proposal in itself provides comparable tax benefits to DISC, due to the complication of now dealing with incorporation abroad, foreign administrative costs and an added layer of taxation, many firms may find FSC an incentive to produce abroad and give up exporting domestically produced products all together. Such results would clearly be contrary to any of the purposes for which DISC was created: increased employment, U.S. investment or exports.[247]

2. Probable Effects of FSC on Small Exporters

As discussed above, the FSC proposal contains two exceptions that apply to exporting firms that have gross receipts below a certain level.[248] The first exception provides that if a company establishes an FSC that generates gross receipts of five million dollars or less, it need not satisfy the foreign presence

242. 26 U.S.C. § 922(a)(1)(A)(i) (West Supp. 1985).

243. *See supra* note 241.

244. 26 U.S.C. § 901(h) (West Supp. 1985). *See id.* § 902.

245. Under DISC, no substance or specific economic processes are required. DISC is a paper corporation. FSC, on the other hand, has specific foreign presence and economic process requirements. *See id.* §§ 992, 924(b) & (c), & (e). *See also* text accompanying notes 101-24.

246. Brumbaugh, *supra* note 234.

247. *See* Joint Committee Print, *supra* note 11, at 3.

248. *See supra* text accompanying notes 149-60.

requirements.[249] For firms that have substantially less than five million dollars in gross receipts, the utilization of this provision may result in a somewhat smaller tax benefit than that received under DISC.[250]

The second exception is for DISCs with ten million dollars or less in income.[251] These "small DISCs" become exempt from the incremental rules that link the DISC benefit with annual increases in export sales.[252] Small DISCs are able to exempt somewhere between 21.3% and 42.5% of their income from taxation based on the DISC rules for income allocation and the portion of a DISC's income that can be retained tax-exempt.[253]

Under the small FSC provisions, it is important to note that the size of the probable tax exemption would not be directly affected by the relaxed foreign economic processes requirements.[254] The FSC exemption for most of these firms, as with other FSCs, would amount to the same 17 to 74% range estimated for larger FSCs.[255] Thus, those that are eligible for small FSC status would receive approximately the same *tax* benefit as a large FSC or DISC. The critical advantage, therefore, for firms that qualify for the small FSC exception is the *cost* benefit of not having the same economic process requirements to dampen the overall level of benefit.[256]

For firms that elect to operate as small DISCs, there is another element to contend with—one which was not part of the original DISC program. Although none of the small DISC's income is deemed distributed, there is an added interest charge on the deferred amount.[257] The actual tax liability of these small DISCs would then be the shareholder's taxes on that share of combined corporate income not allocated to the DISC, the taxes on any voluntary distributions from the DISC, and now the added interest charge.

The size of the tax benefit for interest charge DISCs will vary depending on the interest rate of Treasury Bills at a given time.[258]

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249. 26 U.S.C. § 924(b)(2)(B)(i) (West Supp. 1985). *See supra* text accompanying notes 158-60.
250. Brumbaugh, *supra* note 234.
251. 26 U.S.C. § 995(b)(1)(E) (West Supp. 1985).
252. 1984 Tax Conference Report, *supra* note 113, at H6512, section 802(a)(1).
253. Brumbaugh, *supra* note 234.
254. *Id.*
255. *Id.*
256. *Id.*
257. 26 U.S.C. § 995(f) (West Supp. 1985).
258. *Id.*

Thus, to estimate a precise level of tax benefit is not possible. However, it is arguable that new-DISC benefits, with the interest charge, would be smaller.[259] This is because as treasury bill rates approach the prevailing market rate of interest, any return received on invested DISC deferred income will be theoretically absorbed more and more by the interest charge.[260] Thus, new DISCs may be less of a small exporter's dream than appears on the surface.

V. *CONCLUSION*

This Note began by calling FSC a truly ironic solution to the current DISC controversy. To understand the nature of this claim, it is useful to once again briefly trace the history of the DISC controversy.

Originally, DISC was set up to aid a poor U.S. balance of payments and remove taxes as a factor which promoted overseas investment.[261] The plan, however, had the positive side effect of partially neutralizing two structural, yet GATT legal, distortions contained in EC tax systems which favored the competitiveness of EC exports. First was the export incentive created by the indirect tax exemption, such as the European VAT.[262] Second was the way EC tax laws allowed multinational corporations to beneficially manipulate transfer prices in order to lower the effective tax rate on world wide corporate income.[263]

However, because DISC was a domestic corporation which received a direct tax benefit calculated in relation to exports, the EC seized the opportunity to defeat DISC on an argument of GATT illegal form. This argument based on *form* insulated the EC from having to address the *substance* of the direct-indirect tax and transfer pricing controversies DISC so clearly brought to the fore.[264]

Thus, the first level of the paradox: while DISC's replacement, FSC, is in form arguably GATT legal, in substance the proposal fails to address the clear distorting effects of the EC tax systems. Similarly, instead of resulting in enforcement of arm's-length pricing on both sides of the Atlantic, the proposal merely gives U.S. producers a costly, unilateral mandate to seek arm's-length standards.

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259. Brumbaugh, *supra* note 234.
260. *Id.*
261. *See supra* notes 12-19 and accompanying text.
262. *See supra* notes 208-35 and accompanying text.
263. *See supra* notes 73-86 and accompanying text.
264. *See supra* notes 208-32 and accompanying text.

As a result, trade will be left in an even more distorted position than under DISC—all in the name of GATT and *freer* trade.

The reason for this outcome is the second level of the paradox. In an effort to keep the DISC-GATT legality issue from spilling over into other U.S.-EC discussions, the U.S. Congress, in enacting FSC, blanketed international political considerations over the concerns of the businessmen who actually face the distortions of the EC's tax systems. The result is a replacement that is less favorable than DISC to the large and small businessman, that arguably exports jobs, and may even once again promote foreign investment.[265] In the long run, these trampled constituencies have no way to regain lost ground but to unite behind even greater subsidies or protection than DISC. Whereas DISC should have been a negotiating chip to avert and rectify the long run fears of business about the structural bias of the European systems, the watered down FSC, while representing a short run fix to the U.S.-EC political malaise, may eventually cause an even greater upheaval in the American business community.

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265. *See supra* notes 232-60 and accompanying text.