

## The GATT Qualifier: Its Validity as a Tax Standard and its Effect on Disc and Disc Alternatives

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## THE GATT QUALIFIER: ITS VALIDITY AS A TAX STANDARD AND ITS EFFECT ON DISC AND DISC ALTERNATIVES

Since its enactment in 1971, Domestic International Sales Corporation (DISC) legislation<sup>1</sup> has been attacked as an illegal subsidy under the General Agreement on Tariffs and Trade<sup>2</sup> (GATT or the

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1. Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497, 535-53 (codified at I.R.C. §§ 991-97 (West 1982 & West Supp. 1983)). Under DISC legislation, a United States exporter can obtain a tax deferral on its export income by creating a DISC and channeling export sales through it. To qualify as a DISC, a corporation must be incorporated under the laws of any state and must satisfy the following four requirements:

- (1) at least 95 percent of its gross receipts consists of qualified export receipts (I.R.C. § 993(f) defines "gross receipts" as "the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of trade or business, and gross income from all other sources." I.R.C. § 993(f) (1976). "Qualified export receipts" include: "gross receipts from the sale, exchange or other disposition of export property, . . . gross receipts for services which are related and subsidiary to any qualified sale, exchange, lease, rental, or other disposition of export property by such corporation, . . . gross receipts from the sale, exchange, or other disposition of qualified export assets (other than export property), . . . [and] interest on any obligation which is a qualified export asset. . . ." *Id.* § 993(a)(1). "Qualified export assets" include: inventory meeting specified requirements, assets used primarily in connection with the sale, lease, storage, or handling of export property; accounts receivable arising from DISC transactions; necessary working capital; and stock or securities of a related foreign export corporation. *Id.* § 993(b));
- (2) the adjusted basis of its qualified export assets equals or exceeds 95 percent of the sum of the adjusted bases of all of its assets at the close of the taxable year;
- (3) it has only one class of stock and the par or stated value of its outstanding stock is at least \$2,500 at all times; and
- (4) it has elected to be treated as a DISC and such election is in effect.

*Id.* § 992(a)(1).

DISC profits are not taxed to the DISC itself. *Id.* § 991. Instead, the shareholders (usually the parent corporation) are taxed to the extent that the DISC income is actually, or deemed to be, distributed to them as dividends. *See id.* § 995 (West Supp. 1983). Before the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, 50 percent of DISC income, whether or not distributed, was taxed currently to the DISC shareholders. I.R.C. § 995(b)(1)(F)(i) (1976). The tax on the remaining 50% was deferred until the DISC profits were actually distributed, the shareholder sold his stock, or the corporation lost its DISC status. *Id.* § 995 (West Supp. 1983). The 1982 Act increased the deemed dividend distribution from 50% to 57.5% for tax years beginning after December 31, 1982. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 204(a), 96 Stat. 324, 423-24; I.R.C. § 291(a)(4) (West Supp. 1983).

If a DISC's gross export receipts do not increase over a consecutive four-year period beginning in the seventh calendar year preceding the taxable year, the deferral of tax on the DISC income is effectively nullified. *See* I.R.C. § 995(e)(1)-(5) (1976).

For the legislative history of the passage of DISC legislation, see 1971 U.S. CODE CONG. & AD. NEWS 1825-2079.

2. General Agreement on Tariffs and Trade, *opened for signature* Oct. 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 194 [hereinafter cited as GATT].

General Agreement). In 1976, a GATT Panel<sup>3</sup> issued a series of Reports<sup>4</sup> which found that DISC taxation and certain tax practices maintained by France, Belgium, and the Netherlands<sup>5</sup> constituted

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For the complete text of GATT, as in force March 1, 1969, see 4 GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS (1969). See also Jackson, *The General Agreement on Tariffs and Trade in United States Domestic Law*, 66 MICH. L. REV. 250 (1967), wherein GATT is defined as "a multilateral international agreement which is today the principal instrument for the regulation of world trade." *Id.* On GATT generally, see Jackson, *The Puzzle of GATT-Legal Aspects of a Surprising Institution*, 1 J. WORLD TRADE L. 131 (1967).

3. GATT authorizes a "panel of conciliation" to resolve disputes. GATT, *supra* note 2, at art. XXIII(2). The panel selected to review the legality of DISC taxation and certain tax practices of France, Belgium, and the Netherlands was announced on February 17, 1976 and consisted of the following members: Mr. L.J. Mariadason (Counsellor, Permanent Mission of Sri Lanka, Geneva), Chairman; Mr. W. Falconer (Director of Trade Policy, Department of Trade and Industry, Wellington); Mr. F. Forte (Professor of Public Finance, University of Turin); Mr. T. Gabrielsson (Counsellor of Embassy, Permanent Delegation of Sweden to the European Communities, Brussels); and Mr. A.R. Prest (Professor of Economics of the Public Sector, London School of Economics). Report of the Panel, UNITED STATES TAX LEGISLATION (DISC), GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS (23d Supp.) 98, para. 2 (1977). The Panel met on March 16-18, 1976, June 28-July 1, 1976, and July 26-30, 1976, and concluded its report through a postal procedure. *Id.* at 99, para. 4.

4. Report of the Panel, UNITED STATES TAX LEGISLATION (DISC), GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS (23d Supp.) 98 (1977) [hereinafter cited as UNITED STATES TAX LEGISLATION]; Report of the Panel, INCOME TAX PRACTICES MAINTAINED BY FRANCE, GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS (23d Supp.) 114 (1977) [hereinafter cited as TAX PRACTICES MAINTAINED BY FRANCE]; Report of the Panel, INCOME TAX PRACTICES MAINTAINED BY BELGIUM, GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS (23d Supp.) 127 (1977) [hereinafter cited as TAX PRACTICES MAINTAINED BY BELGIUM]; Report of the Panel, INCOME TAX PRACTICES MAINTAINED BY THE NETHERLANDS, GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS (23d Supp.) 137 (1977) [hereinafter cited as TAX PRACTICES MAINTAINED BY THE NETHERLANDS].

5. The United States, in its complaint against the tax practices of France, Belgium, and the Netherlands, see *infra* text accompanying note 16, described the tax practices of the three countries as follows:

The French income tax system for corporations is based on the territoriality principle which, in general, taxes income earned in France but not income arising outside France. . . . French companies are liable to corporation tax solely in respect of profits made by enterprises operating in France and of profits taxable by France under an international double taxation agreement. [Code général des impôts, art. 209:1]

Under the territoriality rule as applied by France, profits generated by undertakings operated abroad are exempt from French taxation. On the other hand, a French company is not entitled to any foreign tax credit and cannot deduct losses suffered abroad, apart from exceptions specified below.

If a subsidiary is a purely fictitious corporation located abroad and all its activities are directed from France, tax is levied in France on total profits for the reason that all corporations, regardless of nationality or location of the statutory head office, which have an effective management headquarters in France are taxable in France.

Ninety-five per cent of dividends from the French or foreign subsidiaries of a French company is excluded from the profits of the parent corporation. Participation by the parent in the subsidiary must exceed 10 per cent. [*Id.*, arts. 145,

export subsidies in violation of article XVI of the General Agree-

216.] This arrangement stems from the desire to avoid double taxation of the dividends of subsidiaries.

Dealings between French companies and their branches, subsidiaries or associated companies in foreign countries must in principle be conducted as if the companies were independent enterprises, each being regarded as a separate distinct economic entity ('arm's-length' relationship). [*Id.*, art. 57.] . . . The actual application of the principle was interpreted in administrative notes in 1959, 1972 and 1973, according to which [French tax] officials are requested to take into consideration foreign competitive conditions and commercial operations as a whole, not a single transaction alone. . . .

In certain cases provision can be made for losses abroad and certain expenditures relating thereto. [*Id.*, art. 39 octies A.] Since 1 January 1973 this treatment applies only to new establishments, is limited on account of the permitted amount of the reduction, and is limited to five years in time.

French companies are allowed to set up certain reserves to cover risks in respect of medium-term credit for sales or projects carried out abroad. [*Id.*, Annex IV, arts. 4 and 4 *bis*]

Exports are excluded from the application of the inflation levy introduced in France on 1 January 1975. The levy has not been applied in practice. After having been abolished from 1 September 1975, it was re-established in principle for 1976 and is to be applied if increases in prices of manufactures exceed 2 per cent over a period of three months.

TAX PRACTICES MAINTAINED BY FRANCE, *supra* note 4, at 116-17 (footnote material placed in brackets).

The Belgian income tax system is based on the principle of worldwide taxation of residents and on the source principle as far as taxation of non-residents is concerned.

Therefore, non-residents are only taxed in Belgium on income obtained or collected by them there. Profits of foreign subsidiaries of Belgium-based corporations are not taxed by the Belgian authorities, but are subject to the tax jurisdiction of the foreign country in question.

In order to avoid double taxation of sales effected abroad by foreign sales establishments Belgium introduced the principle of tax relief [which] was . . . carried into law in 1919. . . .

Income obtained from foreign establishments by resident corporations and which has been taxed abroad is assessed after deduction of foreign tax. Belgian tax is then applied to it at one quarter of the normal rate. Evidence that the profits are both obtained and taxed abroad must be produced. In practice, evidence of foreign taxation is not required in respect of profits obtained through an establishment located abroad, if it draws up separate accounts. The fact that certain constituent elements of income may not be taxable or may be tax free in the foreign country is not generally sufficient justification for refusing to grant the benefit of Belgian tax reliefs.

As far as sales through foreign sales subsidiaries (permanent equity holdings) are concerned, Belgium taxes foreign profits therefrom only to the degree that they are actually distributed to the parent corporation. However, in order to remedy the effects of cascading taxation of dividends, dividends derived from subsidiaries which would normally have been taxed are deducted from the tax base of the recipient to the extent of 95 per cent (or 90 per cent for certain holding companies) of the net amount received, grossed up by a deemed movable prepayment of 5 per cent; this system is applicable regardless of the size of the Belgian corporation's equity holding generating dividends.

A provision in Belgium's Income Tax Code (Article 24), which is of general scope, lays down that transactions between Belgian enterprises directly or indirectly related to an enterprise established abroad shall be governed by the arm's-

ment.<sup>6</sup> In December 1981, the GATT Council formally adopted the 1976 Panel Reports, subject to a "qualifier" which recognizes the legitimacy of territorial systems of taxation.<sup>7</sup>

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length principle. The administration is given much latitude in its application of this provision.

TAX PRACTICES MAINTAINED BY BELGIUM, *supra* note 4, at 128-29.

The Netherlands system of levying income tax and corporation tax is that profits made by an individual or an enterprise should be taxed in the country where the profits were made. In principle, however, income tax on resident corporations and individuals is levied on the worldwide income. If a treaty provides for different tax treatment the treaty rules will prevail over Dutch national law, and if no treaty exists, unilateral relief will be granted through a proportional reduction in Dutch taxation for foreign-source profits if an income tax is in principle due in the foreign country. The portion of profits or income which is not taxable in the Netherlands is therefore important when determining the tax rate to be applied to the portion that is taxable in the Netherlands. This means in practice that for individuals who are subject to a progressive rate of income tax, the Dutch tax is affected by the amount not taxable in the Netherlands. For resident corporations this system has effects which are similar to those of the territoriality principle. One difference between the Dutch system and the territoriality system in its pure form is that foreign losses of a permanent establishment (the concept includes the location of the principal office of management) or dependent permanent representative are deductible when computing liability to Dutch tax, provided that tax is in principle due in the foreign country.

This method amounts to a credit, not for foreign, but for Dutch tax on foreign income, and is the principal method for avoiding double taxation (Royal Decree providing Unilateral Regulations for the Avoidance of Double Taxation of 1965).

In the Netherlands the taxation of dividends is governed by the territoriality principle applied to the residence of the person entitled to dividends. As a general rule, therefore, no relief from Dutch tax is granted to dividends. However, the Decree provides a relief for all income earned by a permanent establishment, which in practice means that dividends can qualify for relief if they are channelled through a permanent establishment and are subject to tax in the other country. Under Dutch double taxation agreements these rules apply even if the other country does not make use of its taxation rights. A 1970 amendment to the Decree also introduced a special foreign tax credit for interest and royalties paid to Dutch residents from developing countries.

An 'affiliation privilege', laid down in the Corporation Tax Act of 1969, constitutes an exemption for inter-company dividends and other profits connected with a substantial participation in ownership (normally 5 per cent) and was enacted to prevent double taxation of profits when a company receives dividends or other gains from a qualified company. This privilege is also applicable if a resident company participates in a foreign company which is formally subject to some kind of income tax under the laws of a foreign State. The rate of the foreign tax is immaterial, but liability to foreign local or regional taxes is not sufficient. . . .

Under Dutch legislation the profits of an enterprise must be calculated in accordance with 'sound business practice'. There are no administrative guidelines for the application of the arm's-length principle.

TAX PRACTICES MAINTAINED BY THE NETHERLANDS, *supra* note 4, at 138-39.

For a detailed analysis of the tax practices of France and the Netherlands, see Cole & Corette, *Foreign Tax Practice Affecting Exports* 8-18, 34-39 (July 1982) (available from Cole & Corette, 1200 17th Street, N.W., Washington, D.C. 20036).

6. For the relevant text of article XVI, see *infra* note 21.

7. *GATT Acts on Export Tax Aid Panel Reports*, TAX NOTES 1485 (Dec. 14, 1981). A territorial system of taxation only taxes income generated within the territory of the

Although the European Communities (EC) and the United States agree that the qualifier exonerates the tax practices of France, Belgium, and the Netherlands, the parties disagree about whether the qualifier legitimizes DISC.<sup>8</sup> At the June 1982 GATT Council meeting, Deputy United States Trade Representative David R. Macdonald presented the United States position that DISC is GATT-legal in light of the qualifier.<sup>9</sup> Four months later, however, the Reagan Administration made a commitment before the GATT Council to modify or replace DISC in order to bring it into conformity with the General Agreement.<sup>10</sup>

This Note critically analyzes the qualifier and its implications for the DISC GATT-legality dispute. The Note first reviews the DISC controversy and the qualifier's invalidation of DISC.<sup>11</sup> Next, it discusses GATT policy objectives and examines the United States defense of DISC. The Note argues that the qualifier is an inappropriate standard by which to measure the GATT-legality of systems of taxation, because it legitimizes systems that do not optimally serve the policy objectives of the General Agreement. Finally, the Note presents and analyzes various proposals that have been or currently are being considered as viable alternatives to DISC.

## I

### HISTORY OF THE DISPUTE

In 1973, the EC filed a complaint against DISC before the GATT Council.<sup>12</sup> The EC asked a GATT Panel<sup>13</sup> "[t]o find that the

taxing (exporting) country. In contrast, a global system of taxation taxes the world-wide income of the exporting taxpayer.

8. Statement of the Honorable David R. Macdonald for the United States before the GATT Council Opposing Adoption of E.C. Draft Decision, at 1 (June 29, 1982) [hereinafter cited as Macdonald Statement]. Excerpts of Macdonald's speech are reprinted in *The U.S. Defense of DISC Before GATT*, TAX NOTES 269 (July 19, 1982). The full text is available in *Tax Notes Microfiche Data Base*, Doc. 82-7501 (July 19, 1982).

9. Macdonald Statement, *supra* note 8, at 1-9.

10. *U.S. Will Seek Revised DISC Legislation in Response to Long-Term GATT Opposition*, 18 U.S. EXPORT WEEKLY (BNA) No. 1, at 5 (Oct. 5, 1982).

11. A literal application of the qualifier invalidates DISC. *See infra* notes 31-36 and accompanying text. The United States, however, argued that the implicit effect of the qualifier is to legitimize DISC. *See infra* notes 44-88 and accompanying text.

12. *See UNITED STATES TAX LEGISLATION*, *supra* note 4, at 98, para. 1.

13. *See supra* note 3. The Panel apparently adopted the United States' suggestion that the four complaints about DISC legislation and the income tax practices of France, Belgium, and the Netherlands be considered together because they raised the same principles concerning the application of the GATT. *See TAX PRACTICES MAINTAINED BY FRANCE*, *supra* note 4, at 115, para. 6; *TAX PRACTICES MAINTAINED BY BELGIUM*, *supra* note 4, at 128, para. 6; *TAX PRACTICES MAINTAINED BY THE NETHERLANDS*, *supra* note 4, at 138, para. 6. The Panel issued its reports on the tax practices of the United States, France, Belgium, and the Netherlands on the same date.

DISC system was incompatible with the relevant clauses of the General Agreement regarding export subsidies."<sup>14</sup> Canada, in support of the EC complaint, added that "[t]he Panel should recommend to the United States that it should terminate the subsidization promptly."<sup>15</sup>

The United States countered the EC action by filing three similar complaints against France, Belgium, and the Netherlands. The United States requested the GATT Panel to find "that the tax practices of France, [Belgium, and the Netherlands] violated article XVI:4 and that there was therefore a *prima facie* case that these practices were nullifying or impairing benefits accruing to it under the General Agreement."<sup>16</sup>

In 1976, after consulting with the EC and the four nations named in the complaints, the GATT Panel issued its findings.<sup>17</sup> The Panel found that all four nations' tax systems constituted export subsidies under GATT;<sup>18</sup> were therefore covered by the notification obligation of article XVI:1;<sup>19</sup> had effects in some cases that were not in accordance with the four nations' obligations under article XVI:4;<sup>20</sup> and presented *prima facie* cases of nullification or impairment of benefits that other Contracting Parties were entitled to expect under GATT.<sup>21</sup>

14. UNITED STATES TAX LEGISLATION, *supra* note 4, at 99, para. 5.

15. *Id.*

16. TAX PRACTICES MAINTAINED BY FRANCE, *supra* note 4, at 115, para. 5. *See also* TAX PRACTICES MAINTAINED BY BELGIUM, *supra* note 4, at 128, para. 5; TAX PRACTICES MAINTAINED BY THE NETHERLANDS, *supra* note 4, at 137-38, para. 5.

17. *See* UNITED STATES TAX LEGISLATION, *supra* note 4, at 99, para. 3; TAX PRACTICES MAINTAINED BY FRANCE, *supra* note 4, at 115, para. 3; TAX PRACTICES MAINTAINED BY BELGIUM, *supra* note 4, at 127-28, para. 3; TAX PRACTICES MAINTAINED BY THE NETHERLANDS, *supra* note 4, at 137, para. 3.

18. UNITED STATES TAX LEGISLATION, *supra* note 4, at 112, para. 69; TAX PRACTICES MAINTAINED BY FRANCE, *supra* note 4, at 125, para. 48; TAX PRACTICES MAINTAINED BY BELGIUM, *supra* note 4, at 135, para. 35; TAX PRACTICES MAINTAINED BY THE NETHERLANDS, *supra* note 4, at 145, para. 35.

19. UNITED STATES TAX LEGISLATION, *supra* note 4, at 114, para. 77; TAX PRACTICES MAINTAINED BY FRANCE, *supra* note 4, at 127-28, para. 57; TAX PRACTICES MAINTAINED BY BELGIUM, *supra* note 4, at 136, para. 44; TAX PRACTICES MAINTAINED BY THE NETHERLANDS, *supra* note 4, at 146-47, para. 44.

20. UNITED STATES TAX LEGISLATION, *supra* note 4, at 113, para. 74; TAX PRACTICES MAINTAINED BY FRANCE, *supra* note 4, at 126, para. 53; TAX PRACTICES MAINTAINED BY BELGIUM, *supra* note 4, at 136, para. 40; TAX PRACTICES MAINTAINED BY THE NETHERLANDS, *supra* note 4, at 146, para. 40.

21. UNITED STATES TAX LEGISLATION, *supra* note 4, at 114, para. 80; TAX PRACTICES MAINTAINED BY FRANCE, *supra* note 4, at 127, para. 58; TAX PRACTICES MAINTAINED BY BELGIUM, *supra* note 4, at 136, para. 45; TAX PRACTICES MAINTAINED BY THE NETHERLANDS, *supra* note 4, at 147, para. 45.

Article XVI, as cited in the Panel Report, provides in relevant part:

1. 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 on the quantity of the affected product or

In December 1981, the GATT Council formally adopted the Panel Reports,<sup>22</sup> subject to an important qualifier.<sup>23</sup> The qualifier confers GATT-legal status upon certain tax systems that would otherwise violate article XVI. Specifically, the qualifier provides: (1) that an exporting country need not tax economic processes located outside its territorial limits, and (2) that an exporting company must, for tax purposes, treat its related foreign buyers at arm's-length.<sup>24</sup> In addition, the qualifier expressly permits an exporting country to adopt measures to avoid double taxation of foreign source

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products imported into or exported from its territory and of the circumstances making the subsidization necessary. In any case in which it is determined that serious prejudice to the interests of any other contracting party is caused or threatened by any subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the CONTRACTING PARTIES, the possibility of limiting the subsidization.

- . . . .
4. . . . [C]ontracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product for exports at a price lower than the comparable price charged for the like product to buyers in the domestic market. . . .

GATT, *supra* note 2, at art. XVI ("Whenever reference is made in this Agreement to the contracting parties acting jointly they are designated as the CONTRACTING PARTIES." *Id.* at art. XXV:1. This Note uses "Contracting Parties" to refer to contracting parties acting jointly or separately.) For an interpretation of arts. XVI:1 & 4, see GENERAL AGREEMENT ON TARIFFS AND TRADE, ANALYTICAL INDEX, NOTES ON THE DRAFTING, INTERPRETATION AND APPLICATION OF THE ARTICLES OF THE GENERAL AGREEMENT 83-86 (2d ed. 1966).

22. *GATT Acts on Export Tax Aid Panel Reports*, TAX NOTES 1485 (Dec. 14, 1981).

23. The qualifier originally had been proposed by the United States as part of its November 1981 unofficial bilateral settlement with the EC. In that settlement, each party also unofficially agreed to withdraw its complaint against the other, with a reservation of the right to renew the challenge at any time. *See generally Rumors Fly as GATT Again Schedules DISC Hearing*, TAX NOTES 1080 (Nov. 2, 1981); *GATT and DISC: Looking Ridiculous?*, TAX NOTES 1415 (Dec. 7, 1981).

24. The qualifier provides:

The Council adopts these reports on the understanding that with respect to these cases, 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. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the price which would be charged between independent enterprises acting at arm's-length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.

*The U.S. Defense of DISC Before GATT*, *supra* note 8, at 269.

The two prongs of the qualifier establish requirements that a country must meet to avoid violating article XVI. First, the qualifier, by negative implication, requires a country to tax economic processes located within its territorial limits. Second, the qualifier requires observance of arm's-length pricing between a company and its related foreign buyers.



income without violating GATT.<sup>25</sup>

The United States and the EC agree that the qualifier legitimizes the territorial tax systems of France, Belgium, and the Netherlands.<sup>26</sup> Those nations' tax systems, which were designed to avoid double taxation of foreign source income,<sup>27</sup> satisfy the qualifier's two requirements.<sup>28</sup> The systems exempt from taxation only those economic processes located outside the territorial limits of the exporting country and require observance of arm's-length intercompany pricing rules.<sup>29</sup> Thus, as applied to the tax systems of France, Belgium, and the Netherlands, the qualifier removes the article XVI taint and thereby overrules the 1976 Panel Report findings of GATT violations.<sup>30</sup>

The qualifier does not, however, legitimize DISC, because DISC does not satisfy the qualifier's two requirements. Because a DISC must be incorporated in the United States,<sup>31</sup> the economic processes of a DISC are considered to be located within the United States. In this respect, DISC activity is not covered by the exclusion of the first prong of the qualifier.<sup>32</sup> In addition, DISC violates the qualifier's arm's-length requirement.<sup>33</sup> The Internal Revenue Code's intercompany pricing rules,<sup>34</sup> which require observance of arm's-

25. *Id.* The third part of the qualifier is merely permissive, because it provides that countries *may* adopt measures to avoid double taxation of foreign source income.

26. *See supra* note 8 and accompanying text.

27. *See supra* note 5.

28. *See supra* note 24.

29. *See supra* note 5. Although the Belgian system is territorial for non-residents and global for residents, TAX PRACTICES MAINTAINED BY BELGIUM, *supra* note 4, at 128, para. 8, it is still compatible with the qualifier, because the global system taxes economic processes located within its territory. The first prong of the qualifier is a negative directive: economic processes located outside the territory of the exporting country need not be taxed. The Belgian system errs, if at all, on the side of over-taxation. By taxing more than is dictated by the qualifier, it is not in violation thereof.

Note also that the qualifier's arm's-length requirement is not applied in practice as strictly as a literal reading of its language might allow. Under the Belgian system, "[t]he administration is given much latitude in its application of . . . [the arm's-length] provision." *Id.* at 129, para. 13. Under the Dutch system, the standard is "'sound business practice.'" There are no administrative guidelines for the application of the arm's-length principle." TAX PRACTICES MAINTAINED BY THE NETHERLANDS, *supra* note 4, at 139, para. 12. In France, administrative officials, in considering adherence to the arm's-length principle, are "to take into consideration foreign competitive conditions and commercial operations as a whole, not a single transaction alone." TAX PRACTICES MAINTAINED BY FRANCE, *supra* note 4, at 116, para. 12. Thus, DISC's failure to require strict adherence to the arm's-length principle, *see infra* notes 33-35 and accompanying text, does not appear to be a major obstacle to compliance with the qualifier.

30. *See supra* notes 18-21 and accompanying text.

31. *See supra* note 1.

32. *See supra* note 24 and accompanying text.

33. *Id.*

34. The Internal Revenue Code provides that:

In any case of two or more . . . businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may . . . allocate gross income,

length pricing, are inapplicable to sales between a DISC and its related supplier. Rather, DISC provisions allow a parent company to sell export property to its DISC at a transfer price which allows the DISC to earn the greatest of (1) 4% of the qualified export receipts from the sale of such property by the DISC, plus 10% of the related export promotion expenses; (2) 50% of the combined taxable income of such DISC and its related supplier attributable to qualified export receipts, plus 10% of the related export promotion expenses; or (3) taxable income based upon the sale price actually charged, if that price is justifiable on an arm's-length basis.<sup>35</sup>

Because DISC does not satisfy either prong of the qualifier, the article XVI taint cannot be removed. Thus, a literal application of the qualifier reaffirms the 1976 Panel Report finding that DISC violates GATT.<sup>36</sup> In favor of such a literal application, the EC placed a formal document before the GATT Council in May 1982, requesting the Council to "recommend, in accordance with the provisions of [a]rticle XXIII:2 that the United States take appropriate action without delay to bring the DISC legislation into conformity with the provisions of GATT."<sup>37</sup> In addition, the EC requested \$2.3 billion in compensatory damages allegedly caused by DISC,<sup>38</sup> and joined Canada in raising the DISC issue in the GATT Subsidies Code forum.<sup>39</sup>

deductions, credits, or allowances between or among such . . . businesses, if he determines that such . . . allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such . . . businesses.

I.R.C. § 482 (1976). Under the regulations to § 482:

Where one member of a group of controlled entities . . . sells or otherwise disposes of tangible property to another member of such group . . . at other than an arm's-length price . . ., the district director may make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition. An arm's-length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller.

Treas. Reg. § 1.482-2(e)(1)(i) (1983).

35. I.R.C. §§ 994(a)(1)-(3) (1976). Treas. Reg. § 1.994-1 (1983).

36. See *supra* notes 17-21 and accompanying text.

37. *Falkland Islands Crisis Preempts DISC Attack in GATT but EC Taking Hard Line*, U.S. EXPORT WEEKLY (BNA) No. 407, at 192 (May 11, 1982). The EC also requested the GATT Council to:

recognize that the circumstances characterizing this infringement of the provisions of GATT are very serious, and that the question should remain on the Council's agenda, with a view to ascertaining whether the action shortly to be taken by the United States is likely to remedy the situation, and with a view to any appropriate follow-up.

*Id.* (reprinting the text of the EC request).

38. *E.C. Calls for DISC Compensation in GATT, but U.S. Fends Off Decision Until Fall*, U.S. EXPORT WEEKLY (BNA) No. 417, at 597 (July 27, 1982).

39. Sometimes called the "centerpiece" of the Tokyo Round of Multilateral Trade Negotiations (see AGREEMENTS REACHED IN THE TOKYO ROUND OF THE MULTILAT-

## II

GATT POLICY AND THE UNITED STATES  
DEFENSE OF DISC

At the June 29, 1982 GATT Council meeting, Deputy United States Trade Representative David R. Macdonald presented the United States response to the EC opinion that the qualifier not only exonerated the tax systems of France, Belgium, and the Netherlands, but also strengthened the Panel Report's condemnation of DISC.<sup>40</sup> Macdonald neither refuted nor conceded DISC's literal nonconformity with the qualifier. Instead, he defended DISC by focusing upon the system's effect, a factor not accounted for by the qualifier.

An analysis of Macdonald's arguments demonstrates that DISC conforms with GATT policy objectives.<sup>41</sup> This fact, in light of the qualifier's condemnation of DISC, establishes that the qualifier can produce results that do not optimally promote GATT policy. In this respect, the qualifier is an improper standard by which to evaluate a tax system's GATT-legality.

## A. GATT POLICY OBJECTIVES

The preamble to the General Agreement expresses its general purposes and policy objectives. The Contracting Parties are to enter into "reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce."<sup>42</sup>

Article XVI:1 implicitly embodies the Contracting Parties' specific policy regarding the use of subsidies that might block the economic growth of the Parties. Article XVI:1 controls the use of any

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ERAL TRADE NEGOTIATIONS, H.R. DOC. No. 153, 96th Cong., 1st Sess., pt. 1 (1979)), the "negotiation . . . of a Code on subsidies/countervailing measures [(Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade, (Subsidies Code), GATT Doc. MTN/NTM/W236, reprinted in H.R. DOC. No. 153, 96th Cong., 1st Sess., pt. 1, at 257 (1979); and in GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS (26th Supp.) 56 (1980)) resulted in the] . . . writing of new international rules governing the use of subsidies . . ." Rivers & Greenwald, *The Negotiation of a Code on Subsidies and Countervailing Measures: Bridging Fundamental Policy Differences*, 11 LAW & POL'Y INT'L BUS. 1447, 1447-50 (1979).

At the April 29-30, 1982 GATT Subsidies Committee meeting, Canada accused the United States of failing to give article XVI:1 notification (*see supra* note 21) that DISC is a subsidy. The United States, speaking through United States Trade Representative general counsel Donald deKieffer, responded that DISC is not a subsidy. *EC and Canada Join Forces in Attack on U.S. DISC in GATT Subsidies Forum*, U.S. EXPORT WEEKLY (BNA) No. 406, at 139 (May 4, 1982).

40. *See* Macdonald Statement, *supra* note 8.

41. *See infra* notes 42-43 and accompanying text.

42. GATT, *supra* note 2, at Preamble.

subsidy "which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory . . . [and which causes or threatens to cause] serious prejudice to the interests of any other [C]ontracting [P]arty. . . ."43 The arguments in defense of DISC are best analyzed in light of these GATT policy objectives.

## B. ANALYSIS OF THE UNITED STATES POSITION

### 1. *Effect of DISC: Comparison with a GATT-legal Territorial System*

Macdonald's strongest argument against the EC's condemnation of DISC showed that DISC provides a lesser tax benefit to exporters than would the use of a qualifier-legitimized territorial tax system.<sup>44</sup> Using an "effects" or "level of taxation" test derived from conclusions found in the 1976 Panel Reports,<sup>45</sup> Macdonald asserted that the effect of DISC is the deferral of tax on approximately 17%<sup>46</sup> of the combined income attributable to DISC sales, and that this deferral percentage is lower than the percentage of income upon which exemption may be allowed under a territorial tax system.<sup>47</sup> He argued that DISC legislation merely attempts to counteract the adverse relative effect imposed upon United States exporters by the pre-DISC tax system,<sup>48</sup> and that DISC imposes taxes at least equal to the taxes that would be imposed if the United States operated under a territorial tax system.<sup>49</sup> Because DISC is less favorable to United States exporters than would be a qualifier-legitimized territorial tax system, then the qualifier effectively legitimizes DISC.<sup>50</sup>

This conclusion can be illustrated by a mathematical model. Under this model, X is equal to the percentage of tax on foreign source income deferred by DISC, and Y, a function of X, represents the amount of increase in exports from the United States and the extent of prejudice to the interests of other Contracting Parties, caused by the United States' use of DISC. X' is equal to the percentage of tax on foreign source income deferred by a territorial system of taxation, and Y', a function of X', represents the amount of increase in exports from the United States and the extent of prejudice to the interests of other Contracting Parties, caused by the

43. See *supra* note 21.

44. Macdonald Statement, *supra* note 8, at 8.

45. *Id.*

46. This figure is substantiated in 128 CONG. REC. S7897 (daily ed. July 1, 1982).

47. Macdonald Statement, *supra* note 8, at 5, 8.

48. *Id.* at 3-5. See also *infra* note 60-63 and accompanying text.

49. Macdonald Statement, *supra* note 8, at 5.

50. See *id.* at 4-5.

United States' use of a territorial system. According to Macdonald, DISC defers tax on 17% of foreign source income.<sup>51</sup> Thus, X is equal to 17%. Under a territorial system of taxation, more than 17% of the tax on foreign source income would be deferred.<sup>52</sup> X' is therefore greater than X.

Because the qualifier legitimizes the use of territorial systems of taxation,<sup>53</sup> an increase in United States exports and prejudice to the interests of other Contracting Parties to the extent of Y' is within the GATT-permissible limit of article XVI:1. Y', however, must be greater than Y, because (1) Y' and Y are positive functions of X' and X, respectively, and (2) X' is greater than X. Because the relevant economic effects to the extent of Y' are within the GATT-legal range, it follows that the same effects to the extent of Y are also within the GATT-legal range. Hence, DISC is within the language of article XVI:1.

In addition, article XVI:1 states that if serious prejudice to the interests of other Contracting Parties is found, the Contracting Party granting the subsidy shall, upon request, discuss with the other Contracting Parties "the possibility of limiting the subsidization."<sup>54</sup> It is difficult to see, however, how a subsidization of Y could be limited (*i.e.*, reduced) to an acceptable degree of subsidization of Y' when Y' is greater than Y.

The above analysis shows that by preferring a tax system that causes greater prejudice to the interests of other Contracting Parties than does DISC, the qualifier implicitly legitimizes DISC. An alternative conclusion that can be drawn from the qualifier's reverse preference is that the qualifier is an inappropriate standard which does not best promote GATT policy. The percentage of income deferred under DISC or any tax deferral system is directly related to the degree of economic benefit enjoyed by the country granting the deferral and to the degree of injury suffered by other Contracting Parties. Such economic benefit can manifest itself in terms of: an increase in production; an increase in the volume of export sales;<sup>55</sup>

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51. *See supra* note 46 and accompanying text.

52. *See supra* note 47.

53. *See supra* notes 7 & 26 and accompanying text.

54. *See supra* note 21.

55. In a statement before the Senate introducing his bill to supplant DISC (*see infra* note 112 and accompanying text), Senator Boren provided the following statistical analysis:

The positive impact of DISC upon U.S. exports has been significant. Increased exports attributable to DISC grew from \$1.9 billion in 1972 to almost \$7 billion in 1979. Since the enactment of DISC, U.S. nominal exports have increased from \$43 billion in 1971 to \$220 billion in 1980. During this time, export trade has become a larger component, of the gross national product, growing from 4.4 percent in 1970 to 8.2 percent in 1980.

...

positive secondary effects upon the volume of exports of complementary products; and stimulation of the economy, caused by increased employment and by positive corporate behavior changes induced by the tax incentives. When similar products are supplied by many countries, the international market becomes a closed system in which demand for products is especially responsive to price changes.<sup>56</sup> In these cases, an increase in the extent of tax deferral and hence of economic benefit granted one Contracting Party necessarily prejudices the interests of those other Contracting Parties that trade in the same or similar products. Such prejudice results from injury to the domestic market of the importing country and displacement of the exports of like products from other Contracting Parties to the importing country.<sup>57</sup>

The direct relationship between the amount of income tax a nation allows its exporters to defer and the volume of exports from that country establishes that unregulated tax deferral policies contravene the article XVI:1 goal of controlling government-induced increases in exports and avoiding the consequent prejudice to the interests of other Contracting Parties.<sup>58</sup> The qualifier's legitimization of systems which permit the deferral or exemption of a greater percentage of income than does DISC establishes that the qualifier does not best serve the GATT policy goal of promoting reciprocal trade on a mutually advantageous basis.<sup>59</sup> The qualifier prefers tax systems that, in comparison to DISC, cause greater prejudice to the interests of Contracting Parties. Instead of conceding the validity of the qualifier and attempting to defend DISC in light thereof, the United States should attack the qualifier as an inappropriate standard which ignores a tax system's effect and therefore does not optimally effect GATT policy objectives.

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According to the Treasury Department, if DISC had been eliminated, exports of non-manufactured products—mainly agricultural commodities, but not including food and kindred products, leather, and tobacco products—would have been reduced by \$200 million to \$400 million in 1979.

128 CONG. REC. S7895 (daily ed. July 1, 1982).

56. This result is exemplified by the agricultural sector, the principal user of DISC, because identical agricultural products are supplied by many countries. *Id.*

57. The Subsidies Code includes these factors in its list of adverse effects required to demonstrate serious prejudice to the interests of other signatories. Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, (Subsidies Code), GATT Doc. MTN/NTM/W236, *reprinted in* H.R. DOC. NO. 153, 96th Cong., 1st Sess., pt. 1 at 259 (1979); and in GENERAL AGREEMENT ON TARIFF AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS (26th Supp.) 56, 68 (1980).

58. *See supra* notes 42-43 and accompanying text.

59. *See supra* note 42 and accompanying text.

## 2. Purpose of DISC: to Neutralize Erosion of United States International Competitiveness

Macdonald advanced a second strong argument against the condemnation of DISC, based on the purposes embodied in DISC legislation. He justified DISC by stating that its "primary purpose was to alleviate the relative disadvantage that U.S. exporters operated under as a result of the U.S. taxation of foreign source sales income."<sup>60</sup>

Macdonald discussed in detail the background that led to the adoption of DISC. He explained how tax legislation prior to the enactment of Subpart F legislation treated foreign branches of United States corporations differently from foreign subsidiaries of United States corporations, and how this difference necessitated Subpart F legislation.<sup>61</sup> Subpart F, however, by taxing currently the foreign source sales income to the United States shareholders and thus eliminating the tax deferral, placed the United States exporters at a competitive disadvantage, relative to foreign exporters operating under a territorial system.<sup>62</sup> As Macdonald explained:

The dramatic deterioration in the U.S. international balance of trade during the late 1960s created the incentive to correct the global taxation of foreign source income subsequent to 1962 by bringing U.S. tax treatment of foreign source sales income into approximate congruence with the tax treatment available under an exemption tax system. Thus, DISC was enacted in 1971.<sup>63</sup>

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60. Macdonald Statement, *supra* note 8, at 4.

61. Under the pre-Subpart F tax system, foreign source income earned by a foreign branch of a United States corporation was regarded as income of the United States corporation and was taxed on a current basis, regardless of when repatriated from the foreign branch. The problem of international double taxation was alleviated by allowing the United States corporation a credit against its United States tax equal to the amount of tax imposed by the country in which the branch was located. In contrast, foreign source income earned by a foreign subsidiary of a United States corporation was not regarded as income of the corporation; the Internal Revenue Service recognized the separate entity status of the subsidiary. The foreign sales income was deferred until repatriated. Upon repatriation, a foreign tax credit was allowed to offset both the foreign taxes paid by the subsidiary on the earnings from which the dividend was paid and the foreign taxes paid by the dividend recipient.

This pre-Subpart F system treatment of foreign subsidiary income was similar to that under a territorial system, in that the income was not subject to United States taxation unless and until repatriated. Such treatment encouraged United States corporations with foreign sales to form "dummy" foreign subsidiaries through which they could channel products produced and sold for use outside the country in which the foreign subsidiary was located. Under this system, the United States corporation could enjoy the low tax rate of the foreign jurisdiction as long as the foreign sales income was not repatriated.

To close this "loophole," Congress enacted Subpart F legislation (I.R.C. §§ 952-964); Subpart F eliminated the deferral granted to foreign subsidiaries and treated them in a manner similar to foreign branches of a United States corporation. Macdonald Statement, *supra* note 8, at 2-4.

62. *Id.*

63. *Id.* at 4.

A tax system designed to neutralize the competitive advantages enjoyed by other nations promotes GATT objectives by attempting to create or restore reciprocity of advantage and by eliminating discriminatory treatment in international trade.<sup>64</sup> Nevertheless, strict application of the qualifier results in condemnation of such a system.<sup>65</sup> Accordingly, the United States should attack the qualifier as a standard which does not adequately effect GATT policy goals.

An extension of Macdonald's second DISC defense provides the additional argument that the qualifier is a structural limitation which ignores important functional considerations. Macdonald stated to the GATT Council that "[t]he objective of [DISC] legislation was to allow U.S. corporations to structure foreign sales activities in a comparable manner to that which existed prior to enactment of Subpart F in 1962. *The difference was one of form, rather than substance.*"<sup>66</sup>

Because the difference between DISC and pre-Subpart F taxation was one of form only, it follows that if the pre-Subpart F tax system was GATT-legal, DISC must also be GATT-legal.<sup>67</sup> The GATT-legality of the pre-Subpart F tax system can be established in the following manner. First, the Contracting Parties must have recognized in 1946 that the United States would not have entered into an agreement that would have made its existing system of taxation a violation of the treaty.<sup>68</sup> Second, the pre-Subpart F method of taxation is GATT-legal under the qualifier. The pre-1962 system taxed income earned by a foreign branch of a United States corporation on a current basis. It only deferred tax on income earned by a foreign subsidiary of a United States corporation.<sup>69</sup> This treatment is within the language of the first prong of the qualifier, which allows exemption of economic processes located outside the territorial limits of the exporting country.<sup>70</sup> Finally, it cannot be overlooked that the Contracting Parties have never issued any complaints concerning the GATT-legality of the pre-Subpart F system of taxation. Because

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64. See *supra* notes 42-43 and accompanying text.

65. See *supra* notes 31-36 and accompanying text.

66. Macdonald Statement, *supra* note 8, at 4 (emphasis added).

67. See *id.* at 3-4.

68. Long before the GATT existed, the territoriality principle . . . was a part of the tax structure of most of the nations that became the Contracting Parties. When Article XVI(4) was drafted and approved, none of the signatory governments indicated the slightest intention of disturbing these tax structures. GATT obligations are contractual, and the words of a contractual obligation should never be read to arrive at results so clearly at odds with the parties' intentions.

Hudec, *GATT Dispute Settlement After the Tokyo Round: An Unfinished Business*, 13 CORNELL INT'L L.J. 145, 165 n.61 (1980). Similarly, it can be argued that the pre-Subpart F system was "grand-fathered" by the General Agreement.

69. See *supra* note 61.

70. See *supra* note 24 and accompanying text.



pre-Subpart F legislation is GATT-legal in light of the qualifier, and DISC, which differs from such legislation in form only, is not GATT-legal, the qualifier itself appears to be a semantic limitation of form, not substance.

### 3. *United States Source of Income Rules*

Macdonald's third argument against DISC condemnation compared the amount of taxable income deferred under DISC to the foreign source portion of taxable income from export sales, determined under United States source of income rules.<sup>71</sup> Section 863(b) of the Internal Revenue Code<sup>72</sup> provides that income from the sale of property produced in the United States and sold in a foreign country must be allocated to or apportioned between the United States and the foreign country.<sup>73</sup> Thus, an application of section 863(b) results in exemption from taxation of the foreign source portion of export sales income. Because the qualifier permits exporting countries to exempt from taxation economic processes that occur outside the territory of the country, section 863(b) is consistent with the qualifier's interpretation of article XVI:4.<sup>74</sup>

By employing an effects test, Macdonald attempted to establish that DISC is more favorable to the trading partners of the United States than section 863(b), which the qualifier legitimizes.<sup>75</sup> "In most cases, the foreign source portion of the taxable income from an export sale, determined under the section 863(b) rules, would equal or exceed the portion of the combined taxable income of a parent corporation and its DISC on an export sale which would be subject to a deferral of tax under the present DISC rules."<sup>76</sup> Thus, the qualifier legitimizes section 863(b) and condemns DISC, even though sec-

71. Macdonald Statement, *supra* note 8, at 6-8.

72. I.R.C. § 863(b) (1976). *See also* Treas. Reg. § 1.863-2 (1983).

73. Where a factory or production price to wholly independent distributors or other concerns may be established, the taxable income attributable to the United States is computed by reference to such independent factory price. Where an independent factory price may not be established, the taxable income from such sales is first determined by deducting from the gross income from the sale the expenses, losses, or other deductions properly allocated and apportioned to such income. One-half of the taxable income is then apportioned between the United States and the foreign country in accordance with the value of the taxpayer's property subject to the section 863(b) allocation in the United States and in the foreign country. The other one-half of the taxable income is apportioned between the United States and the foreign country in accordance with the taxpayer's gross sales subject to section 863(b) allocation within the United States and such gross sales in the foreign country.

Macdonald Statement, *supra* note 8, at 7.

74. *Id.* at 6-8.

75. *Id.* at 7-8.

76. *Id.*

tion 863(b) causes greater prejudice to the interests of other Contracting Parties. In this respect, the qualifier does not best serve GATT's policy of guarding against such prejudice.<sup>77</sup> By emphasizing the technical question whether the economic activity is within or without the territorial limits of the exporting country, and excluding any consideration of the effect of the tax system, the qualifier produces results which are unrelated to the important policy issues underlying GATT-legality determinations.

#### 4. *Global v. Territorial Systems of Taxation*

Macdonald reminded the GATT Council that the 1976 Panel Report compared the effect of DISC to that of a global system of taxation and that the qualifier shifted the focus of legitimacy from global to territorial systems. Accordingly, he argued, the effect of DISC can be determined only in comparison to territorial systems of taxation.<sup>78</sup> He then reminded the GATT Council of the previously uncontested United States statement that the United States collects more taxes under DISC than it would collect under a GATT-legal territorial system.<sup>79</sup>

As previously demonstrated, a system's level of taxation inversely affects article XVI:1 considerations such as the degree of prejudice to the interests of other Contracting Parties and the increase in exports from or the decrease in imports into the exporting country.<sup>80</sup> Thus, the uncontested United States statement suggests that DISC better serves the intent of article XVI:1 than does a qualifier-sanctioned territorial system.

Extending this fourth argument to its extreme illustrates the inappropriateness of the qualifier. Assume that the United States enacted a strictly territorial tax system which exempted from United States taxation 100% of the income from export activities located outside the territory of the United States. As long as such a system required arm's-length pricing, the system would be a GATT-legal method of avoiding double taxation of foreign income.<sup>81</sup> In contrast, assume that Congress amended DISC legislation to reduce the tax benefits from the present effective level of 17% deferral of tax to an effective deferral of only 1%. Because of the qualifier's territorial focus, this amended DISC legislation would still violate GATT. In terms of the intent of article XVI:1, however, the GATT-legal total

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77. See *supra* note 43 and accompanying text.

78. Macdonald Statement, *supra* note 8, at 8.

79. *Id.*

80. See *supra* notes 55-59 and accompanying text.

81. Such a system would be impractical, however, because of the great strain it would impose upon the Treasury, in terms of lost tax revenue.

exemption system would prejudice the interests of other Contracting Parties more than would the greatly weakened GATT-illegal DISC system.<sup>82</sup>

Rather than condemn a system that would cause greater injury to the interests of other Contracting Parties, the qualifier condemns the alternative system that would better promote the goals of article XVI:1. By focusing upon structural rather than functional considerations, the qualifier cannot optimally further the functional objectives of the General Agreement.

### 5. *The Best Defense is a Good Offense*

Macdonald concluded his defense of DISC by attacking the tax systems of France, Belgium, and the Netherlands.<sup>83</sup> After stating that “[w]hat is sauce for the goose, must be sauce for the gander,”<sup>84</sup> Macdonald condemned France and the Netherlands for employing a global system for losses and a territorial system for profits.<sup>85</sup> By employing a global system for losses, France and the Netherlands allow taxpayers to take advantage of increased loss deductions to offset domestic profits.<sup>86</sup> Thus, although one of the aims of the General Agreement is to achieve “mutually advantageous arrangements,”<sup>87</sup> the qualifier legitimizes the tax systems of two nations whose loss treatment increases the degree of competitive advantage they already enjoy.

If the qualifier examined the effect of tax systems instead of simply adhering to structural guidelines, its scope would not be deficient with respect to the tax treatment of losses. Rather, the qualifier would automatically factor into consideration any relevant feature of a tax system. The qualifier presently is deficient in scope, however, and thus is ineffective in protecting the Contracting Parties from the prejudice of harmful subsidies.

Macdonald concluded by attacking Belgium for providing safe haven levels of taxation on exports, similar to those provided by DISC.<sup>88</sup> The GATT Council’s refusal to consider the validity of Macdonald’s attack upon Belgium suggests that the qualifier’s distinction between GATT-legal and GATT-illegal tax systems is purely semantic. Although the Belgian and United States tax sys-

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82. See *supra* notes 42-43 and accompanying text.

83. Macdonald Statement, *supra* note 8, at 9.

84. *Id.* at 8.

85. *Id.* at 9.

86. Because world-wide profits are not subject to tax under a territorial system, the increased loss deductions arising from recognition of world-wide losses are deducted against domestic profits. See *supra* note 7.

87. See *supra* text accompanying note 42.

88. Macdonald Statement, *supra* note 8, at 9.

tems are demonstrably similar, the Belgian system is GATT-legal because it is a territorial system and is therefore squarely within the language of the qualifier. Conversely, the United States system is GATT-illegal because it is not within the language of the qualifier. By applying a standard that looks only to the form of a tax system and not to its substance, the GATT Council relies too heavily upon the semantics of its rigid guidelines, at the expense of GATT policy.

#### 6. *A Proposed Sixth Defense*

In each case in which Macdonald advanced an otherwise meritorious defense of DISC, the qualifier nullified the defense. The qualifier, in focusing upon structural rather than functional considerations, produces results that ignore GATT policy objectives. The United States should defend DISC on the ground that the GATT Council's qualifier is invalid.

Further, the United States should propose a modification to the qualifier so that it would better serve GATT policy. While retaining the requirement of arm's-length pricing and acceptance of measures designed to avoid double taxation of foreign source income, the modified qualifier should discard the structural distinction between economic processes located within and without the territory of an exporting country. Instead, the modified qualifier should include a level of taxation test which would monitor the effect of the tax system upon the economic interests of other Contracting Parties. Such a modification would produce results that would better promote GATT policy goals. Until the United States contests the validity of the present qualifier, the qualifier will continue to condemn DISC.

### III

#### ALTERNATIVES TO DISC

A literal application of the qualifier does not relieve DISC of the 1976 Panel Report's finding of GATT violations.<sup>89</sup> This result, combined with increased pressure from the EC,<sup>90</sup> apparently forced the United States to concede; in the fall of 1982, President Reagan made a commitment before the GATT Council to propose legislation that would address the concerns regarding the GATT-legality of DISC.<sup>91</sup> Accordingly, a number of tax systems have been proposed to replace it.

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89. See *supra* notes 31-36 and accompanying text.

90. See *supra* notes 37-39 and accompanying text.

91. See *supra* text accompanying note 10.

In analyzing the proposed DISC alternatives,<sup>92</sup> several features should be considered. Most importantly, if the Contracting Parties continue to adhere to the qualifier, the replacement of DISC must meet the qualifier's requirements.<sup>93</sup> The new tax system also should provide United States exporters with benefits similar to those they enjoy under DISC, so as to continue to neutralize, in the aggregate, the competitive advantage enjoyed by other nations. Finally, the new tax system should not decrease the amount of revenue collected by the United States Treasury. The ideal DISC replacement would thus satisfy the qualifier and would be benefit- and revenue-neutral.

## A. INTERNATIONAL SALES CORPORATION

### 1. Description

On December 11, 1981, Representatives Bill Frenzel and Sam Gibbons introduced the International Sales Corporation (ISC) Tax Act of 1981.<sup>94</sup> An ISC is defined as a foreign corporation that would operate as a subsidiary through which the export activity of its United States parent could be channeled.<sup>95</sup> The income of an ISC would be subject to taxation by the foreign jurisdiction in which the ISC was located<sup>96</sup> and no foreign tax credit would be allowed.<sup>97</sup> Dividends actually received by an ISC's United States shareholders would be fully deductible.<sup>98</sup>

ISC rules governing intercompany pricing<sup>99</sup> and qualification for ISC treatment<sup>100</sup> would be similar to their DISC counterparts.

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92. The proposals are presented in chronological order. Although some of the early proposals may no longer be under serious consideration, they are included for historical perspective and comparative purposes.

93. For the purpose of this Note, it is assumed that the qualifier adopted by the GATT Council, *see supra* notes 24-25 and accompanying text, and not the modified qualifier suggested herein, is the standard by which the Contracting Parties will evaluate proposed DISC alternatives. Accordingly, this Note analyzes such alternatives in light of the GATT Council's qualifier. In discussing the revenue effect of the alternatives, however, this Note indirectly performs a modified qualifier analysis. The revenue effect of a tax system is related to its effect upon the economic interests of other Contracting Parties. If, for example, a system is not revenue neutral because it results in a significant loss to the United States Treasury, such loss signifies a corresponding gain (in the form of tax benefits) to United States exporters. These tax benefits strengthen the international competitiveness of the United States exporters, at the expense of other Contracting Parties. Thus, an examination of a tax proposal's revenue effect implicitly includes an analysis of the effect of the proposal upon the economic interests of other Contracting Parties. Consideration of such effect is the essence of the modified qualifier.

94. H.R. 5179, 97th Cong., 1st Sess. (1981).

95. The bill defines a foreign corporation as a corporation that is not incorporated under the laws of any State or the Commonwealth of Puerto Rico. *Id.* § 2(a), at 2.

96. *Id.* § 2(a), at 3.

97. *Id.* § 2(c), at 14-15.

98. *Id.* § 2(b), at 13-14.

99. *Id.* § 2(b), at 12-13.

100. *Id.* § 2(a), at 2-7.

An ISC would not be allowed to have more than one class of stock or more than four related shareholders.<sup>101</sup>

Unlike its successor, the ESC proposal,<sup>102</sup> ISC would require the repeal of DISC,<sup>103</sup> thereby precluding a corporation from operating both a DISC and an ISC. If a DISC shareholder transferred qualified export assets of the DISC to an ISC, no gain or loss would be recognized by the shareholder, the DISC, or the ISC.<sup>104</sup> Any accumulated DISC earnings and profits transferred to an ISC would increase the earnings and profits of the ISC, and would be considered qualified export receipts for the purpose of ISC qualification requirements.<sup>105</sup>

## 2. Analysis

The proposed ISC legislation only partially satisfies the qualifier. Because an ISC would be a foreign corporation located outside the territorial limits of the United States, its "economic processes . . . need not be subject to taxation by the [United States]. . . ."<sup>106</sup> Therefore, the ISC proposal's purpose and method of avoiding double taxation of foreign source income are permissible under the qualifier.<sup>107</sup> ISC's intercompany pricing rules, however, are identical to those of DISC, which violate the qualifier's requirement that transactions between an exporter and its related foreign buyer be at arm's-length.<sup>108</sup> Accordingly, to be GATT-legal, the ISC proposal would have to be revised to require arm's-length intercompany pricing.

Although ISC could be amended to conform to the qualifier, its increased revenue cost threatens its viability as an alternative to DISC.<sup>109</sup> Because ISC shareholders would be allowed a 100% deduction for dividends actually received,<sup>110</sup> the proposal is not revenue-neutral. The United States would lose a share of the revenue that it would otherwise receive under DISC. In addition, the limit

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101. *Id.* § 2(a), at 3.

102. *See infra* notes 112-26 and accompanying text.

103. H.R. 5179, 97th Cong., 1st Sess. § 2(d), at 15 (1981).

104. *Id.* § 4, at 16-17.

105. *Id.*

106. *See supra* note 24.

107. *Id.*

108. *See supra* notes 24, 33-35 & 99 and accompanying text.

109. Macdonald stated that switching to a truly territorial system, like that of European and many other countries, "would be great for our exporters, but unfortunately, it would cost Treasury, it has been estimated, a couple of billion dollars at least." *USTR Suggests Plan to Change DISC to Make It More Compatible with the GATT*, U.S. EXPORT WEEKLY (BNA) No. 418, 622, 623 (Aug. 3, 1982).

110. *See* text accompanying note 98.

upon the number of related shareholders permitted to own an ISC<sup>111</sup> would unnecessarily discourage small exporters from enjoying ISC benefits. Thus, in light of its nonconformity with the qualifier and, more importantly, its heavy revenue cost, ISC legislation does not appear to be a feasible alternative to DISC. Its strict territoriality would impose too great a burden upon the United States Treasury.

## B. EXPORT SALES CORPORATION

### 1. Description

On July 1, 1982, Senate Finance Committee member David L. Boren introduced the Export Sales Corporation (ESC) Act of 1982.<sup>112</sup> An ESC is defined as a foreign corporation that would function as a subsidiary through which the parent United States exporter could perform export activities.<sup>113</sup> The income of an ESC would be subject to taxation by the foreign jurisdiction and not by the United States.<sup>114</sup> The United States shareholders of the ESC, however, would be deemed to have received annually 100% of the taxable income of the ESC as taxable dividends.<sup>115</sup> The dividends received deduction<sup>116</sup> would be limited to the percentage required to hold constant the revenue cost to the United States Treasury.<sup>117</sup> No credit or deduction would be allowed for foreign taxes paid or deemed paid by an ESC or by an ESC shareholder for dividends paid by the

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111. See text accompanying note 101.

112. 128 CONG. REC. S7895 (daily ed. July 1, 1982). A section-by-section analysis of the bill is reprinted at 128 CONG. REC. S7897-98 (daily ed. July 1, 1982).

113. Section-by-Section Analysis of S.2708, 97th Cong., 2d Sess., 128 CONG. REC. S7897, at §§ 2.1, 2.2 (daily ed. July 1, 1982) [hereinafter cited as Section-by-Section Analysis of S.2708]. An ESC may be established in any United States possession, other than Puerto Rico, which is within the customs territory of the United States. *Id.* § 2.1.

114. *Id.* §§ 2.1, 2.3.

115. *Id.* § 2.3.

116. Under the general rule, dividends received by a corporation are fully deductible if the recipient is a member of the same affiliated group as the distributor or if the recipient is a small business investment company. In all other cases, the deduction is limited to 85%. See I.R.C. § 243 (1976) (specifying deductibility of dividends received by corporations).

117. The dividends received deduction percentages would be derived from Treasury Department data, as follows:

ESC.<sup>118</sup>

To qualify as an ESC, a corporation would have to limit its activities to the export of American products and related services.<sup>119</sup> The corporation also would have to meet a gross assets and gross receipts test almost identical to that imposed upon DISCs.<sup>120</sup> Intercompany pricing rules similar to those contained in DISC legislation would govern transactions between an ESC and its parent.<sup>121</sup>

Unlike DISC, the ESC Act would allow smaller exporters to take advantage of the favorable tax treatment.<sup>122</sup> The ESC proposal authorizes the Secretary of the Treasury to promulgate regulations permitting multiple ownership of ESCs by unrelated shareholders.<sup>123</sup> Shareholders who previously could not establish DISCs by themselves would thus be able to combine resources to establish ESCs. Benefits would accrue to each shareholder in proportion to the vol-

	1983	1984	1985	1986
<u>Calendar Year</u>				
Revenue Cost (millions)				
current law .....	\$1,770	\$1,830	\$1,890	\$1,960
ESC proposal with 30 percent div. rec. deduction .....	\$1,650	\$1,777	\$1,920	\$1,073
Additional rev. cost .....	(\$120)	(\$53)	\$ 30	\$ 113
Percentage required to hold rev. cost constant .....	32.17	30.89	29.54	28.36
<u>Fiscal Year</u>				
Revenue Cost (millions)				
current law .....	\$1,730	\$1,810	\$1,870	\$1,930
ESC proposal with 30 percent div. rec. deduction .....	\$1,613	\$1,758	\$1,899	\$2,041
Additional rev. cost .....	(\$117)	(\$52)	\$ 29	\$ 111
Percentage required to hold rev. cost constant .....	32.17	30.89	29.54	28.36

128 CONG. REC. S7897 (daily ed. July 1, 1982) (introductory remarks of Sen. Boren).

118. Section-by-Section Analysis of S. 2708, *supra* note 113, at § 2.4.

119. *Id.* § 2.2.

120. *Id.*

121. *Id.* § 2.6.

122. Rep. Henry Nowak (D., N.Y.), Chairman of the Subcommittee on Tax, Access to Equity Capital and Business Opportunities (of the House Small Business Committee), stated that increasing export opportunities for smaller firms would expand the economic base nationally and in particular would help older urban centers. The Subcommittee estimated that there are approximately 20,000 small companies that, given the proper tax incentive, could begin exporting profitably. Schwartz, *Proposal to Replace DISC Gains Stature*, AMERICAN METAL MARKET, Oct. 26, 1982, at 18.

123. Section-by-Section Analysis of S. 2708, *supra* note 113, at § 4.



ume of exports channeled through the ESC.<sup>124</sup>

DISC shareholders desiring to change their DISCs to ESCs could transfer the assets and earnings of the DISC to an ESC in a tax-free exchange.<sup>125</sup> A corporation would not be allowed, however, to have both a DISC and an ESC as subsidiaries.<sup>126</sup>

## 2. Analysis

In his presentation to the Senate, Senator Boren stated:

The GATT-legality problem [of DISC taxation] would be solved by providing for the establishment of ESC's in a U.S. territory or foreign country that imposes taxes. The ESC would then stand in the same shoes as similar companies utilized by Japanese, Dutch, French, and English exporters. While the DISC is viewed by some as an illegal trade subsidy, the ESC, under GATT precedents, would be a permissible means of avoiding double taxation of foreign income.<sup>127</sup>

Boren's assertion that his territorial proposal is GATT-legal under GATT precedents is only partially correct. Because an ESC would be located outside the territorial limits of the United States, the qualifier would permit the United States to exempt from taxation the economic processes of an ESC without violating article XVI:4.<sup>128</sup> In addition, the ESC proposal's purpose of avoiding double taxation of foreign source income is permissible under the qualifier.<sup>129</sup> By departing from the qualifier's requirement that pricing between a parent and its foreign subsidiary be at arm's-length,<sup>130</sup> the proposed ESC legislation violates the qualifier. ESC intercompany pricing rules, in part, are identical to those of DISC, which violate the qualifier's arm's-length requirement.<sup>131</sup> Thus, in order to establish a system that would accord with the qualifier, Boren should revise the proposed ESC Act to require arm's-length pricing.

In addition to the change necessary to satisfy the qualifier, the ESC proposal should be amended to ensure that the taxation of ESCs would be benefit- and revenue-neutral. Under DISC, an exporter's tax benefit is related to the amount of DISC income it

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124. 128 CONG. REC. S7895 (daily ed. July 1, 1982) (introductory remarks of Sen. Boren).

125. Section-by-Section Analysis of S. 2708, *supra* note 113, at S7897-98, at § 5.

126. *Id.* at S7897, at § 2.5. According to Senator Boren, most exporters will want to use the new ESC provisions. As a result, the legality of DISC under GATT will become moot. *See* 128 CONG. REC. S7897 (daily ed. July 1, 1982) (introductory remarks of Sen. Boren).

127. 128 CONG. REC. S7897 (daily ed. July 1, 1982) (introductory remarks of Sen. Boren).

128. *See supra* note 24.

129. *Id.*

130. *Id.*

131. *See supra* notes 33-35 and accompanying text.

generates, and is unaffected by the activity of its competitors.<sup>132</sup> In contrast, the ESC Act would establish in advance the total amount of allowable relief. The appropriate dividends received deduction percentage would then be calculated as that percentage which, when applied to all ESC income, would grant the aggregate amount of predetermined allowable relief and thus would hold the revenue cost constant.<sup>133</sup> If the number of exporters electing ESC status increased, the benefit accruing to each ESC would necessarily decrease, in order to hold constant the aggregate revenue cost. In addition, the probability that the ESC Act would attract small exporters, for whom DISC qualifications are too burdensome,<sup>134</sup> threatens to decrease further the benefits available to taxpayers under ESC taxation. Hence, the derivative calculation of ESC relief is unlikely to result in benefit-neutrality.

ESC's derivation of the dividends received deduction percentage from estimates of DISC revenue additionally jeopardizes the proposal's benefit- and revenue-neutrality. If, for example, the Treasury Department's estimates of DISC revenue cost are high, the ESC Act would apply an erroneously large dividends received deduction percentage to ESC income, thereby destroying ESC's revenue-neutrality. Similarly, if estimates are low, the system would not be benefit-neutral; an erroneously small dividends received deduction would cause each ESC to owe more tax than it would otherwise owe under DISC.

To avoid these problems, the ESC system's backward-looking aggregate dividends received deduction percentage adjustment should be replaced by a forward-looking individual determination. Instead of applying the derived dividends received deduction percentage "across the board," the legislation should provide that the appropriate percentage be determined on an individual basis. Each ESC should be required to limit its dividends received deduction to the percentage that would result in its owing the same amount of tax that it would owe under DISC.<sup>135</sup> This percentage would be derived from actual, not estimated, data.

Under ESC, as modified above, the system would be GATT-

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132. The DISC system does not predetermine the amount of tax relief available. *See supra* note 1.

133. *See supra* note 117 and accompanying text.

134. *See supra* notes 122-24 and accompanying text.

135. Such a percentage could be provided by the Internal Revenue Service, using a pre-calculated tax table, reading: "If your taxable ESC income is column A, then your dividends received deduction is limited to the percentage in column B." The table of percentages could be calculated in the same manner as that which derived the standard ESC percentages, *see supra* note 117, but actual individual data, as opposed to estimated aggregate data, would be used.

legal, revenue-neutral,<sup>136</sup> and benefit-neutral. Moreover, unlike DISC, the ESC proposal would not require companies to reinvest the income on which the tax benefit is granted.<sup>137</sup> In this respect, ESC benefits would be more attractive than DISC benefits, because their use would be unrestricted.

### C. MACDONALD PROPOSAL

#### 1. Description

On July 27, 1982, Deputy United States Trade Representative Macdonald proposed a revenue-neutral, quasi-territorial system as an alternative to DISC.<sup>138</sup> Under his proposal, United States companies with DISCs would pay the taxes that are currently deferred under DISC.<sup>139</sup> The companies would then receive a credit against foreign source income equal to the amount that previously would have been deferred under DISC.<sup>140</sup> "In this way, the tax benefit of the DISC would be eliminated and replaced with an equivalent tax benefit related to income from economic processes located outside the territorial limits of the United States."<sup>141</sup> The DISC would continue to operate, for accounting purposes, in order to identify the amount of the tax credit that the companies would receive against the foreign income.<sup>142</sup>

#### 2. Analysis

Macdonald's proposal arguably violates the qualifier. The first prong of the qualifier assesses a tax system's GATT-legality by reference to the *source* of the income upon which tax relief is granted, not the *method* of granting relief.<sup>143</sup> Although Macdonald's proposed system would grant tax relief through the use of a foreign source

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136. The individual determination of the benefit-neutral dividends received deduction percentage would ensure an individually revenue-neutral system. A system that is revenue-neutral on an individual basis must also be neutral in the aggregate. (The converse, however, is not always true.)

137. Under DISC, the deferral of tax operates as an interest-free loan. The accumulated DISC income upon which the deferral is granted must be reinvested, however, usually either in qualified export assets or in the form of producer's loans. I.R.C. §§ 993(b)(5), 993(d) (1980).

138. *USTR Suggests Plan to Change DISC to Make It More Compatible with the GATT*, U.S. EXPORT WEEKLY (BNA) No. 418, at 622-23 (Aug. 3, 1982). Macdonald emphasized that his proposal belongs only to the Office of the United States Trade Representative, and is not an official policy of the Reagan Administration.

139. *Id.* at 622.

140. *Id.* at 622-23.

141. Office of the United States Trade Representative, Summary of Ambassador Macdonald's July 27 News Briefing on DISC 2 (July 29, 1982) (on file at the offices of the CORNELL INTERNATIONAL LAW JOURNAL).

142. *Id.*

143. See *supra* note 24.

income tax credit, as opposed to a DISC tax deferral, the income source would still be economic processes arising from a DISC.<sup>144</sup> As a DISC's domestic incorporation precludes DISC legislation from falling within the qualifier's exemption of economic processes which occur outside the territory of the exporting country,<sup>145</sup> the failure of the Macdonald proposal to require incorporation outside the United States similarly causes the proposal to violate the first prong of the qualifier. In addition, by using DISC rules to determine the amount of tax benefit, Macdonald's proposal retains DISC's non-arm's-length pricing feature.<sup>146</sup> The proposal thus violates the second prong as well.

Macdonald's proposal is, however, revenue- and benefit-neutral. Unlike the ISC and ESC proposals, Macdonald's proposal would exempt from taxation the amount of tax that DISC presently defers. In addition, like the ESC proposal,<sup>147</sup> Macdonald's proposed system does not require companies to reinvest the income on which the tax benefit is provided, thus allowing each company to use that income in its most efficient manner.<sup>148</sup>

#### D. FOREIGN TRADING COMPANY INCOME

##### 1. Description

On March 2, 1983, the Cabinet Council on Commerce and Trade (CCCT) approved the Foreign Trading Company Income (FTI) proposal submitted to it by the Treasury Department, the Office of the United States Trade Representative, and the Department of Commerce.<sup>149</sup> The proposal would require a United States exporter to perform export activity through its offshore entity, which must be a foreign corporation.<sup>150</sup> To qualify for the exemption from

144. See *supra* notes 139-40 & 142 and accompanying text.

145. See *supra* notes 31-32 and accompanying text.

146. See *supra* notes 33-35 and accompanying text.

147. See *supra* note 137 and accompanying text.

148. *Id.*

149. *Administration Unveils Tax Alternative to Domestic International Sales Corporation (DISC)*, [1983] 10 STAND. FED. TAX REP.(CCH) ¶ 6157, at 70,868 (Mar. 16, 1983) [hereinafter cited as *Administration's Proposal*].

150. The foreign export sales corporation must be incorporated outside U.S. territory. This requirement reflects the GATT rule that countries need not tax export income from economic processes occurring outside their territorial limits. . . .

For the purposes of this proposal, the U.S. territories of Guam, the Virgin Islands, and the Northern Mariana Islands will be considered outside the territory of the United States. This definition conforms to the definition of territory as customs territory used in the GATT. Additionally, the foreign sales corporation can only be located in a territory or country which has an exchange of information agreement with the United States.

*Id.* §§ I, V, at 70,869-70,870.

taxation on a portion of its income from export sales (its FTI),<sup>151</sup> the foreign corporation would be required to: (1) maintain an office outside the United States, (2) maintain its books and records in the foreign office, (3) have at least one resident director in the foreign office, (4) have an agency agreement or distribution license with respect to the exported product, and (5) solicit and process orders, negotiate contracts, bill customers, and receive payment outside the United States.<sup>152</sup> These foreign presence requirements were designed to satisfy the first prong of the qualifier which allows exemption from taxation of income from economic processes located outside the territory of the exporting country.<sup>153</sup>

A qualifying foreign corporation would not be subject to United

151. FTI is defined as income (including both profits and commissions) derived in connection with foreign trading gross receipts. 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 which is used by the lessee outside the United States;
- c. the performance of services which are related and subsidiary to the sale, exchange, lease, rental, or other disposition of export property by the foreign corporation;
- 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.

"Export property" generally means property manufactured, produced, grown, or extracted in the United States for direct use, consumption, or disposition outside the United States.

*Id.* § II, at 70,869.

152. *Id.* § IV. In response to adverse business reactions, the Administration made the fifth requirement more flexible. The proposal states that some or all of the functions listed in requirement (5) may be performed by the foreign corporation or for it on a contract basis. "If . . . U.S. exporters as part of their normal business practice perform other significant activities outside the United States, consideration will be given to substituting those for some or all of the functions listed in [item (5)]." *Id.* These "other significant activities" include:

- a. disbursement of export related advertising expenses;
- b. maintenance of separate bank account;
- c. maintenance of paid in capital;
- d. holding directors' meetings;
- e. holding shareholders' meetings;
- f. disbursement of dividends;
- g. disbursement of legal fees;
- h. disbursement of accounting fees;
- i. disbursement of officers' salaries;
- j. disbursement of directors' salaries;
- k. communicating with the general public; and
- l. transfer of title.

*Id.*

153. *Id.* § IV, at 70,869-70,870. "It should be noted, however, that these foreign presence requirements do not prevent a foreign corporation from maintaining an office in the United States, or from concluding contracts to have activities performed on its behalf in the United States." *Id.*

States taxation on a portion of its FTI.<sup>154</sup> The tax exempt portion of FTI would be determined under arm's-length transfer pricing principles.<sup>155</sup> Income from export sales would be allocated between the foreign corporation and the related United States company on the basis of an allocation rule designed for administrative convenience to approximate arm's-length pricing.<sup>156</sup> This administrative allocation would be equal to the greater of: (a) 17% of the combined taxable income earned by the United States manufacturer and foreign sales corporation; or (b) 1.35% of the foreign corporation's gross sales, not to exceed 34% of the combined taxable income.<sup>157</sup> As an alternative, taxpayers could determine the allocation of income under the current Internal Revenue Code arm's-length transfer price rules.<sup>158</sup> Regardless of the allocation method elected by the taxpayer, the tax exempt portion of FTI would not be included in the income of a United States shareholder for the purpose of Subpart F taxation.<sup>159</sup> The United States shareholder would be allowed a 100% dividends received deduction for dividends actually received from the tax exempt FTI.<sup>160</sup>

The FTI proposal would accommodate small exporters, for whom the offshore presence requirements might be too burdensome. Small businesses would be given the option of either continuing to operate their DISCs and paying an interest charge on the value of their tax deferral,<sup>161</sup> or participating in jointly-owned foreign sales corporations.<sup>162</sup>

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154. *Id.* § IV, at 70,869.

155. *Id.* § III.

156. *Id.*

157. *Id.*

158. *Id.* See *supra* note 34.

159. *Administration's Proposal, supra* note 149, at § VI, at 70,870. For a discussion of Subpart F, see *supra* notes 61-62 and accompanying text.

160. *Administration's Proposal, supra* note 149, at § VI, at 70,870. "The dividends received deduction will be in lieu of a foreign tax credit. Other earnings will remain subject to the existing U.S. tax regime, including the subpart F and foreign tax credit rules." *Id.* For a discussion of the dividends received deduction, see *supra* note 116.

161. *Administration's Proposal, supra* note 149, at § IXa.

Under this alternative, exporters would be allowed to continue to operate their DISC's for sales of up to \$10 million. An annual deductible interest charge would be imposed on the value of the tax deferral at the Treasury bill rate. The current pricing rules would remain in effect, but the deemed distribution and incremental provisions would be eliminated. Thus, up to 100 percent of the DISC income covered by this alternative could be deferred. This would be necessary to make the approach attractive in light of the additional cost associated with the interest charge.

*Id.*

162. *Id.* § IXb.

## 2. Analysis

The Treasury Department proposal satisfies the qualifier. The foreign incorporation and substantial foreign presence requirements that a company would have to meet to qualify for FTI treatment satisfy the qualifier's first requirement that tax exempt income be from economic processes located outside the United States.<sup>163</sup> A company's allocation of income on the basis of either the safe harbor approximations of an arm's-length transfer price or a transfer price determined under section 482 rules complies with the qualifier's second requirement that an exporter treat its related foreign buyers at arm's-length.<sup>164</sup> Finally, the system's objective of avoiding double taxation is explicitly permitted by the qualifier.<sup>165</sup>

The revenue-neutrality of the FTI proposal is ensured by a combination of the income allocation rules and section VII of the proposal, entitled "Revenue Neutral Cap on the Tax Exempt Benefit."<sup>166</sup> "The CCCT specified that the proposed alternative should cost no more than the DISC in terms of lost tax revenue."<sup>167</sup> The proposal establishes a tax benefit ceiling of: (1) 34% of the combined taxable income of the foreign corporation and its related supplier, if the taxpayer uses the safe harbor allocation rule; or (2) 34% of the foreign corporation's FTI, if the taxpayer determines its transfer prices under section 482 or purchases its goods from unrelated parties.<sup>168</sup>

Because the cost to the Treasury is directly related to the benefit to all exporters, a system that is revenue-neutral must be benefit-neutral, in the aggregate. Individual benefit-neutrality, however, depends upon an exporter's profit expectation and current cash flow position. For example, an exporter in need of funds in year one, but not expecting substantial profits until years two through ten, might prefer in year one a higher DISC tax deferral to a lower FTI tax exemption. In most cases, however, the FTI system would provide United States exporters with the same basic tax benefits they receive under DISC.<sup>169</sup> In addition, in contrast to DISC benefits, the FTI exemption would provide a source of immediately available funds to

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163. *See supra* note 24.

164. *Id.*

165. *Id.*

166. *Administration's Proposal, supra* note 149, at § VII, at 70,870.

167. *Id.*

168. *Id.*

169. Lawrence, *Tax Program for Exports To Replace DISC Outlined*, *The Journal of Commerce*, March 10, 1983, at 23B, col. 1-2 (citing statement of United States Trade Rep. William Brock).

taxpayers.<sup>170</sup>

A major disadvantage of the FTI proposal, however, is that the foreign presence requirements that a company would have to satisfy to qualify for FTI treatment would place substantial burdens upon such qualifying companies. Some members of the business community believe that the offshore sales activity requirements would demand "a heavy commitment of a company's sales force and could have the effect of 'exporting jobs.'"<sup>171</sup>

As foreign incorporation alone arguably satisfies the first prong of the qualifier,<sup>172</sup> FTI's substantial foreign presence requirements are unnecessary to ensure that the proposal will not violate GATT. Maintenance of books and records in a foreign office staffed by one resident director<sup>173</sup> is a requirement which is unrelated to the important issues that underlie the acceptability of export tax incentives in the international community. The Contracting Parties would probably place greater emphasis upon the volume of goods exported than upon the location and contents of the exporter's office. Likewise, the requirement that the foreign corporation have an agency agreement or distribution license with respect to the exported product<sup>174</sup> is a paper requirement which is unrelated to the goal of protecting the interests of the Contracting Parties. The first four foreign presence requirements are mere "window dressing" which elevate form over substance.

The fifth requirement that a company conduct certain of its business activities outside the United States is also unnecessary. The requirement can be satisfied if the activities are performed not *by* the foreign corporation, but *for* it on a contract basis.<sup>175</sup> Accordingly, this requirement, as are the first four foreign presence requirements, is a technicality which is unrelated to the policy concerns of the Contracting Parties. Indeed, the Treasury Department itself is unsure of the necessity under GATT of this required activity.<sup>176</sup>

Analogous to the United States "minimum contacts" jurisdictional requirement,<sup>177</sup> the foreign presence requirements of the pro-

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170. The proposal eliminates conditions of the tax benefit such as the requirement under DISC that tax deferred income be invested in certain assets. *See supra* note 137.

171. *See Treasury Weighs Increasing Its Offshore Requirement for Firms in DISC Substitute*, 18 U.S. EXPORT WEEKLY (BNA) No. 20, at 786 (Feb. 22, 1983). Another critic responded to the proposal, "If a company has to expend this much effort [to get the benefits], they might as well just move offshore." *Id.*

172. *See supra* notes 24 & 150.

173. *See* requirements (1)-(3), *supra* text accompanying note 152.

174. *See* requirement (4), *supra* text accompanying note 152.

175. *See supra* note 152.

176. *See supra* note 153.

177. *See generally* Clermont, *Restating Territorial Jurisdiction and Venue for State and Federal Courts*, 66 CORNELL L. REV. 411, 415-16 (1981). In questions of a state's exercise



posal should be necessary to satisfy GATT only if a company is not incorporated abroad. Because the FTI proposal does require foreign incorporation,<sup>178</sup> however, the burdensome foreign presence requirements should be eliminated.

Although the requirement of foreign incorporation logically satisfies the first prong of the qualifier, the Contracting Parties may interpret the general language of the first prong as requiring actual business activity abroad. If, however, the Contracting Parties adopted a modified qualifier which replaced the first prong with a consideration of a tax system's effects,<sup>179</sup> elimination of the burdensome foreign presence requirements could be justified easily. Foreign presence would be unnecessary, because there would be no prerequisite that economic processes be located outside the territory of the United States.

As the CCCT's FTI proposal is GATT-legal under the qualifier, the United States should seriously consider adopting it as a replacement for DISC. Once the foreign presence requirements other than foreign incorporation are eliminated, the proposal will constitute a GATT-legal method of providing tax benefits to United States exporting companies that places minimal burdens upon qualifying taxpayers.<sup>180</sup>

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of jurisdiction over a corporation, consideration of the level of in-state activity is unnecessary if the corporation is incorporated in that state. Likewise, in questions of a corporation's qualification for FTI treatment, consideration of the level of foreign presence should be unnecessary if the corporation is incorporated in the foreign territory.

178. See *supra* text accompanying note 150.

179. See *supra* text at § IIB.6 *A Proposed Sixth Defense*.

180. On August 4, 1983, Senator Dole (representing himself and Senators Boren, Symms and Danforth) and Representatives Rostenkowski and Conable introduced the Foreign Sales Corporation (FSC) Act of 1983. The proposal incorporated many of the features of the FTI proposal, but also made substantive and technical changes.

Under the FSC Act, DISC provisions would be replaced by rules that would exempt from taxation either 17% of the taxable income that a FSC and a related party would derive from an export transaction or up to 1.35% of gross receipts from the transaction.

The FSC Act would impose substantial foreign presence requirements similar to those under the FTI proposal. The FSC, a foreign corporation, would be required to: have at least one director who is not a United States resident; maintain an office outside United States customs territory; and keep tax records both at that office and in the United States. The legislation would apply to the export income of an FSC if: (1) the corporation is managed outside the United States (*i.e.*, if (a) shareholders' meetings and board of directors' meetings are held outside the United States; and (b) principal bank accounts are located outside the United States); and (2) economic processes occur outside the United States (*i.e.*, if (a) the FSC or its agent solicits, negotiates, or forms contracts outside the United States; and (b) either (1) 50% of the costs for advertising, transportation, collection, assumption of credit risk, and handling orders relates to FSC activity outside the United States, or (2) 85% of costs for any two of those five activities relates to activity outside the United States).

If the FSC or its agent performs all five activities of the economic process test, *some* export transactions between the FSC and its related United States taxpayer would qualify for administrative transfer pricing rules. Under these rules, the FSC would earn the

## CONCLUSION

The dispute over the GATT-legality of DISC has been affected by many developments, the most significant of which, in terms of future ramifications, is the GATT Council's decision to resolve the issue by reference to the standards contained in its 1981 qualifier. This Note demonstrates that the qualifier, by focusing upon a tax system's structural framework and thus ignoring functional considerations, produces results which do not best serve GATT policy objectives. The qualifier provides a semantic distinction between GATT-legal and GATT-illegal systems of taxation and disregards the practical economic effects of such systems. Accordingly, the United States should defend DISC by arguing that the standard by which DISC has been condemned is invalid.

In addition, the United States should urge the GATT Council to modify the qualifier to include a level of taxation test which would monitor a tax system's effect upon the interests of the Contracting Parties. If such a modification were adopted, the Contracting Parties would be assured that the resulting replacement of DISC would better accord with GATT policy objectives. Under either the GATT Council's 1981 qualifier or the suggested modified qualifier, the Foreign Trading Company Income proposal, without the substantial foreign presence requirements, is an attractive, GATT-legal DISC alternative which both serves the interests of the United States and protects the interests of other Contracting Parties.

*Janet B. Rosenblum*

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greater of: (1) 23% of the taxable income that the FSC and the related party derive from the transaction; or (2) 1.83% of the gross receipts from the transaction.

The FSC Act would exempt from U.S. taxation a portion of the export income of an FSC. If the transaction is subject to an administrative transfer pricing rule, the exempt portion would be seventeen twenty-thirds (17/23) of the FSC's income from the export transaction. Otherwise, the exempt portion would be 34% of the FSC's export income. Dividends paid to a United States corporate shareholder from an FSC's export income would also be tax exempt.

The FSC Act would allow companies with up to \$10 million of export receipts to receive DISC tax deferrals; those companies, however, would have to pay interest on the deferred tax. In addition, the FSC Act contains special rules for small FSCs with up to \$2.5 million of export receipts. See 129 CONG. REC. H6580-H6582 (daily ed. Aug. 4, 1983) (statements of Sens. Rostenkowski and Conable) and 129 CONG. REC. S11,761-66 (daily ed. Aug. 4, 1983) (statement of Sen. Dole). The proposed FSC Act is printed at 129 CONG. REC. S11,762-66.

