

## Foreign Sales Corporations: Cause for Deja Vu?

E. William Pastor

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## FOREIGN SALES CORPORATIONS: CAUSE FOR DEJA VU?

E. WILLIAM PASTOR\*

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## I. INTRODUCTION

As of January 1, 1984, domestic international sales corporations<sup>1</sup> (DISCs) are passé, having fallen victim to the Tax Reform Act of 1984.<sup>2</sup> DISCs may be dead, but the same legislation that brought their demise also caused the remarkably similar "foreign sales corporations"<sup>3</sup> (FSCs) to emerge, phoenix-like, from their funeral pyre. This paper will explore the broad similarities, significant differences, and the domestic and international policy concerns applicable to both of these statutory export incentives, as well as the reasons for the replacement of one export incentive scheme with another. It will become apparent that the similarities between DISCs and FSCs outweigh their differences, and that DISCs were replaced on the basis of poorly-reasoned interpretations of international trade treaties, rather than on the basis of domestic fiscal policy arguments which had more merit.

## II. POLICY JUSTIFICATIONS FOR TAX EXPORT INCENTIVES

A review of the policy considerations that shaped and reshaped the DISC provisions during their thirteen year life is essential to a full understanding of why FSCs replaced DISCs, and why the FSC provisions took the shape that they did.

1. 26 U.S.C. §§ 991-997 (1982) amended by 26 U.S.C.A. §§ 991, 992(a)(1)(E), 992(a)(3), 995(b)(1)(E) & (F)(i), 995(b)(4), 995(f)(1)-(5), 996(g) (West Supp. 1984). In addition, old section 995(e) was eliminated, and old section 995(g) was redesignated as new section 995(e).

The definition of a "DISC" is found in the Internal Revenue Code (hereinafter "I.R.C." or "Code") section 992. Technically, DISCs have survived. However, their utility has been drastically curtailed by two provisions of the Code. First, income which would otherwise be tax deferred is taxable to the DISC's shareholder to the extent it exceeds \$10 million. 26 U.S.C.A. § 995(b)(1)(E) (West Supp. 1984). Secondly, 26 U.S.C.A. § 995(f) now provides that interest will be charged on the deferred tax liability, thus limiting or eliminating the value of that deferral. Therefore, if not dead, the DISC provisions are certainly eviscerated and will be discussed herein in the past tense, unless the DISC provisions in their current attenuated state are under review. 26 U.S.C.A. § 995(f) (West Supp. 1984).

2. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 495, 985-1003 (codified as amended in scattered sections of 26 U.S.C.A. (West Supp. 1984)).

3. Enacted as part of the Tax Reform Act of 1984, the FSC provisions are codified at 26 U.S.C.A. §§ 921-927 (West Supp. 1984). DISCs continue to be of some use because not every exporting corporation may be able or willing to meet the foreign presence requirements of the FSC provisions. See *infra* text accompanying notes 124-62. These corporations may elect to use the revised DISC provisions. Since these provisions now charge interest on tax deferral, they are arguably GATT-legal. See *infra* text accompanying notes 78-123. Of course, the absence of such an interest charge under the FSC provisions makes those provisions generally more attractive to exporters.

The late 1960's and early 1970's saw significant signs of deterioration in the United States economy. Interest rates rose, the stock market fell, and the economy faltered. One cause of this malaise undoubtedly was the governmental deficit spending which reached unprecedented levels during the Vietnam conflict. At the same time, the 1971 U.S. trade deficit of \$2.7 billion engendered considerable concern, as it was the first United States trade deficit since 1888.<sup>4</sup> The broader measure of United States economic interaction with the world—the balance of payments—had shown deficits in virtually every year since 1949.<sup>5</sup> Trade surpluses, however, had been relied on to offset, at least in part, deficits in other accounts comprising the balance of payments bottom line figure. Thus, while foreign aid and similar items in the federal budget resulted in a consistent cash outflow from the United States, all was well for a time because superior American technology and productivity created an unflagging “cash cow,” in the form of an excess of exports over imports, which bankrolled U.S. activities in the international sphere.<sup>6</sup>

During the decade of the 1960's both United States imports and exports increased at different rates. The chart below illustrates that from 1960 to 1970, exports grew from \$18.0 billion to \$40.8 billion, a 126.7% increase, while imports jumped from \$16.2 billion to \$43.8 billion, a more significant 170.4% increase.<sup>7</sup> The cross-over point, at which the United States trade position first showed a deficit, occurred in 1966.<sup>8</sup>

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4. R. FEINSCHREIBER, *TAX INCENTIVES FOR U.S. EXPORTS* 16 (1975).

5. *Id.* at 14.

6. *See id.*, at 16.

7. 1973-1 C.B. 721. Exports are quoted net of foreign aid, and imports are quoted “c.i.f.” (net of transportation and insurance costs).

8. The fact that red ink appeared five years earlier than was suggested in the text accompanying footnote 4 is due to computational differences between Mr. Feinschreiber and the Treasury Department; the Treasury Department's figures, while compiled differently, illustrate the widening trade deficit with equal clarity.

*U.S. Exports (x) and Imports (o), 1960-1970*

<u>Billions of Dollars</u>											
45											
44											o
43											
42											
41											x
40											
39											o
38											
37											
36										o	
35											x
34											
33											
32											
31											
30									o	x	
29											
28									o	x	
27									x		
26											
25											
24											x
23											o
22											
21											o
20											x
19											o
18											x
17											o
16											o
15											o
<u>Amounts (billions of dollars)</u>											
Exports(x):	18.0	18.5	18.9	19.8	22.9	24.1	26.7	28.1	30.1	35.2	40.8
Imports(o):	16.2	16.0	18.0	18.6	20.6	23.5	28.1	29.5	36.0	39.4	43.8
Year:	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970

Notwithstanding the computational subtleties, the trend during the 1960's unequivocally revealed a consistent worsening in the U.S. trade balance of payments. The surpluses (or deficits) during those years were as

follows:<sup>10</sup>

<u>YEAR</u>	<u>TRADE BALANCE</u> (in billions of dollars)
1960	1.8
1961	2.5
1962	0.9
1963	1.2
1964	2.3
1965	0.6
1966	(1.4)
1967	(1.4)
1968	(5.9)
1969	(4.2)
1970	(3.0)

Even larger deficits followed. Clearly the "cash cow" was ailing, and finding an effectual elixir appeared to be essential. Among other effects of these deficits was an \$8.4 billion depletion of the United States gold stockpile during the same decade.<sup>11</sup>

It is against this backdrop that Congress, in conjunction with the Treasury Department, sought to create tax incentives that would generate additional exports, while keeping the "tax expenditure" cost as modest as possible.<sup>12</sup> In a closed-door meeting with U.S. business leaders in early 1970,

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10. The figures here result from combining the export and import data presented in the chart of exports and imports.

11. R. FEINSCHREIBER, *supra* note 4, at 15. Presumably this bullion was valued for exchange purposes at \$35.00 per ounce. If so, the current replacement cost could exceed \$100 billion.

12. The concept that tax incentives are essentially an indirect subsidy to the behavior generating such a tax benefit has been propounded by Stanley Surrey, and is discussed in Surrey & McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. INDUS. & COM. L. REV. 679 (1976). "Tax expenditures [are] those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income, or which provide a special credit, a preferential rate of tax, or a deferral of tax liability . . ." Congressional Budget Act of 1974, § 3(a)(3), 2 U.S.C. § 622(3) (1982).

As will be seen, the DISC provisions, as well as the FSC provisions, fall squarely within this definition, and Surrey and McDaniel cite the Staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation as their source for the proposition that the tax expenditure, "deferral of income of domestic international sales corporation," resulted in a revenue loss in excess of \$1 billion for each of the years 1977 through 1981. Surrey and McDaniel, *supra* note 12, at 726. Further discussion of the tax expenditure concept is found in S. SURREY, *PATHWAYS TO TAX REFORM* (1973) and in Ault, *Steuervergunstigungen in der*

Edwin Cohen, Assistant Secretary for Tax Policy at the Treasury Department, sent up a trial balloon by discussing the then-proposed DISC export incentive legislation.<sup>13</sup> A cursory perusal of the statutory provisions confirms their pro-export bias; the DISC provisions were referred to as the "Export Promotion Act of 1977."<sup>14</sup> The House Committee on Ways and Means described the DISC provisions as "a bill to stimulate domestic production for export by making provision for tax deferral in the case of corporations substantially engaged in exporting."<sup>15</sup>

Undoubtedly, the DISC provisions had a noble objective: to increase exports from the United States. An understanding of their flaws illuminates the FSC provisions that replaced the DISC enactment.

### III. THE DOMESTIC INTERNATIONAL SALES CORPORATION SCHEME

#### A. *Definitions and Function*

A broad-brush overview of the now-defunct DISC legislation facilitates an understanding of the similar present FSC provisions. It is in this light that the following synopsis is provided.

The DISC provisions comprised Internal Revenue Code (I.R.C.) sections 991 through 997.<sup>16</sup> Section 991 was the cynosure of those seven sections of the I.R.C. Succinct yet powerful, section 991 vitiated the corporate income tax, the minimum tax, and the accumulated earnings tax,<sup>17</sup> along with any other tax imposition provisions of Subtitle A,<sup>18</sup> by providing a tax

*Bundesrepublik Deutschland und den U.S.A., 1974 STEUR AND WIRTSCHAFT* 335 (1974).

13. N.Y. Times, Feb. 13, 1970, at 61, col. 1.

14. STAFF OF HOUSE COMMITTEE ON WAYS AND MEANS, 92D. CONG., 1st SESS., PREPARED STATEMENTS SUBMITTED TO THE COMMITTEE ON WAYS AND MEANS 25 (Comm. Print 1971).

15. *Id.*

16. 26 U.S.C. §§ 991-997 (1982) amended by 26 U.S.C.A. §§ 991, 992(a)(1)(E), 992(a)(3), 995(b)(1)(E) & (F)(i), 995(b)(4), 995(f)(1)-(5), 996(g) (West Supp. 1984). In addition, old section 995(e) was eliminated, and old section 995(g) was redesignated as new section 995(e).

17. 26 U.S.C. §§ 11, 56, 531 (1982). 26 U.S.C. § 992(d)(2) rendered and still renders a personal holding company, defined in I.R.C. section 542, ineligible for DISC status, so that the personal holding company tax could not have been vitiated. 26 U.S.C. § 992(d)(2) (1982); 26 U.S.C. § 542 (1982).

18. Generally, Subtitle A provides for income taxes, as opposed to later subtitles, which provide for estate, gift, employment, excise, and other taxes. The sole exception to the general tax exemption applicable to the income of a DISC provided by I.R.C. section 991 was the loophole-closing excise tax imposed by I.R.C. section 1491 on certain transfers of appreciated property to foreign entities. 26 U.S.C. § 991 (1982), amended by 26 U.S.C.A. § 991 (West Supp. 1984); 26 U.S.C. § 1491 (1982).

deferral. Significantly, DISC income deferred through December 31, 1984 was forever exempted from tax at both the corporate and shareholder levels.<sup>19</sup>

In order to receive this tax deferral, a corporation had to qualify as a DISC. I.R.C. section 992 required that (1) the DISC had to be an actual corporate entity formed under the laws of any state; (2) a high percentage of gross receipts was to be generated by export activities; (3) a high percentage of the assets had to be used in carrying on export activities; (4) only one class of stock could exist and a minimum capital requirement had to be met; and (5) an election to be treated as a DISC had to be made.<sup>20</sup> These requisites can be called, respectively, the corporate form, qualified receipts, qualified assets, stock, and election requirements. Their central goal was to ensure that a corporation receiving the benefits of DISC status in fact engaged in the desired export-related activity.

#### 1. *Limits on the Tax Deferral: Safeguards Against Abuse*

Sections 994 and 995 provided certain safeguards against abuse in their determination of the actual taxation of DISC income.

a. *Restrictions on the allocation of income to DISCs.* Section 994 imposed restrictions on the allocation of income to the DISC by governing transfer prices between a DISC and a related taxpayer. To the extent a DISC's income was favorably treated, a business using a DISC for its export operations could minimize its world-wide tax liability by shifting as much income as possible from its domestic operations to the DISC. Section 994's limitations were apparently perceived by Congress as an adequate barrier against abuse, since they remained in effect essentially as originally drafted throughout the history of the DISC legislation.<sup>21</sup>

Part of the explanation of section 994's combined effectiveness and simplicity is that it incorporated I.R.C. section 482 by reference.<sup>22</sup> I.R.C.

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19. While the DISC itself was exempt from a corporate level tax, I.R.C. sections 995 through 997 provided that a shareholder would, in certain situations, be taxed on the DISC's income (e.g., when earnings were distributed or deemed distributed). 26 U.S.C. §§995-997, amended by 26 U.S.C.A. §§995(b)(1)(E) & (F)(i), 995(b)(4), 995(e) & (f), 996(g) (West Supp. 1984).

20. 26 U.S.C. §992 (1982), amended by 26 U.S.C.A. §992(a)(1)(E) (West Supp. 1984).

21. The Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 495, 985-1003 (codified as amended in scattered sections of 26 U.S.C.A. (West Supp. 1984)), left 26 U.S.C. §994 (1982) untouched.

22. Section 994 provides that if a DISC chooses to determine its taxable income according to actual prices paid for transfers of export property between parents and subsidiaries, then this determination will be subject to the rules of section 482. 26 U.S.C. §§994(a)(3) & 482



section 994 thereby drew on the voluminous case law and judicial gloss that developed in the decades during which I.R.C. section 482's "silent policeman" has pursued those who would subvert the progressive tax rate structure and loot the Treasury through use of multiple taxable entities and economically implausible income shifting.<sup>23</sup>

Aimed at intercompany pricing,<sup>24</sup> I.R.C. section 994 established three different methods for determining and limiting the amount of income properly allocable to the DISC in the event a related party sells export property to the DISC. The prong which would in a given case allocate the greatest income to the DISC was the operative provision. Two of the prongs were mathematical percentage tests, and the third was based on the actual sales price, but subject to I.R.C. section 482.<sup>25</sup> The legislative history does not completely explain how the formulation resulted, but does indicate that administrative convenience was a goal. The aim was "to avoid the complexities of the present pricing rules . . . and also to provide encouragement for the operation of DISCs."<sup>26</sup> This thinking explains the departure from the usual arm's-length intercompany pricing rules, and for the allocation of the greatest of three amounts derived under I.R.C. section 994. Use of the lowest of the three amounts would undoubtedly have resulted in a smaller revenue loss at the first-tier level, but would also have served as a smaller export incentive. Trade deficits, not domestic fiscal deficits, were of primary concern in 1971.

b. *Section 995's deemed distribution mechanism.* Section 995 provided that the tax deferral given a qualifying DISC did not apply to all of its income. Amounts actually distributed to shareholders were taxed, subject to the ordering rules of section 996, which were necessitated by the deemed distribution mechanism of section 995. In addition, I.R.C. section 995's

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(1982).

23. The catchy characterization of I.R.C. section 482 derives from 5 Stand. Fed. Tax Rep. (CCH) 2993.01 (1985). The provision has existed in some form since at least 1928, since income-splitting is a fundamental tax avoidance technique under a progressive tax system. I.R.C. section 45, under the Revenue Act of 1928, allows reallocation of income and deductions if necessary to "prevent evasion of taxes or clearly to reflect income of any [commonly controlled] trades or businesses." The "clear reflection of income" concept remains in effect today. See 26 U.S.C. § 482 (1982).

24. Intercompany pricing is the pricing of transfers between parent corporations and subsidiaries.

25. I.R.C. section 482 permits the Internal Revenue Service to "distribute a portion or allocate gross income, deductions, credits, or allowances between or among [two or more commonly-controlled organizations, trades, or businesses], . . ." where such adjustments are necessary to "clearly . . . reflect the income" of the respective entities. 26 U.S.C. § 482 (1982).

26. H.R. REP. NO. 533, 92d Cong., 1st Sess. 73 (1971).

deemed distribution mechanism taxed certain amounts to shareholders whether distributed or not.<sup>27</sup> Remaining earnings and profits were tax-deferred; deferral continued until the untaxed amounts were distributed, the DISC was disqualified, or the stock was sold.

The undistributed amounts taxed under the deemed distribution concept consisted of several components. The first type of deemed distribution, set forth in I.R.C. section 995(b)(1)(A), was "gross interest derived during the taxable year from producer's loans." Producer loans were deferred DISC income loaned to a U.S. producer of export property.<sup>28</sup> The underlying theory was that it is too great a tax benefit to allow income to avoid current taxation and yet be brought back into the United States, with the U.S. borrower — usually the parent of the DISC — deducting interest payments flowing back to the DISC. This limitation is roughly analogous to I.R.C. section 951(a)(1)(B), which includes in a U.S. shareholder's income the controlled foreign corporation's increase in earnings invested in U.S. property.<sup>29</sup> In both cases, the loan versus dividend distinction was factually too difficult to draw, and presented too great a possibility for repatriating capital tax free. Thus, a bright-line rule was established to ensure greater certainty. The unfavorable tax status of dividend distributions raised the same characterization issue as is presented in the context of many capital transfers by domestic corporations, especially where the domestic corporation is closely held and related parties operate under several hats.

The second type of deemed distribution, found in I.R.C. section 995(b)(1)(B), was comprised of the DISC's gain from sale of property which is not a qualified export asset and which the DISC received in a nonrecognition transaction.<sup>30</sup> The third category, in I.R.C. section 995(b)(1)(C), resulted in a deemed distribution as to gain from sale of property not covered by subparagraph (B), received in a nonrecognition transaction, which was not an I.R.C. section 1221(1) inventory asset in the DISC's hands, and which would have been neither a capital asset nor an I.R.C. section 1231 asset in the transferor's hands.

Both the second and third provisions were aimed at a specific tax avoidance technique, namely the transfer of appreciated assets to a DISC,

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27. 26 U.S.C. §995 (1982) amended by 26 U.S.C.A. §995(b)(1)(E) & (F)(i), 995 (b)(4), 995(e), 995(f)(1)-(5) (West Supp. 1984).

28. 26 U.S.C. §993(d) (1982). Certain other requirements are set forth in the Code, including a term of five years or less, and a designation of the transaction is a "producer's loan" from the outset. 26 U.S.C. §993(d)(1)(B) & (D) (1982).

29. 26 U.S.C. §951(a)(1)(B) (1982).

30. A nonrecognition transaction is a transfer of a property to a corporation where no tax is recognized. An example is a §351 transfer to a controlled corporation. 26 U.S.C. §351 (1982).

followed by sale of those assets by the DISC. But for section 995, such a tax free transfer of assets to a DISC followed by sale of those assets by the DISC would have resulted in deferral of tax on a non-export-related transaction.

The provisions were eminently sensible, and in no way hindered the export incentive characteristics of a DISC. One is reminded of I.R.C. section 644, which attacks a similar perceived abuse by trusts, but contains a two year limit, perhaps because a domestic trust, unlike a DISC, is subject to current U.S. taxation on its income, and so the tax avoidance possibilities are more limited.

The remaining categories of deemed distributions underwent considerable revision and were much debated even before the DISC provisions became law.<sup>31</sup> I.R.C. section 995(b)(1)(G) was present in the 1971 version, though differently numbered.<sup>32</sup> It provided that the amount of foreign investment attributable to producer loans was a deemed distribution. This prevented excessive deferral by members of a controlled group resulting from capital transfers by a DISC to a related party. In that sense it worked in conjunction with the other deemed distribution provisions to curtail free use of DISC funds by a U.S. parent corporation while the benefits of tax deferral remained in force.

Again, the bright-line test of deemed distribution treatment obviated the need to scrutinize the facts and circumstances of control-group intercorporate transfers, since a producer loan, made by a DISC to its U.S. parent, for instance, was treated as a taxable distribution to the extent of foreign investment attributable thereto. The amount of the distribution was limited by the definition of "foreign investment attributable thereto" to the amount of the loans,<sup>33</sup> the actual foreign investment by domestic members of the group,<sup>34</sup> and the net increase in foreign assets by members of the controlled group.<sup>35</sup>

Since qualified export assets are excluded from the net increase in foreign assets, what we see is a statute drafted with the purposes of the DISC provisions in mind, carefully crafted to inhibit repatriation, without tax, of DISC income, to be used for non-export-related purposes. The deemed distribution was appropriately limited to the amount of the producer loan.

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31. The incremental approach provision, which affected deemed distributions, was originally amended out of the 1971 House version of the DISC legislation. Note, *Domestic International Sales Corporations (DISCs): How They Provide A Tax Incentive for Exports*, 14 VAND. J. TRANSNAT'L L. 535, 539, 543 (1981).

32. The 1971 version of 26 U.S.C. §995(b)(1)(G) (1982) was 26 U.S.C. §995(b)(1)(E).

33. 26 U.S.C. §995(d)(1)(C) (1982).

34. 26 U.S.C. §995(d)(1)(B) (1982).

35. 26 U.S.C. §995(d)(1)(A) (1982).

## 2. *Limits on the Tax Deferral: Reducing the Tax Cost of DISCs*

One of the most important aspects of the DISC provisions was that only the tax on the incremental increases in export income from year to year over a base period moving average amount was subject to deferral.<sup>36</sup> To best understand the important controversy over incremental export deferral, the original and final I.R.C. section 995 provisions relating thereto should be contrasted. As first enacted, I.R.C. section 995 imposed deemed distribution treatment on certain classes of income.<sup>37</sup> Then, as to the remainder, one-half of such excess, unreduced by distributions, was deemed distributed.<sup>38</sup> The oversimplified formulation of the DISC provisions' taxing scheme was that one-half of a DISC's income was taxed to shareholders, while one-half was tax-deferred.

The Tax Reform Act of 1976 imposed an incremental approach on the determination of the income subject to deferral.<sup>39</sup> I.R.C. section 995(b)(1)(E) mandated a deemed distribution of taxable income for the "taxable year attributable to base period export gross receipts."<sup>40</sup> This quantity was obtained by multiplying the DISC's "adjusted taxable income" (income less the I.R.C. section 995(b)(1)(A)-(D) deemed distributions) by a fraction, the numerator of which is the amount of the adjusted base period export gross receipts, and the denominator of which is the DISC's current year export gross receipts.<sup>41</sup>

Thus, in order to minimize the deemed distribution under I.R.C. section 995(b)(1)(E), a firm had to maximize current year export gross receipts, since circumstances involving near-parity of current year export gross receipts and 67% of the moving average of export gross receipts during the fourth through seventh preceding taxable years would result in nearly one hundred percent of the DISC's income being deemed distributed.<sup>42</sup> It is clear, then, that the use of the moving average so central to the

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36. 26 U.S.C. §995(b)(1)(E) (1982), amended by 26 U.S.C.A. §995(b)(1)(E) (West Supp. 1984).

37. These are essentially anti-abuse provisions, and are embodied in 26 U.S.C. §995(b)(1)(A)-(C) (1982).

38. 26 U.S.C. §995(b)(1)(D) (1971). The subparagraph was redesignated as § 995(b)(1)(F) in 1976. Additionally, the 26 U.S.C. §995(b)(1)(E) amount was deemed distributed. The subparagraph was redesignated as §995(b)(1)(G) in 1976.

39. 26 U.S.C. §995(b)(1)(E) & (F) (1982) appeared in the Tax Reform Act of 1976, Pub. L. No. 94-455, §1101(a)(1), 90 Stat. 1520, 1655 (codified as amended in scattered sections of 26 U.S.C.A.). The same provisions are lacking in the FSC provisions.

40. 26 U.S.C. §995(b)(1)(E) (1982), amended by 26 U.S.C.A. §995(b)(1)(E) (West Supp. 1984).

41. 26 U.S.C. §995(e)(1) (1982). The paragraph was eliminated in 1984.

42. 26 U.S.C. §995(e)(1982).

incremental approach put each DISC on a treadmill requiring ever-increasing export efforts if any tax deferral was to be achieved. Only small DISCs — those with adjusted taxable income of \$100,000 or less — were fully exempted from these rigors.<sup>43</sup>

The 1976 change was meant to reduce the tax cost of the DISC provisions, and to increase the effectiveness of their provisions as an incentive for increased exports. The legislative history indicates that both factors were important to the 94th Congress. The Senate Finance Committee Report notes that the DISC provisions were examined at “great length,” and it was determined that they had a “beneficial impact” on the level of U.S. exports.<sup>44</sup> Nevertheless, revenue losses of well in excess of \$1 billion per year were attributed to those provisions.<sup>45</sup> Addressing the export incentive issue, the Report states that “the committee believes that the DISC legislation is made less efficient because the benefits apply to all exports of a company, regardless of whether or not a company’s products would be sold in similar amounts without export incentive and regardless of whether or not the company is increasing or decreasing its exports.”<sup>46</sup> The dual prospect of increasing export activity by putting companies on the incremental deferral treadmill, and raising \$84 million of revenue in 1977 and annual amounts increasing to almost one half billion dollars by 1981,<sup>47</sup> all by adding thirty-six words to the statute, proved irresistible, and the incremental approach became law.<sup>48</sup>

The incremental approach granted deferral to only 50% of the excess over 67% of base period average export sales. The Tax Equity and Fiscal Responsibility Act (TEFRA) tightened the belt further, however, by amending the effect of section 995(b)(1)(F) in I.R.C. section 291(a)(4) so as to allow deferral on only 42.5% of the excess of current year export sales over 67% of base period average export sales, for corporate owners of DISCs.<sup>49</sup>

### B. *The Failure and Demise of the DISC Scheme*

The DISC provisions were subject to a two-pronged attack during their

43. 26 U.S.C. § 995(f) (1982), amended by 26 U.S.C.A. § 995(f) (West Supp. 1984).

44. S. REP. NO. 938, 94th Cong., 1st Sess. 291 (1975).

45. *Id.* at 292.

46. *Id.*

47. *Id.* at 302.

48. *Id.* at 301. By contrast, the 7.5% increase in the amount of the deemed distribution of the 26 U.S.C. section 994(b)(1)(F) residue to corporate owners was solely revenue-motivated.

49. Tax Equity and Fiscal Responsibility Act of 1982, § 204(a), 26 U.S.C. § 291(a)(4) (1982).

final years. One prong centered on domestic fiscal concerns, while the other focused on international issues relating to the General Agreement on Tariffs and Trade (GATT).<sup>50</sup> Ironically, while the fiscal arguments presented more cogent reasons for a statutory overhaul of DISCs, it was almost exclusively the GATT-related arguments that ultimately prompted Congress to replace DISCs with FSCs.<sup>51</sup>

### 1. *Excessive Domestic Fiscal Costs of DISCs*

The domestic and fiscal concerns relate to the cost-benefit trade-offs of DISCs. The underlying assumption behind DISCs was that export activity is desirable. Given that foundation, obvious questions arose: Did the DISC provisions promote export activity at the lowest possible cost? How much export activity was attributable to the DISC provisions? Did the economic benefits of the DISC provisions justify their costs?<sup>52</sup> A macroscopic cost-benefit analysis should facilitate an evaluation of the policy decisions made regarding both DISCs and FSCs.

a. *Projected and actual revenue effects.* A useful starting point for an economic analysis of the DISC provisions is a consideration of the projected revenue effects of the DISC proposal found in the legislative history of the Revenue Act of 1971.<sup>53</sup> The Committee on Ways and Means predicted a \$100 million revenue loss in fiscal year 1973 tax receipts, with a loss twice that in 1974.<sup>54</sup> While these amounts are not insignificant, a comparison of the revenue effects of other provisions of the 1971 Act gives perspective.

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50. General Agreement on Tariffs and Trade, *opened for signature* Oct. 30, 1947, 61 Stat. A3 (1947), T.I.A.S. No. 1700, 55 U.N.T.S. 194 (1947) [hereinafter cited as GATT]. Although the Senate has never ratified GATT, it is enforceable as an executive agreement.

51. See *infra* note 80 and accompanying text.

52. In examining the economic concerns relating to DISCs, we need not be greatly concerned with the effects of those provisions at the level of an individual corporation. It is sufficient to note that a DISC enabled its owner to defer tax on export-related income, at least when such income was increasing. 26 U.S.C. §§ 991 & 995 (1982), *amended by* 26 U.S.C.A. §§ 991 and 995(b)(1)(E) & (F)(i), (b)(4), (f)(1)-(5) (West Supp. 1984). If a corporation qualified for DISC status, it would almost always have been advantageous to obtain and avail itself of such status. A few exceptional situations exist where a potential DISC would not benefit from DISC status. These include cases where administrative costs would outweigh the advantages of tax deferral, or where net operating losses exist and render the corporation's income effectively tax-free. The problem here analyzed is not the corporate-level effect of the DISC provisions, but the societal effect.

53. Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497, (codified as amended in scattered sections of 26 U.S.C. (1982)). The legislative history appears at 1971 U.S. CODE CONG. & AD. NEWS 1825.

54. H.R. REP. NO. 533, 92d Cong., 1st Sess. 11 (1971).

Modifying the standard deduction and personal exemption cost \$1.37 billion in 1972, while eliminating the three-fourths year convention from the asset depreciation range (ADR) system generated an extra \$2.47 billion in the same period.<sup>55</sup> Gertrude Stein observed that "money is always there, only the pockets change"; the significance of a few statutory words in affecting whose pocket is involved is seldom more apparent than in regard to the DISC provisions and the subsequent FSC provisions.

The hazards of prediction are revealed by the actual effects of the DISC provisions. More money than expected stayed in private pockets. In its first report to Congress on the DISC provisions, the Treasury Department noted a sizable cost overrun:

Based on [actual tax] figures and on estimates of the alternative taxes, the revenue loss is estimated at \$250 million for the year ended March, 1973. The estimated revenue loss for the year ended March, 1973 is higher than the figure of \$100 million projected at the time the statute was enacted.<sup>56</sup>

Had the revenue cost estimate proved low due to an unexpectedly high level of exports, one would hardly have minded. The Treasury, however, attributed the discrepancy to the 1971 dollar devaluation and higher-than-anticipated DISC profit margins.<sup>57</sup> Revenue losses continued upward throughout the decade. Estimated in 1971 at \$170-\$200 million and in 1972 at \$250 million,<sup>58</sup> the 1973 tax loss due to DISCs was actually \$640 million.<sup>59</sup> By 1980, the lost revenue was running at \$1.41 billion per year.<sup>60</sup> An inherent and ultimately insurmountable problem in the DISC cost-benefit analysis is that establishing both the costs and the benefits requires com-

55. *Id.* See also S. REP. NO. 437, 92d Cong., 1st Sess. 3 (1971). The years 1972-73 correspond to the years 1973-74 mentioned in the House Report. The House reference is to fiscal year tax receipts, while the Senate Report refers to calendar year tax liability. The Senate Report estimates the tax loss at between \$100 million and \$200 million.

56. U.S. DEP'T OF THE TREASURY, 1972 ANNUAL REPORT: THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION 3 (1974) [hereinafter cited as 1972 ANNUAL REPORT]. Pursuant to section 506 of Pub.L. 92-178, the Revenue Act of 1971, the Treasury analyzes the DISC program's effects annually. This requirement was repealed by Pub. L. 98-369, Title VIII, §804(5)(1), 98 Stat. 1000 (1984).

57. 1972 ANNUAL REPORT.

58. *Id.* at 13.

59. U.S. DEP'T OF THE TREASURY, 1973 ANNUAL REPORT: THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION 18 (1975).

60. U.S. DEP'T OF THE TREASURY, 1980 ANNUAL REPORT: THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION 18 (1982) [hereinafter cited as 1980 ANNUAL REPORT].

paring what was with what would have been, an inexact science at best.<sup>61</sup> The existing estimates must be relied on for purposes of analysis, however, as they are the best we have.

b. *Export benefits generated.* The benefit side of the DISC cost-benefit analysis involves a more subjective and longer chain of assumptions. Nevertheless, the Treasury Department did reach a conclusion — in DISC year 1980, exports would have been \$6.2 billion to \$9.4 billion lower without the DISC provisions.<sup>62</sup> This conclusion involves assumptions about international supply and demand elasticity, or the degree to which the quantity of exports will vary as the overall cost to the buyer is reduced, as well as assumptions regarding the degree to which tax costs are passed through to the buyer and/or absorbed by the seller.<sup>63</sup> Again, one obtains the best information available and hopes that computational errors, erroneous assumptions, and methodological shortcomings have tended to balance each other out, rather than compounding or exacerbating the discrepancy between the estimate and the true picture.

Assuming the accuracy of the Treasury's cost and benefit figures, each dollar of tax lost because of the DISC provisions generated a mere \$6.67 of additional export sales.<sup>64</sup> That figure seems unacceptably low, particularly when one realizes that it represented the culmination of a decade of refinements of the DISC legislation.

Major improvements in the DISC legislation did occur throughout the life of those provisions. As noted above, an incremental approach was

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61. The estimates of the DISC provisions' costs found in the yearly reports given to Congress by the Treasury Department result from the multiplication of the deferred income by the effective tax rate to be applied to such income, had it been subject to tax. This procedure fails to take into account alternative tax avoidance or deferral tactics that corporations might have availed themselves of if the DISC provisions had not been available. More importantly, second tier effects are ignored; it is probable that business activity was altered in far-reaching ways due to the DISC provisions.

62. 1980 ANNUAL REPORT, *supra* note 60, at 11-14.

63. Clearly, both economic and tax incidence analysis issues arise here. The latter area is particularly elusive; it is truly a morass "best avoided by the merely competent," to borrow Professor Martin Ginsburg's incisive phrase (applied by him to partnership taxation). For an indication of the difficulties in determining the extent to which various taxes are passed back to the producer and/or forward to the consumer, see E. BROWNING & W. JOHNSON, *THE DISTRIBUTION OF THE TAX BURDEN* (1979); Mills, *DISC: Response to Trade-Distorting Border Tax Adjustment Under GATT*, 31 TAX EXECUTIVE 135, 151 n.11 (1979).

64. Taking the most optimistic 1980 export increase figure, \$9.4 billion, 1980 ANNUAL REPORT, *supra* note 60, at 13, and dividing by the \$1.41 billion revenue cost, *id.* at 18, yields \$6.67 of increased export sales per dollar of tax cost. If \$6.2 billion, the low estimate of increased export sales attributable to DISCs, is used in the calculation, each dollar of lost revenue purchased a mere \$4.40 of additional export sales.



adopted in 1976, with the results that only income from increased amounts of export sales qualified for tax deferral.<sup>65</sup> The incremental method reduced the amount of lost revenue, and presumably was grounded on the theory that the level of exports from the prior year was, in the case of most corporations, a given for the current year. Adoption of the incremental approach was a clear improvement upon the initial DISC provisions, enabling those provisions to direct the substantial tax benefits offered in a more efficient manner. With an ideal export incentive scheme, tax deferral benefits would be granted only as to income from those export sales which would not occur in the absence of the tax deferral incentive. To the extent the benefitted group is too large or too small, the program is imperfect. In the case of overinclusiveness, tax benefits will be granted with respect to export sales which would occur even without the incentive. This produces an unacceptable tax revenue loss. Where the benefitted group is underinclusive, by contrast, the incentive program fails to stimulate sales which it otherwise could.

Even adoption of the incremental approach did not completely alleviate the problem of overinclusiveness of the group of export sales benefitting from the DISC provision. The incremental approach restricted tax deferral to income from increased export sales, but it did not address the fact that some of these increased sales would occur even without the DISC provision. The result was that the revenue cost was greater than it needed to be. On the other hand, targeting the tax benefits more precisely — even assuming that greater precision was a practical possibility — would have resulted in an enormously more complex statute. The apparent conclusion, in the absence of a major legislative overhaul of the DISC provisions themselves, was that export sales and relative statutory simplicity were each so desirable that further refinements were unnecessary.<sup>66</sup> Still the fact that only between \$4.40 and \$6.67 of increased export sales arose from each revenue dollar foregone because of the DISC provisions<sup>67</sup> must lead to a critical

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65. 26 U.S.C. §995(b)(1)(E) (1982), amended by 26 U.S.C.A. §995(b)(1)(E) (West Supp. 1984) was the incremental approach provision.

66. The other possibility is that a significant improvement in the targeting of the DISC statute's tax benefits was considered a practical impossibility.

67. See *supra* note 34 and accompanying text. The issue of whether this is the true cost or merely a first tier cost remains. For example, in calendar year 1974, DISCs were credited with \$7 billion to \$9 billion of export growth, achieved at a tax cost of \$1 billion. TASK FORCE ON TAX POLICY AND TAX EXPENDITURES OF SENATE BUDGET COMM., 94TH CONG., 1ST SESS., DISC: AN EVALUATION OF THE COST AND BENEFITS 63 (Comm. Print 1975). However, the Special Committee for U.S. Exports, an industry group, claims that the \$1 billion tax cost is "hypothetical" due to the GNP multiplier effect. *Id.* The Committee cites a Commerce Department's estimate that GNP increased by \$21 billion to \$27 billion as a result of the increased exports, with a net increase in tax revenue. *Id.* See Taylor, *The Foreign Tax Credit*,

evaluation of the effectiveness of those provisions. Even assuming that the secondary and tertiary effects of the DISC provisions reduced the tax cost of the export incentive, problems remained.

c. *Costs perceived as exceeding benefits.* Many of the problems with the DISCs are concisely set forth in a scathing sixteen-page critique of the DISC provisions prepared by the House Budget Committee.<sup>68</sup> The report's bottom line is that "DISCs have not fulfilled their primary goal of improving significantly on the U.S. balance of trade."<sup>69</sup> Admitting that during the first half of the decade of the 1970's "exports have climbed dramatically,"<sup>70</sup> the report goes on to cite various sources for the proposition that "less than 1 percent of the increase is attributable to the establishment of DISCs."<sup>71</sup>

The problems that were perceived with the DISC provisions can be summarized as follows:

(1) Maximum stimulation of export sales is only achieved if the DISC's cost savings are passed on to the foreign buyer, and there is reason to believe this did not occur;

(2) Pass-through of tax savings to foreign buyers helps the foreign consumer, not the American consumer;

(3) Employment stimulation could more effectively be achieved in a number of alternative ways; and

(4) Overinclusiveness of the benefitted groups occurred during the early 1970's as a result, among other reasons, of the granting of tax benefits for export activities that had been decided upon and set in motion prior to the 1971 Act.<sup>72</sup>

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*Deferral, and the DISC Provisions: Casualties in a Holy Way of Protectionism?* [sic], 16 Hous. L. Rev. 82 n.148 (1978). If the secondary, tertiary, and even more remote effects of the DISC provisions significantly reduced or eliminated the first tier effect (namely, a significant tax revenue reduction), then having an export incentive in the nature of the DISC provisions or the FSC provisions appears highly advisable. Unfortunately, determining the distant consequences of a major business tax provision seems impracticable.

Incidentally, it is interesting to note that business entities, like other special interest groups, are ready to depart from free market principles by accepting subsidies when such departures are in their interest, as Milton Friedman has noted. See M. FRIEDMAN, *FREE TO CHOOSE* 297 (1980).

68. TASK FORCE ON TAX EXPENDITURES OF THE HOUSE BUDGET COMM., 94TH CONG., 1ST SESS., *AN ANALYSIS OF DOMESTIC INTERNATIONAL SALES CORPORATIONS* (Comm. Print 1975).

69. *Id.* at vii.

70. *Id.*

71. *Id.*

72. *Id.* at 3-8. The problem with full, rather than incremental, deferral, since remedied, is also mentioned.

The question addressed by the Budget Committee was whether exports should be subsidized.<sup>73</sup> Justification could not be found in the saving of U.S. jobs, for the Committee contended that in 1974 the DISC provisions created 16,000 jobs, while a comparable direct expenditure by the government would have created ten times as many jobs.<sup>74</sup> Even a direct transfer of \$1.5 billion to the private sector by cutting the corporate income tax rate by two percentage points would have created 90,000 jobs.<sup>75</sup>

The report takes the position that there is no valid reason to subsidize exports. Giving an incentive to raise domestic sales would benefit the American consumer more. The DISC provisions effectively taxed "production for domestic consumption more heavily than production for export,"<sup>76</sup> arguably an indefensible situation.

How would the failure to encourage exports, or even the encouraging of production for domestic sale, affect the serious balance of trade problems? A direct benefit would result, since less expensive U.S.-made goods would reduce imports. Also, any increase in the return on capital invested on the U.S. would attract foreign capital, with this inflow further alleviating the balance of payments deficit.<sup>77</sup>

It is clear then that the DISC provisions were in general a well reasoned mode of addressing a persistent problem. Nevertheless, three fundamental problems remained:

(1) the fact that any legislation of this type, for practical reasons, could never be completely devoid of overinclusion and/or underinclusion of the benefitted companies and transactions:

(2) the fact that an incentive program causes unpredictable and possibly undesirable dislocations, such as a flight of capital away from domestic sales activities; and

(3) the fact that, as will be discussed below, the DISC provisions are perceived by European trading partners as violating international free trade policies.

## 2. *GATT Members' Perception that DISCs Violated GATT*

While the domestic economic concerns regarding DISCs clamored for changing the DISC provisions, much less persuasive international issues ac-

73. *Id.* at 9.

74. *Id.* at 7. The precise estimate of new jobs created by the DISC provisions in 1974 is 15,960, while the estimate of jobs created by direct government expenditures ranges from 112,500 to 240,000. *Id.*

75. *Id.* at 8.

76. *Id.* at 9.

77. *Id.* at 10.

tually persuaded Congress to relegate the DISC provisions to the scrap heap of tax law history.<sup>78</sup> The true executioner of the DISC provisions was GATT,<sup>79</sup> an international agreement which has for several decades served as a kind of affirmation of the principles of *laissez-faire* capitalism in the international sphere.<sup>80</sup> The perception by complaining trading partners that the DISC provisions violated GATT was the impetus that prompted Congress to replace DISCs with FSCs.

a. *Potential GATT violations.* GATT prohibits certain types of export incentives. The major prohibition is against direct or indirect export subsidies resulting in the sales of exported goods at a lower price than that for identical goods sold to domestic buyers.<sup>81</sup>

Did the DISC provisions run afoul of GATT? Did they create a tax exemption with respect to exported goods? The Treasury Department "does not consider the DISC provisions of the Internal Revenue Code to be contrary to United States obligations under GATT regarding export subsidies."<sup>82</sup> Cool reflection should lead one to agree fundamentally with this assessment.

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78. The provisions thereby join such auspicious company as *Crown v. Commissioner*, 585 F.2d 234 (7th Cir. 1978) *aff'g* 67 T.C. 1060 (1977).

GATT-related concerns were almost the sole impetus behind the adoption of the FSC provisions. See SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984: EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984 630 (Comm. Print 1984) [hereinafter cited as D.R.A. EXPLANATION].

79. GATT, *supra* note 50.

80. An excellent historical overview of GATT is found in *Foreign Government Policies and Programs to Support Exports: Hearings Before the Subcomm. on International Finance of the Senate Comm. on Banking, Housing, and Urban Affairs*, 95th Cong., 2d Sess. 223-43 (1978) [hereinafter cited as *Export Hearings*].

GATT signatories include Australia, Belgium, Brazil, Burma, Canada, Ceylon, Czechoslovakia, France, India, Lebanon, Luxemburg, The Netherlands, New Zealand, Norway, Pakistan, Southern Rhodesia, Syria, the Union of South Africa, Britain and Northern Ireland, and the United States. Note Japan's absence. Mills, *supra* note 63, at 151 n.11.

81. GATT, art XVI, para. 4 provides:

Contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market.

4 GATT: BASIC INSTRUMENTS AND SELECTED DOCUMENTS (1969) [hereinafter cited as GATT:BISD].

82. *Congressional Record*, 16 TAX NOTES 1151 (1982). Yet the Reagan Administration effectively promised the GATT Council a modification of DISC to conform with GATT. See *The U.S. will seek revised DISC legislation in response to long-term GATT opposition*, 18 INT'L TRADE REP. U.S. EXP. WEEKLY (BNA) 5 (Oct. 5, 1982). See also *infra* notes 88 and 89 and accompanying text.

While general economic growth incentives, or production subsidies, appear to be acceptable under GATT, export subsidies, which are essentially production subsidies aimed specifically at the export market, are unequivocally prohibited by Article XVI.<sup>83</sup> Unfortunately, "the term export subsidy has successfully eluded any universally accepted definition."<sup>84</sup> In an effort to clarify the application of Article XVI, paragraph 4 of GATT, a GATT "working party" in 1961 enumerated eight forbidden practices. The fourth was an "exemption, in respect to exported goods, of charges or taxes . . . ."<sup>85</sup> Specifically excluded from the prohibited tax exemptions, however, are "indirect taxes levied at one or several stages on the same goods if sold for internal consumption."<sup>86</sup>

Considering first whether the DISC provisions resulted in exported goods being sold at a price lower than the domestic price of those same goods, the U.S. position is that no such violation of GATT ever arose. Nevertheless, although some commentators argue that a special GATT panel convened in 1976 found "no evidence whatsoever that DISC causes such bi-level pricing. . . ."<sup>87</sup> the panel did decide that the DISC legislation should be regarded as an export subsidy under Article XVI, paragraph 4. The panel relied on some presumptions supporting the finding of GATT violations. It attached to the prohibited practices a presumption of bi-level pricing, but considered that the presumption was not absolute. The next presumption was that the DISC export subsidy *could* lead to (a) the lowering of prices; (b) an increase of sales efforts; and (c) an increase of profits per unit.

Because the subsidy was both significant and broadly based it was to be expected that all of these effects would occur . . . . A concentration of the subsidy benefits on prices could lead to substantial reductions in prices. The Panel did not accept that a reduction in prices in export markets needed automatically to be accompanied by similar reductions in domestic markets . . . . The Panel therefore concluded that

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83. GATT, art. XVI, para. 4, *supra* notes 50 and 81.

84. Mills, *supra* note 63, at 137.

85. *Id.*; in full, the fourth enumerated practice prohibited by the working party is:

The exemption, in respect of exported goods, of charges or taxes, other than charges in connection with importation or indirect taxes levied at one or several stages on the same goods if sold for internal consumption, or the payment, in respect of exported goods, of amounts exceeding those effectively levied at one or several stages on these goods in the form of indirect taxes or of charges in connection with importation or in both forms.

GATT:BISD, *supra* note 81, (9th Supp.) at 185-87 (1961).

86. GATT:BISD *supra* note 81, (9th Supp.) at 185-87 (1961).

87. *Export Hearings*, *supra* note 80, at 216.

the DISC legislation *in some cases* had effects which were not in accordance with the United States' obligations under Article XVI:4.<sup>88</sup>

Thus, based on certain potentially valid presumptions, prohibited bi-level pricing was argued to exist in some cases. While debate will remain on the accuracy of the conclusion, GATT's condemnation of DISC for bi-level pricing was strong enough to prompt the Reagan administration to act.

The second question is whether the DISC provisions exempted export income from tax. Factually, DISC deferred tax on some export income — which at most is to say that a temporary exemption arose.<sup>89</sup> While deferral thus appears suspect, it must be noted that “GATT does not expressly prohibit the deferral of direct taxes.”<sup>90</sup> Indeed, a persuasive argument for the fundamental distinction between tax deferral and tax exemption can be made. “Deferral merely postpones the day on which the tax must be paid. The obligation to pay the tax endures throughout the period the taxpayer retains the use of the money.”<sup>91</sup> As was discussed, the DISC provisions merely gave a tax deferral, not a tax exemption. Accordingly, the 1976 GATT Panel did not equate DISC's tax deferral, though of unlimited duration, with exemption. It did, however, find a *partial* exemption because the deferral “did not attract the interest component of the tax normally levied for late or deferred payment.”<sup>92</sup>

Determining whether tax deferral on export income is a prohibited subsidy under GATT thus leads on into a semantic quagmire; the best one can say is that this is a “gray area.”<sup>93</sup> A study of our trading partners' approaches to export encouragement, however, reveals that the United

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88. (Emphasis added). Report of the GATT Panel on DISC: Conclusions, paras. 73 and 74, G.A.T.T. Doc. L/4422 (Nov. 2, 1976).

89. The discussion here is of the DISC provisions as they stood during their operative history, and not of the transitional rules relating to the abolition of DISCs or the replacement of DISCs by FSCs. These transitional rules actually resulted in complete forgiveness of the tax on a DISC's deferred income. Pub. L. 98-369, Title VIII, §805(b) 98 Stat. 1000 (1984). Therefore, the DISC provisions ultimately resulted in a tax exemption falling squarely within GATT objections. See D.R.A. EXPLANATION *supra* note 78, at 659. See, e.g., Bruce, *Foreign Sales Corporation Conference*, 24 Tax Notes 1299, 1299 (1984); *Europeans Announce Plans to Force GATT Review of DISC and FSC*, 24 Tax Notes 228 (1984).

90. Mills, *supra* note 63, at 141. The interpretive provisions under GATT are similarly devoid of any directive “on all fours.”

91. *Id.* Ironically, as will be seen, the FSC provisions grant an outright tax exemption, yet, because of other aspects of the provisions, they seem more palatable to our trading partners.

92. Report of the GATT Panel on DISC: Conclusions, *supra* note 88, at para. 71.

93. *Export Hearings*, *supra* note 80, at 216.

States has fewer, not more, export incentives than most countries.<sup>94</sup> As will be seen, however, the export incentives implemented by our trading partners possess qualitative differences that enable these incentives to pass muster under technical GATT distinctions. The differences between our trading partners' tax systems and our own allow them to use more beneficial export incentives within GATT limitations, so that technical application of GATT rules to bar DISCs places our export producers at a disadvantage. On equitable grounds, then, DISCs should have been viewed as legal within the spirit of GATT.

b. *Inequities in GATT treatment of U.S. taxation.* There are two factors that, in interaction with GATT, produce a lack of horizontal equity on an international scale. These are:

(1) The concept of territoriality in foreign tax systems, and the general absence in such systems of provisions analogous to Subpart F, sections 951-964, of the Internal Revenue Code, dealing with the taxation of U.S. controlled foreign corporations;<sup>95</sup> and

(2) The relative mix of "direct" and "indirect" taxes imposed on commercial entities and transactions by the United States and by our trading partners.

With respect to the first factor, territorial tax systems impose less tax on income generated by activities outside the nation's own borders. If a company subject to a territorial tax system has an extraterritorial subsidiary, the subsidiary's income may be entirely free of tax imposed by the home territory.<sup>96</sup> Likewise, even a foreign branch, as opposed to a distinct subsidiary, may escape taxation by the home territory under a territorial tax system. In contrast, a subsidiary of a U.S. company may be subject to U.S. tax under I.R.C. section 951, and a foreign branch of a U.S. corporation may be subject to United States tax under I.R.C. section 61. Therefore, the DISC provisions were intended partially to compensate for the tax

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94. A study by the Washington, D.C. law firm of Cole and Corette, sponsored by Dow Chemical Company, so concluded. *Dow-Sponsored Study Finds Many Countries Foster Exports Through Tax Aids*, 16 TAX NOTES 549 (1982). See *Export Hearings*, *supra* note 80, at 131, for a quantitative comparison of the deferral benefits of the DISC provisions and the foreign export subsidies of other nations.

95. Subpart F is codified at 26 U.S.C. §§951-964 (1982). France has a recently modified version of Subpart F, in article 209:B of the *Code général des impôts*.

96. See Note, *Tax Incentives to Exportation: Alternatives to DISC*, 9 GA. J. INT'L & COMP. L. 413, 425 (1979) [hereinafter cited as *Georgia Note*] See also Note, *The GATT Qualifier: Its Validity As a Tax Standard and its Effect on DISC and DISC Alternatives*, 16 CORNELL INT'L L. J. 469, 470 n.5 (1984) [hereinafter cited as *Cornell Note*]. (*Code général des impôts*, art. 209:1).

advantages accruing to companies subject to the territorial tax systems of our trading partners, where such companies had moved their export activities outside their home territory.

In December 1981, the GATT Council reviewed the findings of the 1976 Panel which had considered the legality under Article XVI, paragraph 4, not only of DISCs, but also of certain tax practices of France, Belgium, and the Netherlands.<sup>97</sup> The Council technically adopted the Panel's finding of illegality as to all four questions. It qualified its conclusion, however, effectively exonerating three nations' tax practices, while ruling DISCs illegal.<sup>98</sup> The "understanding" provides, first, that GATT signatories need not tax export income arising outside territorial limits. Secondly, in order to comply with GATT's prohibition of export subsidies, signatories must require arms-length pricing as between parents and subsidiaries.<sup>99</sup> The three nations' tax practices satisfy these requisites.<sup>100</sup> On the other hand, since DISCs are domestic corporations, the tax relief granted them, although analogous in purpose to the nontaxable status of foreign nations' extraterritorial subsidiaries, is not literally GATT-legal. Similarly, the DISC provisions allow intercompany pricing which is more favorable than the arms-length pricing of section 482, and the standard required under the GATT understanding.<sup>101</sup>

The territorial tax issue is less persuasive than the second point noted, in implying either that our trading partners should have accepted the DISC provisions or that their own tax systems should have been changed because of GATT. Nonetheless, many other countries clearly impose less tax on the unrepatriated foreign-source earnings of a corporation's foreign branches or subsidiaries than does the United States.<sup>102</sup>

Nevertheless, the United States has chosen to apply I.R.C. section 61 to a U.S. corporation's worldwide income, and to tax some of a foreign subsidiary's earnings to the domestic parent under I.R.C. section 951.<sup>103</sup> It cannot complain that other countries are more lenient with off-shore activities. Suppose corporation A is a subsidiary of a U.S. corporation, and meets

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97. *Cornell Note*, *supra* note 96 at 470-71.

98. *DISC Substitute Details in Administration Draft Proposals*, 20 TAX NOTES 240, 241 (1983).

99. *Id.* at 241; *Cornell Note*, *supra* note 96, at 472.

100. *Cornell Note*, *supra* note 96, at 476.

101. 26 U.S.C. §482 (1982); 26 U.S.C. §994 (1982).

102. *Export Hearings*, *supra* note 80, at 126. The territorial approach, common among GATT signatories, stands in contradistinction to a system like that of the United States, where U.S. persons (whether individuals or legal entities) are subject to United States income tax on their worldwide income.

103. 26 U.S.C. §951 (1982).



the I.R.C. section 957 definition of a controlled foreign corporation. Corporation B is a subsidiary of an European corporation subject to a territorial tax system. A and B are organized in the same low-tax country, and both generate the same I.R.C. section 952 "Subpart F income." Corporation B will have a competitive advantage over corporation A,<sup>104</sup> but this cannot be blamed on inequities in GATT. On the other hand, the 1981 understanding condones differential GATT treatment of foreign-based subsidiaries. Still, it is worth noting that "most foreign exporters can completely *avoid* payment of tax on substantially *all* export income . . . ,"<sup>105</sup> a result not possible to the same extent for U.S. exporters.

The second factor, concerning the direct-indirect tax structures of GATT signatories, points more clearly toward the need for changing the current interpretations of GATT. "[GATT] places severe restrictions on the ability of a nation to use its direct tax system to promote exports, . . ."<sup>106</sup> The GATT rules, however, "give *carte blanche* to the remission or rebate of indirect taxes on export transactions. This places the United States at a major disadvantage, because it has made a policy decision to rely principally for its revenue on progressive income taxes rather than regressive indirect taxes."<sup>107</sup>

Thus, when a foreign enterprise exports goods from a foreign country, the indirect taxes imposed can be remitted by the country of manufacture. Such taxes would include sales, excise, and value-added taxes, or other taxes "levied against the product or transaction."<sup>108</sup> By contrast, a similar remission of income taxes would violate GATT, since a "direct tax" is involved.<sup>109</sup> One could argue here that this result, like the unfavorable consequences of Subpart F when contrasted with a territorial approach, is simply a product of the U.S. tax system which we must accept.

A consideration of the assumptions underlying GATT's differential treatment of direct and indirect taxes, however, will demonstrate that the distinction is both miscalculated and inequitable. When the contracting parties drafted GATT in 1947, it was assumed, first, that direct taxes such as corporate income tax work only to reduce a *producer's* profits, the producer being incapable of passing the tax on to the ultimate consumer.<sup>110</sup>

104. 26 U.S.C. §952 (1982); A is taxed currently by the United States, while B is taxed only to the extent that the country where the corporation's activities are based imposes a tax. *Export Hearings*, *supra* note 80, at 194.

105. *Export Hearings*, *supra* note 80, at 214.

106. *Id.* at 211.

107. *Id.* at 212.

108. *Id.* at 211.

109. *Id.*; GATT:BISD, *supra* note 81, (9th Supp.) at 185-87 (1961).

110. Banks, *GATT, Altered Economics, and DISC: A Legitimate Application of Rebus*

Thus, the final price of the good would reflect neither the imposition of a direct tax, nor, significantly, the remission or rebate of the direct tax. Secondly, it was assumed that indirect taxes work to increase the price of the *product* only, in its intermediate and final stages.<sup>111</sup>

One commentator gives the example of a ball-bearing's route through manufacture to market. When first produced it is sold to a wheelmaker at cost plus a profit margin. The wheelmaker is required to pay to the government a percentage of this price in the form of an indirect sales tax. The wheelmaker sells the bearing at cost, which now includes sales tax, plus profit, to a roller skate manufacturer. This producer also factors the second sales tax he pays into cost, and adds a profit percentage, to establish the price to the ultimate consumer. Accordingly, the producer does not himself absorb the tax.<sup>112</sup> Thus the imposition of indirect taxes, as well as the remission of indirect taxes, must affect product prices. The crucial point of the theory is that direct taxes are fully shifted backwards on to the producer, and indirect taxes are fully shifted forward to the product. Under these hypothetical conditions, the rebate of indirect taxes on goods exported removes a comparative disadvantage placed on goods by those indirect taxes, as they enter another market to compete with directly taxed goods.

These assumptions have been convincingly refuted.<sup>113</sup> To the extent that the producing industry is either purely competitive or oligopolistic, an indirect tax *is* a cost of doing business which cannot be passed on to the consumer without some effect of reduced sales.<sup>114</sup> Whether a producer is able to shift indirect taxes forward 100% also depends on economic conditions. A high degree of competition, a tight money supply, or a high elasticity of demand, will militate against full forward shifting.<sup>115</sup> Unfortunately, it is virtually impossible to calculate accurately the degree of forward and backward shifting that occurs on a macroeconomic scale. These assumptions were made in part precisely for the sake of convenience in avoiding such endless calculations.<sup>116</sup> The fact remains, however, that to the extent that an indirect tax is not fully shifted forward, while fully rebated, an export subsidy exists. Similarly, to the extent that a direct tax is not fully

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*Sic Stantibus*, 5 DEN. J. INT'L L. & POL'Y 121, 129 (1975); Mills, 31 TAX. EX. 135, *supra* note 63, at 139.

111. Banks, *supra* note 111, at 129; Mills, *supra* note 63, at 139.

112. Mills, *supra* note 63, at 139.

113. *Id.*

114. Banks, *supra* note 111, at 130; *see also* discussion, *supra* note 67. *See generally*, Lindholm, *National Tax Systems and International Balance of Payments*, 19 NAT'L TAX J. 163 (1966).

115. Mills, *supra* note 63, at 147-48.

116. *Id.* at 150, 146.

shifted backwards, while there is no rebate, there is a corresponding comparative disadvantage.<sup>117</sup> Some analysts argue that if direct taxes do not affect the final product price, then their partial deferral under the DISC provisions could not have created an export subsidy.<sup>118</sup> This conclusion rests on the logic that if a firm's product prices are not lowered by the deferral of the direct tax, then exports cannot rise as a result of deferral.<sup>119</sup> The 1976 GATT Panel, however, determined that the exemption of direct taxes was a practice prohibited under Article XVI, paragraph 4, presumably because it was thought that such exemptions would eventually cause an export increase.

In sum, in light of the major inequity resulting from the GATT differentiation between direct and indirect taxes, a distinction without economic basis in the eyes of "the overwhelming majority of economists,"<sup>120</sup> a change in GATT or the interpretation of that agreement would have been more defensible than requiring the United States to overhaul its tax system by substituting "indirect" for "direct" taxes in order to obtain the export benefits so long enjoyed by foreign corporations. In other words, our trading partners should have accepted DISC deferral as proper, either by distinguishing tax exemption from tax deferral, or by reinterpreting or amending GATT to allow remission of the direct taxes, as well as of the indirect taxes, imposed on exports.

c. *U.S. promises adjustment.* After a decade of negotiation with our trading partners, it appeared that convincing them of the GATT-legality of the DISC provisions was futile. Accordingly, the United States finally appeared ready, in the early 1980's, to change the DISC provisions. It is somewhat ironic that the changes resulted not from well-grounded fiscal policy concerns, but from unpersuasive external objections. It is some consolation that both the proposed changes, and the FSCs that ultimately resulted, reflect primarily changes of form, not substance. The FSC provisions therefore should encourage exports without running afoul of GATT, and fiscal policy concerns can be addressed later by amending or "fine-tuning" those provisions as their effects become more apparent.

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117. *Id.* at 145.

118. *Id.* at 140.

119. This logic ignores second-tier macroeconomic effects of deferral. Accepting the premise concerning direct taxes, that they do not affect price, but simply cut into producer profits, then deferral raises profits. This effect attracts market entry, which then causes an increase in exports. The second tier effects, however, are not at issue in considering indirect taxes, so that their exclusion with respect to direct taxes would seem to be required for the purposes of comparison.

120. *Export Hearings, supra* note 80, at 218.

On October 1, 1982, the United States promised the GATT Council that a GATT-legal DISC substitute would be sent to the 98th Congress for approval.<sup>121</sup> The first step in this process was the proposal of a DISC alternative by the Reagan Administration on March 9, 1983.<sup>122</sup> Four goals affected the formulation of the proposal: (1) complying with GATT; (2) avoiding tax increases for exporters; (3) avoiding any additional revenue costs; and (4) maintaining the suitability of the provisions for small business.<sup>123</sup> The final legislation took a somewhat different form than the initial proposal, though the two were similar. Before evaluating the potential results of the statutory change, the new FSC provisions themselves warrant scrutiny.

#### IV. THE EMERGENCE OF THE FOREIGN SALES CORPORATION SCHEME

##### A. *Definitions and Function*

A "foreign sales corporation" (FSC) is a corporation: (1) created or organized under the laws of a foreign country or a United States possession; (2) having no more than twenty-five shareholders at any time during the taxable year; (3) with no preferred stock outstanding during the taxable year; (4) which maintains an office in a foreign country or U.S. possession and (5) maintains permanent books of account at such office; (6) which maintains the records required by I.R.C. section 6001 within the United States; and (7) which has at all times during the taxable year at least one non-resident individual on its board of directors.<sup>124</sup> Further, a would-be FSC must not at any time during the taxable year have been a member of a controlled group of corporations of which a DISC is a member, and must elect to receive FSC treatment.<sup>125</sup>

Given FSC status, the "exempt foreign trade income" of a FSC is treated as foreign source income "not effectively connected with the conduct of a trade or business within the United States."<sup>126</sup> The result is that the income is not subject to taxation even when remitted to the United States corporate owner(s).<sup>127</sup>

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121. *Administration Proposes DISC Replacement Plan*, 18 TAX NOTES 976 (1983).

122. *Id.*

123. *Id.* at 978.

124. 26 U.S.C.A. §922(a) (West Supp. 1984). Both the country of organization or incorporation and the country where the office is maintained must have agreements or treaties with the United States providing for exchange of tax information. 26 U.S.C.A. §927(e)(3) (West Supp. 1984).

125. 26 U.S.C.A. §922(a)(1)(F) (West Supp. 1984).

126. 26 U.S.C.A. §921 (West Supp. 1984).

127. 26 U.S.C.A. §245(c) (West Supp. 1984). If a foreign corporation has income from

### 1. *Exempt Foreign Trade Income*

Defining "exempt foreign trade income" is the task of I.R.C. section 923 in conjunction with I.R.C. section 924, and to some extent other sections of the FSC provisions. Exempt foreign trade income is a subclass of "foreign trade income"; foreign trade income is defined as the gross income of a FSC attributable to "foreign trading gross receipts."<sup>128</sup> One should note, however, that foreign trading gross receipts will only arise where the management of the FSC takes place outside the United States and where the economic processes with respect to the transaction take place outside the United States.<sup>129</sup>

Moving at last to the empirical or transactional level, one sees that foreign trading gross receipts consist of the gross receipts of a FSC which arise from certain enumerated activities.<sup>130</sup> These activities include (1) the sale, exchange, or other disposition of export property, (2) the lease or rental of export property for use by the lessee outside the United States, (3) the provision of services which are related and subsidiary to the sales, exchanges, dispositions, leases, and rentals described above, (4) the provision of engineering or architectural services for construction projects located or proposed for location outside the United States, and (5) the performance of managerial services for an unrelated FSC or DISC in furtherance of foreign trading gross receipts from activities 1-3 above, where at least 50% of the FSC's gross receipts for the taxable year are from such activities.<sup>131</sup>

sources within the United States (as defined in 26 U.S.C. §861 (1982)), that income can be subject to United States income tax. 26 U.S.C. §881 (1982). Likewise, if a foreign corporation has income which is effectively connected with the conduct of a U.S. trade or business, that income is subject to United States income tax. 26 U.S.C. §882 (1982). 26 U.S.C. §921(a) prevents either section 881 or 882 from imposing a tax on an FSC's "exempt foreign trade income." 26 U.S.C.A. §921(a) (West Supp. 1984).

128. 26 U.S.C.A. §923(b) (West Supp. 1984).

129. Foreign management occurs where all meetings of board members and shareholders take place outside the United States, the principal bank account is outside the United States, and the expenditures of the corporation in the areas of dividends, legal and accounting fees, and officers' and directors' salaries are disbursed from bank accounts outside the United States. 26 U.S.C.A. §924(b) (West Supp. 1984).

130. 26 U.S.C.A. §924(a) (West Supp. 1984).

131. 26 U.S.C.A. §924(a) (West Supp. 1984).

The term "export property" is defined as property "(A) manufactured, produced, grown, or extracted in the United States by a person other than a FSC, (B) held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct use, consumption, or disposition outside the United States, and (C) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States." 26 U.S.C.A. §927(a) (West Supp. 1984). Certain items otherwise falling within the above definition are excluded. These include: (1) property leased to a member of a controlled group of

The income of a FSC attributable to foreign trading gross receipts constitutes foreign trade income.<sup>132</sup> Finally, a FSC's foreign trade income qualifying under I.R.C. section 923(a) as exempt foreign trade income is not subject to current United States income taxation under I.R.C. sections 921, 881, and 882 and, when distributed to a corporate shareholder, under I.R.C. section 245(c).

## 2. *Restrictions on the Allocation of Foreign Trade Income Through Intercompany Pricing Rules*

Exempt foreign trade income is the foreign trade income of a FSC described in I.R.C. section 923(a)(2)-(3).<sup>133</sup> I.R.C. section 923(a)(3) provides the computation of foreign trade income when formulaic transfer pricing is used as between related parties. I.R.C. section 923(a)(2) provides the computation of foreign trade income when arms-length intercompany pricing is used.<sup>134</sup>

Where the FSC has earned foreign trade income that is calculated with arms-length pricing, 32 percent of that income will be exempt from current United States income tax.<sup>135</sup> By contrast, where the foreign trade income is calculated with a transfer-pricing formula, certain administrative rules come into play to prevent tax avoidance.<sup>136</sup> Regardless of the price actually charged as between the related companies, the taxable income of both the FSC and the related entity will be determined based on a transfer price which allows the FSC to derive taxable income in an amount which does not exceed the greatest of (1) 1.83 percent of the foreign trading gross receipts derived from the sale; (2) 23 percent of the combined taxable income of the FSC and the related person which is attributable to the foreign trading gross receipts derived from the sale of such property by the FSC; or (3) the taxable income based on the price actually charged (subject to the rules of I.R.C. section 482).<sup>137</sup> Once the foreign trade income is so deter-

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which a FSC is a member; (2) patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions); (3) oil, gas, and primary products thereof; or products the export of which is prohibited or curtailed pursuant to the Export Administration Act of 1979, §50 U.S.C. app. §2402(2)(c) *extended by* Exec. Order No. 12,470, 219 Fed. Reg. 13,099 (1984). 26 U.S.C. §927(a)(2) (West Supp. 1984).

132. 26 U.S.C. §923(b) (West Supp. 1984).

133. 26 U.S.C. §923(a) (West Supp. 1984).

134. 26 U.S.C. §482 (1982) (referenced by 26 U.S.C.A. §923(a)(3) (West Supp. 1984) via 26 U.S.C.A. §925(a) (West Supp. 1984)).

135. 26 U.S.C.A. §923(a)(2) (West Supp. 1984).

136. 26 U.S.C.A. §923(a)(3) (West Supp. 1984).

137. 26 U.S.C.A. §925(a)(1)-(3) (West Supp. 1984).

mined, 16/23ds of it will be exempted from current United States income tax.<sup>138</sup> Section 291(a)(4) reduces the percentage of a FSC's foreign trade income which is exempt from 16/23ds to 15/23ds, in the case of related party situations, and from 32% to 30% in all other cases.<sup>139</sup>

## B. DISCs and FSCs Compared

### 1. Structural Similarities and Differences

The DISC provisions and the FSC provisions are fundamentally similar. Certain technical differences exist, of course. For example, the DISC provisions began by rendering all corporate-level taxes inapplicable<sup>140</sup> and then imposed tax upon actual distributions and upon certain deemed distributions.<sup>141</sup> The FSC provisions, by contrast, do not grant a blanket corporate-level tax exemption to FSCs; rather, they exempt a certain defined class of the income of a FSC from tax.<sup>142</sup> This difference is probably the result of the fact that DISCs are always domestic corporations,<sup>143</sup> and hence subject to tax<sup>144</sup> absent an exemption, while FSCs are always foreign corporations,<sup>145</sup> and are therefore not routinely subject to tax.<sup>146</sup>

Differences exist also in the way the two sets of provisions define the activities which give rise to the exempt income.<sup>147</sup> Such differences are slight, however. Both direct their benefits toward export activities.

Likewise, the computational aspects of the two sets of provisions dif-

138. 26 U.S.C. §923(a)(3) (West Supp. 1984). A 100% exemption exists as to income attributable to the agricultural or horticultural activities of a qualified cooperative that is a shareholder of the FSC. 26 U.S.C.A. §923(a)(4) (West Supp. 1984). A special, and less favorable, rule also exists as to income derived from military property. 26 U.S.C.A. §923(a)(5) (West Supp. 1984).

139. 26 U.S.C.A. §291(a)(4) (1982).

140. 26 U.S.C.A. §991 (1982) *amended by* 26 U.S.C.A. §991 (West Supp. 1984).

141. 26 U.S.C. §§995 & 996 (1982), *amended by* 26 U.S.C.A. §§995 & 996 (West Supp. 1984).

142. 26 U.S.C.A. §921 (West Supp. 1984).

143. 26 U.S.C.A. §992(a)(1) (1982).

144. 26 U.S.C.A. §11(a) (1982).

145. 26 U.S.C.A. §922 (West Supp. 1984).

146. *See* 26 U.S.C. §§551, 881, 882, & 951, as examples of provisions that do result in U.S. income tax being imposed on the income of foreign corporations. Sections 551 and 951 result in a tax at the shareholder level, while sections 881 and 882 impose a corporate level tax.

147. *Compare* 26 U.S.C.A. §924 (West Supp. 1984) *with* 26 U.S.C. §993 (1982), *amended by* 26 U.S.C.A. §993(a)(3) (West Supp. 1984). While both require some type of disposition of export property, the FSC provision includes in the description of foreign gross trading receipts certain foreign presence requirements.

fer.<sup>148</sup> These differences are more than *de minimis*, but it is too early to determine the actual effects of the changes, either in revenue terms, or with respect to export stimulation or differential industry impact.

One major change that occurred was the failure to adopt anything analogous to the incremental approach found in the DISC provisions.<sup>149</sup> This may result in additional revenue losses. It may also result in greater stimulation of exports than occurred as a result of the DISC provisions, regardless of one's view about the degree to which federal income tax is absorbed by the producer of goods or passed forward to the consumer.

Thus, if one assumes that all federal income tax is absorbed by the producer, then the FSC provisions clearly reduce a company's costs of carrying out export activities. As a result of the increased profitability of export endeavors, companies already exporting goods may shift resources from domestic production to export production, thereby increasing exports.<sup>150</sup> The increased production will in turn increase competition for sale of those goods and thereby reduce their price. This price reduction will decrease profitability of export activities, and ultimately an equilibrium will result, though with more goods being exported than was previously the case.

On the other hand, if one assumes that all federal income tax is passed forward to the consumer, then a reduction in the price of exported goods will result from a reduction of, exemption from, or deferral of the tax on the activities giving rise to the exported goods. Such a price reduction will, to a greater or lesser degree, depending upon the demand elasticity applicable to the goods, increase purchases of the exported goods.

FSCs resemble DISCs in their overall approach to encouraging export activity. There is no doubt that the FSC provisions will increase exports above a level that would prevail in their absence. It is currently impossible, absent any operating history for FSCs, to determine how effective, in exact quantitative terms, the provisions will be in promoting exports. However, their essential similarity with the DISC provisions must lead one to question whether the incremental increase in exports will justify the lost tax revenue.

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148. Compare 26 U.S.C.A. §§924(a) and 925 (West Supp. 1984) with 26 U.S.C. §§994(a) and 995(b) (1982), amended by 26 U.S.C.A. §995(b)(1)(E), (F)(i) & (4) (West Supp. 1984). Although different formulae for transfer pricing are provided in the DISC and FSC provisions, both statutory schemes allow for actual pricing, subject to 26 U.S.C. §482 (1982).

149. 26 U.S.C. §995(b)(1)(E) (1982) was replaced by a different provision, 26 U.S.C.A. §995(b)(1)(E) (West Supp. 1984), and 26 U.S.C. §995(e), dealing with the computation of base period gross receipts, was eliminated and replaced by former section 995(g).

150. An unintended and undesirable second-tier effect of this relocation of resources may be that the costs of domestic goods rise.



## 2. *Avoidance of Technical GATT Infractions*

The key change that occurred was the addition of the foreign incorporation,<sup>151</sup> foreign management,<sup>152</sup> and foreign economic processes requirements.<sup>153</sup> The overall effect is to predicate export tax incentives on substantial offshore activities. The sole reason for this change was to placate our trading partners, with their territorial tax systems,<sup>154</sup> since “[u]nder GATT rules, a country need not tax income from economic processes occurring outside its territory.”<sup>155</sup> By exempting some income derived from foreign-based export activities from tax, the FSC provisions “afford U.S. exporters treatment comparable to what exporters customarily obtain in territorial systems of taxation.”<sup>156</sup>

Substantively, the foreign incorporation, foreign management and foreign economic processes requirements are trivial modifications to the DISC provisions. To a large corporation, they present a minor additional hurdle to obtaining beneficial tax treatment for export activities. In fact, to the extent that jobs formerly based in the United States are moved offshore to areas with lower wages, a cost savings may take place and may offset some of the additional administrative costs resulting from the FSC provisions. However, to the extent that the FSC provisions require United States companies to maintain a foreign presence and to conduct business other than sales activities abroad, a net outflow of jobs may occur. This should please our trading partners, but from a United States perspective must be viewed as a negative aspect of the shift from DISCs to FSCs. Yet, such a job outflow will probably be small, since one would expect that export companies would have already moved part of their operations offshore if such a move appeared beneficial for economic reasons unrelated to United States income tax laws. In other words, the bulk of export-related jobs involves the actual manufacturing of goods. Those manufacturing jobs already have been moved to low wage areas of the United States and the world for purely economic reasons. The FSC provisions may move some additional jobs offshore, but such an effect will probably not be a massive one.

The addition of the foreign incorporation, management, and economic processes requirements provides a cosmetic change which should effectively silence GATT signatories who had expressed concern about the GATT-legality of the DISC provisions. This result is achieved by forcing businesses

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151. 26 U.S.C.A. §922(a)(1)(A) (West Supp. 1984).

152. 26 U.S.C.A. §924(b)(1)(A) & (c) (West Supp. 1984).

153. 26 U.S.C.A. §924(b)(1)(B) & (d) (West Supp. 1984).

154. *See supra* notes 54-57 and accompanying text.

155. D.R.A. EXPLANATION, *supra* note 78, at 634.

156. *Id.* at 635.

wishing to obtain FSC benefits to move some of their activities offshore. The offshore activities may, under GATT, receive favorable tax treatment, while bestowing the same benefits upon export activities taking place within the United States is violative of GATT.<sup>157</sup>

#### V. CONCLUSION

FSCs may well turn out to be DISCs in sheep's clothing, since it is possible that this powerful tax incentive will stimulate exports to a greater extent than do the DISC provisions. Any resulting harm to businesses of GATT signatories will then be attributable to the signatories' narrow emphasis on technicalities and form, for the DISC provisions provided a tax incentive substantively similar to their replacement, the FSC provisions.

Given the fact that the FSC provisions clearly parallel the DISC provisions, they are subject to many of the same United States policy concerns. The domestic economic costs of the FSC provisions include higher costs for domestic goods, lost jobs, and diminished tax revenue. It remains to be seen whether the benefits of higher export levels will offset these costs. FSCs are a new phenomenon, and therefore have no history to serve as the basis for evaluation. On the other hand, their resemblance to DISCs makes them susceptible to analysis in light of the United States experience with DISCs. We will be in a better position to pass judgment when actual tax cost and export increase data for 1985 and subsequent years are available. As with the DISC data, however, the numbers will provide a false sense of objectivity, since they are always subject to interpretation due to the complexity of cause and effect relationships in the real world.

It has long been recognized that erecting trade barriers and tariffs carries the risk of reprisals in the form of counter-restrictions on trade. The result can be a stifling array of moats and walls running counter to the interests of all in the long run, and accepted only because of the apparent short-run benefit to a nation's trade balance and profits of domestic corporations.

Export incentives are analogous to import restrictions. It is in the interests of all to multilaterally reduce government involvement in trade policy, excluding, of course, justified policing functions in the arena of commerce. The FSC provisions will neither increase nor significantly decrease the United States' role in granting export incentives. Comparatively, the United States practices *laissez-faire* capitalism in the international marketplace.<sup>158</sup> Given that the DISC or FSC provisions constitute our only major export

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157. See *supra* text accompanying notes 78-123.

158. See *supra* text accompanying notes 94-106.

subsidy,<sup>159</sup> an abolition of these without corresponding concessions from our trading partners would be unwarranted. A partial list of the tax and non-tax export incentives provided by some or all of our major trading partners includes rebates of indirect taxes; subsidized loans, export credit insurance, technical assistance, buyer entertainment, trade fairs, and diplomatic assistance; and diminished antitrust concerns for export industries.<sup>160</sup> As demonstrated, the FSC provisions at most render the United States system of taxation as generous toward offshore export activities as the territorial systems of our trading partners.

Rather than taxing our ingenuity in an effort to find GATT-legal export subsidy devices, the United States should properly seek to reduce worldwide use of such incentives, and strive to encourage freer trade.<sup>161</sup> The undesirability of import barriers has already been learned, and now the logical next step, reduction of export incentives, is called for. The two require each other in order to have a maximum effect in making goods and services available to the world's population in an economical manner.<sup>162</sup>

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159. See Banks, *supra* note 111, at 121.

160. See *Export Hearings*, *supra* note 80, at 56-128. "The list [of export tax incentives granted by other nations] could be expanded almost indefinitely. The ingenuity of modern nations in creating tax export subsidy devices appears to be without limit." *Id.* at 125.

161. This would seem a proper government function, obviating the need for private actions, like that taken by Zenith Radio Corporation. *Zenith Radio Corp. v. United States*, 437 U.S. 443 (1978). Relying on the Tariff Act of 1930, Zenith sought to require the Secretary of the Treasury to impose a duty on Japanese products imported into the United States in an amount equal to the indirect taxes Japan remitted on such exports. Zenith contended that such remission constituted an improper "bounty" or "grant" under the Act, but the Court found otherwise. Note that granting the relief sought by Zenith, the imposition of a countervailing duty on Japanese goods imported into the United States, would have led to more restrictive international trade, not freer trade. Persuading Japan to cease export subsidies would have been preferable; the onus of such persuasion properly lies with the U.S. government.

162. See *Export Hearings*, *supra* note 80, at 102-06.