1984

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Transition from the Domestic International Sales Corporation to the Foreign Sales Corporation: Form Without Substance

I. Introduction

During the early 1970's, the United States' economic position in the international marketplace seriously deteriorated. The balance of payments deficit was approximately 23 billion dollars in 1971 whereas there had been year-end trade surpluses of 7.1 billion dollars in 1965, 2 billion dollars in 1969, and 3.6 billion dollars in 1970.1 By the second quarter of 1971, the deficit registered 88 million dollars. This situation culminated in the August 1971 "dollar crisis" when the United States terminated its use of a convertible gold currency standard.2 By the end of the third quarter of 1971 the merchandise trade balance was a 298 million dollar deficit, a distinct contrast to the third quarter 2.4 billion dollar merchandise trade surplus of 1970.3

In an effort to remedy this alarming imbalance of payments, Congress legislated to spur the nation's economy. In large part this legislation was designed to encourage export of American goods and services. The Revenue Act of 19714 introduced an important export incentive by allowing a Domestic International Sales Corporation (DISC) to achieve indefinite deferral of income tax on unrepatriated income earned abroad.5 From the time of their inception, however, DISC benefits to qualified American overseas traders drew sharp criticism from several of America's trading partners, most notably European members of the General Agreement on Tariffs and Trade (GATT).6 In order to blunt GATT-European Community (EC)

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2. Id.
3. Id.
6. General Agreement on Tariffs and Trade, opened for signature Oct. 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 194 [hereinafter cited as GATT]. In assessing the role of the United States in the GATT, it is important to recognize that the majority of its trading partners are members of the GATT. The following countries are signatories of the GATT: Argentina, Australia, Austria, Bangladesh, Belgium, Benin, Brazil, Burma, Burundi, Cameroon, Canada, Chile, Congo, Cuba, Czechoslovakia, Denmark, Dominican Republic,
charges that DISC benefits operate as an invalid United States trade subsidy under the GATT, the Reagan Administration introduced legislation to modify DISC tax deferral benefits through use of the Foreign Sales Corporation (FSC).

Although FSC provisions are intended to repeal the bulk of the DISC provisions of the Internal Revenue Code of 1954 (IRC), the Foreign Sales Corporation Act contains a provision “forgiving” currently accumulated deferred DISC tax liabilities. The effect of this FSC provision is to create a substantial windfall to previous DISC users, estimated at 9 to 10 billion dollars. This provision will continue to engender domestic and international debate.

This Note will first address the DISC mechanism for providing incentives to foreign export traders and the benefits enjoyed by DISC users. The discussion will then shift to an examination of criticisms levied against the DISC provisions by domestic and European sources. The next section will outline both the FSC legislation, and the following section will analyze its applicability to GATT Council Rulings on the DISC. Finally, this Note will conclude that the FSC provisions will also draw GATT-EC attack as “illegal” trade practices by the United States.

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8. Treasury officials estimated that as of 1981, about $17 billion in accumulated tax deferred income of DISCs existed. Sources have estimated that this total has probably risen by about $3 billion a year since then. [3 Current Developments] WEEKLY TAX REP. (BNA) 439 (April 2, 1984). It is very possible that this forgiveness will provide the companies with an exemption of $10 billion to $15 billion in taxes.

The Congressional and Administrative Highlights accompanying the Official Legislative History and text of the Deficit Reduction Act of 1984 (H.R. 4170) pegs the “forgiveness” figure at $13.6 billion.
II. Purpose and Mechanism of DISC Provisions

A. Overview

The previous DISC provisions were part of a tax package in the Revenue Act of 1971 designed to stimulate the then-lagging domestic economy toward higher growth, to increase exports, and to improve the balance of payments.9 Tax incentives for increased exports were intended to lower the cost of exporting goods in foreign markets, thereby increasing demand for and export of American products. By extending their sales markets overseas, United States corporations willing to incur added export costs and to conform to the DISC provisions would receive unlimited tax deferral on qualified export receipts.10 In 1971 the House Ways and Means Committee reported,

This is important not only because of its stimulative effect but also to remove a present disadvantage of U.S. companies engaged in export activities through domestic corporations. Presently, they are treated less favorably than those which manufacture abroad through the use of foreign subsidiary corporations. United States corporations engaging in export activities are taxed currently on their foreign earnings at the full U.S. corporate income tax rate regardless of whether these earnings are kept abroad or repatriated. In contrast, U.S. corporations which produce and sell abroad through foreign subsidiaries generally can postpone payment of U.S. tax on these foreign earnings so long as they are kept abroad.11

In addition to diminishing the advantage enjoyed by foreign incorporated subsidiaries of domestic corporations, Congress intended

10. See Note, DISCs: Toward More Effective Export Incentives in the 1980s, 34 TAX LAW. 197, 199 (1980).
11. See House Report, supra note 9, at 1872. The legislative summary of the Revenue Act of 1971 adds:

Your [House Ways and Means] Committee believes that this bill is necessary because the performance of the economy in recent months has been unsatisfactory. The growth in our gross national product has been small, unemployment has remained too high, and capital goods expenditures have hardly grown at all. Despite these factors, which would usually point toward deflation, we have been unable to shake the persistent inflationary trend of prices. All this has been compounded by our serious adverse balance of trade and the accompanying crisis in the position of the dollar abroad.

Id. at 1825, 1827.
to prevent discrimination by major trading nations that impose value-added or multi-stage taxes on imported goods but refund the same tax paid by their exporters at the time of export.\textsuperscript{12}

Under the DISC tax deferral provisions, DISC profits were not taxed to the DISC but were instead taxed to the shareholders\textsuperscript{13} on a pro rata basis when DISC income was repatriated to them. DISC shareholders were deemed to have received their pro rata share of DISC income in an amount equal to as much as 57.5 percent of the DISC export profits, even if in actuality the shareholders received less or nothing at all.\textsuperscript{14} For example, assume Acme Manufacturing Corporation is the sole shareholder of Beta Sales Corporation, a DISC. At the end of the taxable year, Beta earned 1 million dollars of qualified export income. During that year, Acme would have been deemed to have received 57.5 percent of that income as a dividend distribution, even if the board of the DISC decided against granting a dividend. When DISC dividends were paid to corporate shareholders in the United States, the shareholders were treated as the initial recipients of the profits. The income was then treated as foreign source income, entitling the shareholder to take a credit against its tax liability on the income. The amount of this credit was the sum of any related income taxes paid to a foreign country.\textsuperscript{15} Thus, the shareholders avoided the burden of corporate "double taxation."\textsuperscript{16}

The remaining 42.5 percent of DISC export income was theoretically treated as if the DISC were a domestic corporation which had not elected to be treated as a DISC\textsuperscript{17} for purposes of determining depreciation deductions, expenses incurred in a trade or business, etc. This calculation, however, is only theoretical because the resulting tax was deferred for the life of the DISC.\textsuperscript{18}

\textsuperscript{12} Id. at 1996.
\textsuperscript{13} The Statute and the I.R.C. of 1954 do not appear to limit who or what may qualify as a shareholder. Essentially, a DISC need not have any employees or perform any function other than to provide an accounting tool in determining which income may be deferred and when taxation will occur. In effect, it may be a "paper company." Most often, the DISC operates as a foreign sales subsidiary of a parent or "producer" corporation. Treas. Reg. § 1.992-1 (1980).
\textsuperscript{15} Congress specifically stated in the legislative summary that DISC-generated income tax liability cannot be offset by unrelated foreign tax credits. House Report, supra note 9, at 1873.
\textsuperscript{17} Treas. Reg. § 1.991-1(b) (1980). Thus, the DISC may choose its methods of depreciation, inventory, and annual accounting in the same manner as if it were a corporation which had not elected to be treated as a DISC. In fact, "[a]ny elections affecting the determination of taxable income shall be made by the DISC." Treas. Reg. § 1.991-1(b)(1) (1980). Of course, if the DISC is a member of a controlled group or the method of accounting chosen distorts the actual income of the DISC, the DISC may not elect this method. Treas. Reg. § 1.991-1(b)(2) (1980).
\textsuperscript{18} In the Acme Manufacturing/Beta Sales Corporation example, the 42.5 percent of the remaining DISC income is tax-deferred income. Thus, Beta (in effect, Acme Manufacturing) is receiving an interest-free loan. I.R.C. § 991 (1984), and Treas. Reg. § 1.991-1(a)
DISC benefits were only available if the corporation fulfilled specific IRC requirements for attaining and retaining DISC status. The IRC required that a corporation desiring DISC treatment:

1. be incorporated under the laws of a State or the District of Columbia;¹⁹
2. have 95 percent or more of its gross receipts consist of qualified export receipts;²⁰
3. possess an adjusted basis of the qualified export assets³¹ of

(1980).

²⁰. I.R.C. § 993(a)(1) states:
[T]he qualified export receipts of a corporation are—
(A) gross receipts from the sale, exchange, or other disposition of export property,
(B) gross receipts from the lease or rental of export property, which is used by the lessee of such property outside the United States,
(C) gross receipts for services which are related and subsidiary to any qualified sale, exchange, lease, rental, or other disposition of export property by such corporation,
(D) gross receipts from the sale, exchange, or other disposition of qualified export assets (other than export property),
(E) dividends (or amounts includible in gross income under section 951) with respect to stock of a related foreign export corporation (as defined in subsection (e)),
(F) interest on any obligation which is a qualified export asset,
(G) gross receipts for engineering or architectural services for construction projects located (or proposed for location) outside the United States, and
(H) gross receipts for the performance of managerial services in furtherance of other qualified export receipts of a DISC.

Specifically excluded from qualified export receipts are:
receipts from the sale, exchange, lease, rental, or other disposition . . . or furnishing of services—
(A) for ultimate use in the United States;
(B) accomplished by a subsidy granted by the United States or any instrumentality thereof; (C) for use by the United States or any instrumentality thereof where the use of such export property or services is required by law or regulation.


²¹. I.R.C. § 993(b) states:
(b) [T]he qualified export assets of a corporation are—
(1) export property (which is) property—
(A) manufactured, produced, grown, or extracted in the United States by a person other than a DISC,
(B) held primarily for sale, lease, or rental, in the ordinary course of business, by, or to, a DISC, 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 (as appraised by the Secretary under the Tariff Act of 1930 importation laws),
(2) assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembly, or servicing of export property, or the performance of engineering or architectural services described . . . in furtherance of the production of qualified export receipts . . . ;
(3) accounts receivable and evidences of indebtedness which arise by reason of transactions of such corporation or of another corporation which is a DISC and which is a member of a controlled group which includes such corporation . . . ;
the corporation at the close of the taxable year equal to or
in excess of 95 percent of the sum of all corporate assets at
the close of the taxable year;\textsuperscript{22}

(4) have not more than one class of stock and a par or stated
value of its outstanding stock of at least 2,500 dollars on
each day of the taxable year;\textsuperscript{23} and

(5) make a timely election of DISC status to be in effect
throughout the taxable year.\textsuperscript{24}

Substantial Treasury Regulations fleshed out the above
requirements.\textsuperscript{25}

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\textsuperscript{24} I.R.C. § 992(A)(1)(D) (1984) (election, unless the Secretary indicates otherwise,
must be made within 90 days of the beginning of tax year in which DISC treatment is desired;
DISC status must be re-elected each subsequent taxable year).
\textsuperscript{25} An example will enhance understanding of the DISC provisions. Assume that Man-
ufacturing Corporation (MC) and Sales Corporation (SC) are both Delaware corporations.
MC owns all the common stock of SC, a DISC. SC is a commission agent, but not exclusively
of MC.

MC manufactures a few products it desires to market overseas through SC, but SC's
board of directors is unsure whether the product in SC's hands will qualify as DISC export
property. Management and counsel for SC examine the products carefully for compliance with
the Treasury Regulations. Several product lines are at issue:

1. \textit{Acme Shoe Polish}.—The Regulations state that any export product
containing greater than 50 percent “oil, gas, coal, or uranium,” is not valid
DISC export property in the hands of the DISC. Treas. Reg. § 1.993-3(g)(3)
(1977). SC knows that Acme Shoe Polish contains some petrol distillates and asks
MC to specify the percentage, determinable at the time of ultimate consumption

Acme Shoe Polish contains 55 percent Norwegian cod oil (cheaper than
lanolin or sheep oil), 20 percent petrol distillate, and 25 percent dyes and other
by-products. The polish qualifies as export property with regard to the petrolis-
distillate. Treas. Reg. § 1.993-3(g)(3) (1977). However, the 55 percent Norwegian
cod oil \textit{disqualifies} the polish as DISC export property, according to Treasury
Regulations requiring that DISC export property possess no greater than 50 per-
cent “foreign content.” Treas. Reg. § 1.993-3(e)(1) (1977). For purposes of the
IRC, “foreign content” refers to articles imported into the United States
whether originally produced in the United States or not. Thus, SC may not in-
clude sales of Acme Shoe Polish in calculating qualified export receipts eligible
for DISC tax deferral.

2. \textit{Patent for Acme Shoe Polish}.—MC, dismayed that the domestic mar-
B. DISC Benefits

The benefits to a domestic exporting corporation fulfilling and operating under the DISC provisions were manifold. First, United States companies had a decreased tax burden and were able to lower their product prices internationally, not only because of immediate tax savings, "but perhaps more importantly, because the DISC scheme permitted year-after-year accrual of an interest-free fund that grows, revolves and is continuously invested in eligible export activities."\(^{26}\) In effect, the DISC provisions provided a vehicle for reduced capital costs to United States exporters, thereby encouraging small firms with limited financing to enter the international market.\(^{27}\)

Second, by lowering export costs the DISC provisions encouraged private development of export markets and new products. The DISC provisions placed United States firms on equal footing in export markets with foreign companies that receive tax and non-tax incentives\(^{28}\) from their home governments.\(^{29}\)

ket is weak for their fishy smelling shoe polish and that SC cannot receive DISC treatment on export receipts from overseas sales of the polish, decides to offer its shoe polish patent for sale in the international market through SC.

According to the Regulations, patents, copyright, and other intangibles are not valid export property in the hands of the DISC. Treas. Reg. § 1.993-3(f)(3) provides: "Intangible Property. Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, tradebrand, franchise, or other like property." SC suggests instead that MC allow SC to investigate possible licensure agreements, deemed valid export property for the DISC. A license of patented or copyrighted property is not disqualified under this section from being export property. \(\text{id.}\)

3. Screws and Bolts.—MC owns ten tons of stainless steel rods, remnants of its manufacture of high quality playground equipment. MC would like SC to convert the rods to nautical quality screws and bolts for export.

The Regulations, however, preclude further manufacture or production (of export property) outside of the United States prior to sale or lease. Treas. Reg. § 1.993-3(c) (1977). Conversion of the stainless steel rods to screws and bolts constitutes a "substantial transformation" and would disqualify the product from characterization as DISC export property. Treas. Reg. § 1.993-3(c)(2)(ii) (1977).

If SC were instead to purchase the playground equipment from MC and assemble it prior to export resale, Treas. Reg. § 1.993-3(a) (1977), this activity would not in itself disqualify the resulting income from DISC treatment. Treas. Reg. § 1.993-3(c)(2)(ii) (1977).

The above illustrates the potential complexity involved in interpretation of the Treasury DISC regulations. In a transnational business enterprise that utilized a DISC, product and management decisions had to be carefully plotted in accordance with legislation to prevent alienation of DISC benefits from certain export receipts.


27. Id. at 183 (the author also notes that the advantage of lower capital cost is even greater in capital-intensive industries, such as heavy manufacturing).

28. Non-tax incentives include business failure and fortuitous loss of profits insurance such as that offered and underwritten by the French Government.
Third, the DISC provisions sometimes served as a "bargaining chip" in multinational trade negotiations by enhancing United States trade policy.30

DISCs also contributed to the fiscal health of the United States economy. This is illustrated by an August 1983 Treasury Department report indicating that total United States exports had increased an estimated 7 to 11 billion dollars in 1981 because of the DISC provisions.31 This represents an increase of approximately 16 percent in United States exports for this period. In 1981, 8665 DISCs filed tax returns, reporting gross receipts of 111.6 billion dollars in exports of manufactured goods.32 Net income reported by all DISCs in 1981 was 9.9 billion dollars, with a decrease in the consolidated profit margin during the same period from 13.9 percent to 13.1 percent in 1981.33 The largest dollar amounts in income resulted from sales, leases, or other dispositions of nonelectrical machinery, transportation equipment, and chemicals. These overall increases, the Treasury reported, occurred at a "cost" to the Treasury (in terms of revenue lost) of 1.65 billion dollars—a "cost" increase of 17 percent over the same 1981 figure.34

From these statistics it can be inferred that DISCs were an economic asset. The 1983 Treasury Report indicates that DISCs provided tax revenue at a reasonable cost—approximately 15 to 23.6 percent of revenue produced was attributable to DISC operation.35 Surprisingly, however, the DISC provisions continued to receive substantial criticism, both at home and abroad.

III. Complaints Against the DISC

A. Domestic Criticism

The substantial fiscal advantages offered to corporations by the DISC provisions were not without domestic detractors. The primary objection to the DISC was its costliness and its tenuous relation to increases in export trade. While Treasury estimated the revenue lost

29. See infra notes 60-61 and accompanying text.
30. See infra notes 50-61 and accompanying text.
31. [2 Current Developments] WEEKLY TAX REP. (BNA) 211 (Aug. 15, 1983). The Treasury report added, "The range of estimates [$7-11 billion] is based on an analysis of demand for various product categories. DISC tax savings increase the profitability of exports, but the extent to which export supply is stimulated depends upon the change in the profitability of capital used for export production." Id.
32. Id.
33. Id.
34. Id.
35. This estimate is the result of dividing the "revenue cost" by the gain attributed to the IRC DISC provisions in the 1983 Treasury Report figures. Thus, for every $100 of export income attributable to the DISC, the "cost" to the Treasury Department (U.S. consumer) is between $15 and $23.60.
in 1981 to be 1.65 billion dollars, one commentator estimates a revenue "loss" in excess of 1.80 billion dollars in 1982. The Congressional Research Service of the Library of Congress (CRS) reported in December 1983 that Treasury figures concerning revenue attributable to DISCs are "substantially overstated."

Certain factors, the CRS report asserts, offset the value of the Treasury statistics. First, the Treasury Report does not clearly reveal whether the increased income was the result of increased DISC-encouraged sales or merely derivative of extrinsic, unrelated increases in demand. Second, when the dollar is strong against most foreign currencies, as is presently the case, there is an increased desire in foreign markets to acquire United States dollars. This desire lowers the price of imports to the United States and simultaneously increases domestic demand for lower-priced goods. Cultivating a high demand for imports could have a deleterious effect if the value of the United States dollar were to drop dramatically or if a cartel were to appear in an import area. The United States experienced such an effect in the early 1970's as the result of OPEC controls on United States imports of crude petroleum. Some commentators contend that, given the nebulous benefit to the domestic economy, the revenue lost through the DISC provisions might create a greater economic impact through tax cuts or the creation of jobs.

Commentators have also criticized the DISC for providing a tremendous windfall to large exporters to the exclusion of smaller firms. These critics contend that export activity is "a function of considerations other than tax incentives. For example, an airplane company doesn't sell a plane because it is getting a break from DISC. It sells a plane because it has found someone over there who wants to buy it." Recognition of the DISC windfall to larger corporations prompted curtailment of DISC benefits by the Tax Reform Act of 1976. For DISCs with income of more than 100,000 dollars DISC benefits were limited to income attributable to export gross receipts in excess of 67 percent of the average export gross receipts of a four-year base period.

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36. See supra notes 31-34 and accompanying text.
37. Export Promotion, supra note 26, at 192.
39. Id.
40. Id.
41. Export Promotion, supra note 26, at 192.
42. Id. at 191. For further discussion of tax deferral and Administration tax policy, see Taylor, The Foreign Tax Credit, Deferral, and the DISC Provisions: Casualties in a Holy War of Protectionalism? 16 Hous. L. Rev. 63 (1978).
43. "Larger" corporations are generally those corporations filing an IRC form 2952 which is used by corporations with valued assets in excess of $250 million.
A third, but no less important, criticism of the DISC provisions is the Government’s failure to take adequate measures to stem the tide of increased United States reliance on imports in many sectors. United States productivity, particularly in the heavy manufacturing sector, is alarmingly low, both in the domestic market and in relation to several of America’s trading partners. In 1979 President Carter established the President’s Export Council to “formulate recommendations on programs and policies to increase U.S. exports and to promote the development of a greater national export consciousness.” On November 20, 1980, the Council submitted an extensive report on United States export trade in the 1970’s and made eight final recommendations for accomplishing the Executive mandate. The recommendations advised that “we as a nation . . . become export-conscious and export-oriented” and that “we . . . increase national export consciousness through increased export programs and incentive systems.” Additionally, the Council admonished that the United States should begin to match other industrial nations in the percentage of GNP invested in developing new technology, plants, and equipment. An increase in productivity at home would tend to reduce the cost of American-made products in the domestic market and make them more competitive against imported goods.

In sum, the primary objections to the DISC provisions from domestic critics were the inconclusive relation of the DISC “cost” (in terms of revenue lost) to gain in revenue or increase in exports, and the substantial windfall available to large firms which operate with minimal regard to the specialized tax incentive of the DISC. In addition, recognition of the need to improve domestic productivity and decrease domestic demand for inexpensive imports appears to mandate a more balanced export policy to reduce reliance upon imports in several areas of the domestic economy.

B. European Criticism

Shortly after adoption of the DISC provisions, several members of the European Community launched vigorous attacks on the United States tax policy. This disapprobation culminated in submis-

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46. Id.
47. Id. at 16.
48. Id. at 21.
49. Id. at 20.
sion of a formal complaint to the GATT Panel of Reconciliation by the governments of Belgium, France, and the Netherlands in 1973.50 These nations jointly asserted that the DISC deferral of taxable export income constituted an illegal export subsidy under the terms of the GATT. A brief excursus into the background and purpose of the GATT will facilitate an understanding of the controversy.

The General Agreement on Tariffs and Trade emerged in the post-World War Two period as the central trade institution. Its primary aim was to promote equitable, nondiscriminatory free trade.51 The charter members52 articulated their goals in the opening paragraphs of the Agreement as follows:

[R]elations in the field of trade and economic endeavor should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods; . . . . [T]hese objectives should be pursued by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and the elimination of discriminatory treatment in international commerce . . . .53

Accompanying GATT provisions forbade illegal government subsidization of export industries. These provisions are found in article 16 of the Agreement, and are particularly pertinent to the current discussion of the DISC and the GATT-EC response thereto.

Article 16 of the GATT prohibits use of unauthorized subsidies or other income or price supports that tend to increase exports from

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51. The final draft of the charter of a United States State Department sponsored international trade organization, called the Havana Charter, was not ratified by the United States Congress. Instead, the General Agreement, drawn in Geneva in 1947, became the founding document for an international institution with a commercial policy role. K. DAM, LAW AND INTERNATIONAL ECONOMIC ORGANIZATION 10-11 (1970) [hereinafter cited as DAM]. Dam also states that:
Although the General Agreement contains neither the institutional provisions nor all the substantive provisions of the Havana Charter, it contains most of the provisions on commercial policy supported in the 1940's by U.S. diplomats. The General Agreement is therefore a sufficiently direct expression of U.S. views on the appropriate form of concerted international action in the commercial policy area that it cannot be understood without an examination of those views . . . . Simply stated, the U.S. position was that, in general, nontariff barriers should be abolished forthwith and that all tariffs should be reduced through international negotiations.
Id. at 12. Thus, the United States evidently possesses a large political stake in insuring compliance with the Agreement, in addition to the obvious economic interest.
52. All of the parties to the current controversy, France, Belgium, the Netherlands, and the United States, are all charter members of the GATT.
53. GATT, supra note 6, at paras. 2, 3 (emphasis added).
or reduce imports to a country. Although it originally condemned only direct government aid to production, article 16 was expanded in 1960 to include the "remission and exemption of direct taxes" under the heading of "practices deemed invalid export subsidies." This amendment specifically excluded remission (or rebate) of indirect taxes. Thus, under article 16, remission of indirect taxes is not a prima facie invalid export subsidy, but the exemption (deferral without charged interest) is invalid. This, is the origin of the EC complaint against the United States DISC tax deferral scheme.

The United States relies primarily upon direct income taxation as its source of federal revenue by taxing income wherever generated. The majority of Western European trading nations generate revenue through an indirect or multi-stage territorial system of taxation, most frequently the value-added tax (VAT). The ultimate consumer bears the greatest weight of the VAT paid on the value added to the goods during each phase of production. If, however, the

54. GATT, supra note 6, art. 16. Article 16 of the GATT reads, in part:

Subsidies—

(2) The contracting parties recognize that the granting by a contracting party of a subsidy on the export of any product may have harmful effects for other contracting parties, both importing and exporting, may cause undue disturbance to their normal commercial interests, and may hinder the achievement of the objectives of this Agreement.

(3) Accordingly, contracting parties should seek to avoid the use of subsidies on the export of primary products. If, however, a contracting party grants directly or indirectly any form of subsidy which operates to increase the export of any primary product from its territory, such subsidy shall not be applied in a manner which results in that contracting party having more than an equitable share of world export trade in that product, account being taken of the shares of the contracting parties in such trade in the product during a previous representative period, and any special factors which may have affected or may be affecting such trade in the product (emphasis added).

The European Community derives its complaint from this GATT provision.

55. DAM, supra note 51, at 12.

56. Export Incentives, supra note 50, at 545.

57. Treas. Reg. § 1.861-7(a) states:

Gains, profits, and income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which the property is sold. Thus, gross income from sources within the United States includes gains, profits, and income derived from the purchase of personal property without the United States and its sale within the United States.

See also Treas. Reg. §1.862-1(b) which adds:

[T]axable income from sources without the United States, in the case of items of gross income specified in paragraph (a) of this section [above], shall be determined on the same basis as that used . . . for determining the taxable income from sources within the United States.

However, income earned abroad is not subject to United States tax unless (1) the taxpayer repatriates the income, as in the form of dividends to shareholders, or (2) absent repatriation, the taxpayer elects to be taxed on income earned outside the territorial limits of the United States as foreign source income. The DISC typifies the first form of taxation on foreign source income, while the FSC characterizes the latter. The mechanism of the FSC is discussed in notes 78-79 infra.

58. Export Incentives, supra note 50, at 546.
country of origin imposes a VAT on certain goods which are then exported, the VAT is rebated to the exporter. These taxes are then imposed on the importers of such goods. This method prevents double taxation of the goods when consumed in a foreign market.  

Territorial tax laws of Belgium, France, and the Netherlands do not subject specified income earned abroad to domestic income taxation. Thus, foreign subsidiary operations enjoying a "tax holiday" in a country with a lower tax rate are in effect exempted from taxation on that foreign source income. This practice is enjoyed by French corporations operating through foreign subsidiaries. The United States claims that this practice constitutes an invalid trade subsidy in violation of the GATT and therefore justifies the United States' use of the DISC provisions.

IV. The Foreign Sales Corporation Act of 1984

A. Reasons for the Change

The GATT Panel of Reconciliation determined in 1976 that the United States DISC, as well as the challenged European territorial tax practices, had the effect of providing export subsidies in violation of the GATT. The Panel reports, modified in December 1981 by GATT Council Decision, stated that:

(a) GATT signatories were not required to tax income earned without their territorial limits, and

(b) arm's length pricing should be observed in transfers between controlled-group or related enterprises.

The EC, dissatisfied with the GATT Council's noncommittal response, sought authorization from the GATT Council to pressure United States reformation of the DISC under threat of retaliatory action. Specifically, the EC sought authority to increase trade restrictions on 2.3 billion dollars in United States exports to the EC. Other GATT countries also sought direct compensation from the United States for benefits allowed United States exporters under the DISC provisions.

59. Id.
60. Export Promotion, supra note 26, at 185.
61. The perception that the United States firm operates at a disadvantage in the foreign market was a moving force in the enactment of the DISC provisions of the Revenue Act of 1971. See supra notes 9-12 and accompanying text.
63. Id.
64. Id.
On October 1, 1982, the Reagan Administration, via the United States Trade Representative, made a commitment to the GATT Council that the Administration would promptly propose legislation addressing the interests and concerns of the EC and the GATT nations. Less than one year later, on August 5, 1983, the Administration introduced the Foreign Sales Corporation Act of 1983 (S. 1802, H.R. 3810) to honor this commitment.

B. Purpose and Mechanism of the FSC

The FSC provisions represent the Reagan Administration's effort to conform United States export incentives and tax policy to the letter and spirit of the GATT. The FSC provisions also propose to provide benefits to exporters comparable to those of the DISC at approximately the same revenue "cost" to the Treasury. The goals of the FSC were recently outlined by Deputy Assistant Secretary for Tax Policy, Ronald A. Perlman:

The [FSC Act of 1984] was drafted with four objectives: to meet U.S. obligations under the GATT; to be revenue neutral with the DISC; to preserve to the extent possible the position of existing DISC users; and to provide incentives for small businesses.

The Administration is actively seeking assurances from a coalition of European nations on the FSC replacement of the DISC in order to avoid retaliation in the form of trade restrictions.

65. Id.


Upon presentation of the bill to the House, Ways and Means Committee Chairman Rostenkowski asked for a conference on the Senate and House versions of the major tax bill. The bill entered conference committee, finally emerging on June 23 at 5:30 a.m., after a dramatic marathon conference session. 130 Cong. Rec. H6369 (daily ed. June 22, 1984, Part II). The final version of the legislation appears as the Deficit Reduction Act of 1984 (H.R. 4170).

69. Id.
ing from economic processes outside its own borders." The FSC accomplishes this in large part by fulfilling a foreign presence requirement.

The FSC requires that an electing corporation meet the following criteria:

1. The corporation must be organized under the laws of a jurisdiction outside of the United States customs territory;
2. At least one director of the FSC must not be a United States resident;
3. The corporation must maintain, throughout the taxable year,
   a. an office located outside of the United States,
   b. a set of permanent books of account at the foreign office, and
   c. a set of permanent records at an office within the United States;
4. The corporation's income must be "foreign trade income (FTI)," that is,
   a. income earned with respect to sales or leases of certain export property or the performance of certain export-related services,
   b. managed outside of the U.S., and
   c. the result of certain recognizable economic processes in furtherance of an export transaction outside the U.S.;
5. The corporation must make a timely election of FSC classification; and
6. All transactions between FSCs and related suppliers (producers) must be made on an arm's length basis with fair market value as an indication thereof.

These qualifications must be met in every instance for the resulting income to qualify as foreign trade income.

FSC provisions exempt a portion of the corporation's foreign trade income.

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70. Senate Comm. on Finance, Explanation of Provisions, supra note 62.
71. Id. § 922(a)(1)(E).
72. Id. § 922(a)(1)(D)(i)-(iii).
73. Id. § 922(a)(1)(A)(i)-(ii).
75. Id. § 924(b)(1)(A) (1984).
76. Id. § 924(b)(1)(B) (1984).
77. Id. § 922(a)(2) (1984).
78. Id. § 925(a) (1984).
79. Id. § 924(a) (1984).
trade income, ordinarily 34 percent, unless special Administration transfer-pricing rules are in effect during the transaction or series of transactions.\textsuperscript{80} If a corporation elects FSC status and files a United States return, the domestic corporate shareholders of the FSC are entitled to a 100 percent dividends-received deduction with respect to the dividends earned as foreign trade income of the FSC.\textsuperscript{81}

In mid-March of 1984 the Senate Finance Committee agreed to the Administration's FSC proposal, but not without certain changes. Businessmen and attorneys testifying before the Committee raised several concerns, reflected in the following modifications of the bill:

1. a FSC may be organized only in a foreign country that is either
   a. a party to an exchange of information agreement that meets the standards of the Caribbean Basin Legislation (now section 274(h) of the IRC), or
   b. an income tax treaty partner of the United States, and the Secretary of the Treasury certifies the exchange of information program with that country;

2. the small business exemption was increased from 2.5 million dollars to 5 million dollars of export gross receipts;

3. a FSC that performs managerial services (such as export market studies and contacting potential foreign purchasers) for other FSCs will be eligible for FSC treatment for the resulting income, whether or not it is engaged in exporting; and

4. the untaxed export trade income of an export trade corporation (ETC) may also be treated as previously taxed income, making it exempt from U.S. tax.\textsuperscript{82}

The Administration's proposal, complete with Senate Finance Committee modification, passed out of the Committee into full debate in April 1984.

One concern of the business community was that inadequate measures would be taken to protect smaller exporting firms. However, the bill contains two special provisions intended to benefit the smaller exporter. First, if a FSC elects to limit the exclusion of exempt foreign trade income to foreign trade income derived from less than 2,500,000 dollars of foreign trading gross receipts, that FSC

\textsuperscript{80} Id. § 923(a)(2). Section 923(a)(3) adds, in the case of any transaction in which Administration pricing rules are in effect, that $17/23 of the foreign trade income derived from such transactions shall be treated as foreign trade income (thus exempt from United States tax). The remaining $6/23 (26.1%) is subject to United States tax.

\textsuperscript{81} Id. § 926(b) (1984).

\textsuperscript{82} Senate Comm. on Finance, Explanation of Provisions, supra note 62.
will not be required to satisfy the foreign management and foreign economic process requirements of the Bill. This provision recognizes the potential hardship to a small firm required to maintain an overseas office, an often prohibitively expensive venture. Second, a smaller firm may opt to use an “interest-charge DISC” if the shareholders (the taxpayers under the DISC scheme) agree to pay, for each taxable year, “interest in an amount equal to the product of (A) the shareholder’s DISC-related deferred tax liability for such year, and (B) the base period T-bill rate.” Interest-charge DISC’s are then allowed a 100 percent tax deferral on the DISC income up to and including 10 million dollars of export receipts annually. At this point, an example of the FSC mechanism may prove helpful in understanding the recent changes to the DISC.

C. The FSC In Operation—An Example

Assume that Amalgamated Production Enterprises (APE) is a medium-sized manufacturing concern incorporated in Delaware. APE currently exports its products through American Sales Professionals (ASP), a DISC in which APE owns no share or interest. The board of directors of APE have asked corporate counsel to advise the board as to the advantages, if any, of establishing its own FSC overseas. In the absence of controlling Treasury Regulations, counsel formulates certain factors deemed relevant to the board’s decision. Two examples follow.

1. Product Target Markets and Foreign Tax Rates.—The FSC denies any credit against the FSC tax rate (ordinarily 34 percent). This denial includes credits against taxes withheld at the source that are levied upon corporations and taxes paid on foreign source income to a foreign government by United States taxpayers. Therefore, operation of a FSC in a high-tax nation could create a heavy tax burden and therefore decrease the profitability of the FSC. By matching the intended product target market with

85. Id. § 995(f)(4) (1984) defines the T-bill rate as “the annual rate of interest determined by the Secretary to be equivalent to the average investment yield of United States Treasury bills with maturities of 52 weeks which were auctioned during the one-year period ending with the close of the taxable year of the shareholder.”
86. There are no “deemed distributions” under the proposed § 995 until the $10 million threshold is reached. Certain events require a deemed distribution, punitive in effect. For example, participation in an unsanctioned (illegal) international boycott, or payment of any illegal bribe, kickback or other payment to an official or agent of a government. Id. § 995(c) (1984) (Elimination of Certain Deemed Distributions Relating to Taxable Income of the DISC).
87. Id. § 921(c).
89. IRC § 901(a) (1984).
favorable tax rates in the target country, two beneficial effects emerge: (1) greater repatriatable income (in this example, to APE); and (2) a physical foreign presence most likely to satisfy Treasury Regulations requiring foreign presence requirements under the proposed legislation.

2. Intended Longevity of the Business Venture.—Under the FSC scheme, a qualifying exporter can choose between two forms of tax incentives: a FSC or an "interest-charge DISC."90

As previously discussed,91 the DISC provides "accrual of an [interest-free] fund that grows, revolves and is continuously invested in eligible export activities." Although the proposal requires that interest be paid on the deferred tax, it may be deferred on as much as 10 million dollars in foreign trade income.92 Thus, a business venture without a definite lifespan might find this method of tax deferral the least burdensome.

On the other hand, if the lifespan of the business venture is relatively short-term, such as eight to ten years, then the FSC tax rate, 34 percent, with exemption on the remaining foreign trade income, would probably best serve the exporting firm.

Thus, many factors come into play when determining the best vehicle for minimizing the tax obligation of the exporting firm. Treasury Regulations, when issued, will provide a more definitive basis for these and other business judgment decisions.

V. Responses to the FSC

A. European Community Response

The FSC provisions contain many of the export incentive features found in the DISC provisions.93 These include favorable tax treatment on income earned in the sale, lease, or other disposition of qualified export property and special provisions for smaller exporting firms.94 The FSC goes beyond the DISC by incorporating a positive response to domestic and international objections to the DISC. This is evidenced by the compatibility of the FSC provisions with the general rules outlined in the 1981 GATT Decision.95 The European Community, however, has objected to the specific provisions of the bill which "forgive" current accumulated DISC tax deferral.

90. Foreign Sales Corporation Act, supra note 7, at § 995(a).
91. See supra note 26 and accompanying text.
92. Foreign Sales Corporation Act, supra note 7, § 995(b)(1)(E).
93. See Letter to Senate Finance Committee, supra note 68 and accompanying text.
94. The Foreign Sales Corporation Act specifically defines "small FSC." See Foreign Sales Corporation, supra note 7, § 922(b).
95. See supra notes 62 and accompanying text.
The primary impetus behind the alternative to the DISC was the need to satisfy United States obligations under the GATT while retaining the substantial tax benefits currently enjoyed by DISC users. After introduction of the FSC legislation in August 1983, several attorneys representing sophisticated DISC users as well as members of the small business community questioned the Treasury about its interpretation of the new rules in the bill. Business concerns that the Treasury would take a hard line interpretation of the undefined tax terms were allayed by the Administration's release of a technical explanation of the legislation on February 2, 1984. During the following Senate hearings on the proposed FSC, business groups testifying at the hearings "unanimously supported" the legislation.

According to the Administration, the FSC complies with GATT Council rulings. The EC has expressed dissatisfaction with various aspects of the Administration's legislation, but United States Trade Representative William Brock has discussed the matter with EC officials. The largest and most widely known EC complaint concerns the provision "forgiving" accumulated deferred DISC tax liabilities to date upon passage of the FSC Act of 1984.

The controversial provision reads:

(b) Transition Rules for DISCs
(2) EXEMPTION OF ACCUMULATED DISC INCOME FROM TAX For purposes of applying the IRC of 1954 with respect to actual distributions made by a DISC or former DISC after December 31, 198[4], any accumulated DISC income of a DISC or former DISC (within the meaning of section

96. See supra note 68 and accompanying text.
98. Id.
99. The Senate Finance Committee Explanation of the FSC provisions states:

Although it is aware that the EC has again raised questions about the GATT-compatibility of certain aspects of this proposal, the Committee has reported this legislation based on its own assessment and that of the Administration, that the legislation satisfies GATT rules. In light of the considerable effort required to replace the DISC and the new burdens placed on the U.S. exporters, the Committee expects the Administration to vigorously defend this legislation against any GATT challenge and to inform the Committee immediately of all GATT developments relating to this legislation.

SENATE COMM. ON FINANCE EXPLANATION OF PROVISIONS, supra note 62, at 635.
996(f)(1) of such Code) which is derived before January 1, 1985, shall be treated as previously taxed income (within the meaning of section 996(f)(2) of such Code). 100

According to the EC, this forgiveness of deferred taxes constitutes an illegal subsidy under the GATT. 101 According to informal Treasury estimates, the amount of accumulated deferred taxes that would be forgiven under the FSC “probably amounts to 9-10 billion dollars.” 102 Thus, although the remainder of the FSC provision tracks with GATT rules, the forgiveness of currently deferred taxes promises to be a contentious issue in convincing the EC and GATT nations that the FSC is acceptable under the terms of the GATT.

B. Origin and Future of the FSC

The FSC provisions were part of the highly technical Deficit Reduction Act of 1984 (DEFRA). 103 DEFRA is expected to increase government revenue by approximately 50.6 billion dollars while reducing government spending by 1 billion dollars. 104 The election-year bill, according to the Administration was “fashioned in a bipartisan manner,” and “contains both spending reductions and measures to close tax loopholes of questionable fairness.” 105 The tax provisions of DEFRA contain no increase in individual tax rates. 106

Progress on the bill in the House Ways and Means Committee was slow as the Committee awaited assurance from the EC that the FSC would be “GATT-proof.” 107 Several members of the Committee expressed the sentiment that the DISC tax deferrals represent “a ripe source of revenue.” 108 In view of the historical conflicts within the Committee over the DISC, there was also a general reluctance to take up a bill presenting similarly divisive questions. 109 In the Senate

100. Foreign Sales Corporation Act, supra note 7, § 4(b)(2) Effective Date; Transition Rules (emphasis added).
102. See supra note 8.
103. See supra note 66 and accompanying text.
106. Id. at 1457.
Finance Committee, Senator John Heinz (R-Pa.) argued that replacing the DISC with the FSC will not necessarily dissuade the Europeans from retaliating against the United States for using an illegal export subsidy. Pointing out that the Europeans need not go through a lengthy approval process in GATT to set up countervailing duties against the United States, Heinz warned that in enacting FSC—which may be viewed as an illegal subsidy—Congress may be “substituting one kind of trouble with another kind of trouble.” Senator John Chafee (R-R.I.) argued that the bill should be expanded to include services as “valid export property” eligible for FSC benefits, since this is an area where the United States competes successfully abroad. The Offices of the United States Trade Representative and the Treasury Department objected to expanding the bill to include services because the move would entail too large a revenue “loss” to the Treasury. The ramifications of separating hardware from software, as in the mushrooming field of computer services, are not yet clear.

Despite opposition to and controversy surrounding the DISC-FSC programs of tax-deferral “loopholes,” the House passed DEFRA (H.R. 4170) on June 27, 1984, by a vote of 268 to 155. The Senate followed suit the same day with an 83 to 15 vote adopting the conference report on H.R. 4170, thus clearing the bill for the President’s signature.

VI. Conclusion

The United States, no longer enjoying the preeminence in foreign trade characteristic of former years, now experiences vexing perennial trade deficits throughout international markets. In 1971, with the United States dollar weak against most major foreign currencies and reliance on imports increasing, Congress enacted an export incentive program through the Treasury tax laws. The DISC provisions, and now the FSC provisions, provide a tax “break” to qualified United States exporters through income tax deferral on qualified export trade receipts. The FSC, however, serves two equally important purposes—it continues and expands current DISC export promotion policy and conforms substantially to United States obligations under the GATT.

110. Id.
111. Id.
112. Members of the House of Representatives had voiced concern over the advantages provided to the larger corporations by DISC-type tax schemes. At one point “subsidized foreign investment” through tax deferral was awarded the “honor” of “Loophole of the Week.”
115. See supra note 62 and accompanying text (emphasis added).
Tremendous debate stirred in the 1970's concerning the "legality" of the United States DISC legislation under the GATT prohibition of "illegal" trade subsidies. The United States, as a prominent and founding member of the GATT, has an obligation to fulfill the letter and spirit of the Agreement—to promote and preserve free trade through a "substantial reduction of tariffs and other barriers to trade and the elimination of discriminatory treatment in international commerce." According to the European Community, the DISC provisions represented a direct tax subsidy that allowed United States exporters to lower their prices through a mechanism adverse to GATT "free trade" principles. The FSC provisions represent the Reagan Administration's realization that in order to prevent breakdown of the GATT dispute settlement process and isolation of the United States over the DISC issue, the United States itself must comply with the letter and spirit of the GATT. Both domestic and European commentators, however, have criticized the FSC, particularly with regard to its "forgiveness" of tax liabilities previously deferred by DISC.

If the European Community strongly opposes the FSC, the Administration should, if possible, alter it in an attempt to quell European claims of unfair trade advantage without emasculating the legislation's export incentive component. The trade balance with the EC has traditionally been relatively favorable to the United States, 

116. See supra notes 54-61 and accompanying text.
117. See Senate Comm. on Finance, Explanation of Provisions, supra note 62.
118. See The Export Imperative, supra note 45, at 42. William Brock, United States Trade Representative, says that more than a dozen major trade issues are simmering between the United States and Western Europe. Collectively, he adds, the Europeans pose a greater challenge to America's trade balance than do the Japanese. He recently told Congress that: Over the next few months protectionist pressures on both sides of the Atlantic may actually increase in response to our mounting trade deficits and their [European] high unemployment. We must all recognize that a new wave of trade restrictions would threaten recovery in both the United States and Europe.

U.S. Chamber of Commerce, Nation's Business 42-43 (June, 1984).

Nation’s Business adds that as recently as 1980, the United States had a $20.9 billion surplus in trade with the EC. The free-fall drop is chiefly attributable to a strong dollar that makes exports more expensive and European imports here more attractive. Id. at 42. Nation’s Business reports the following Commerce Department forecasts on EC-United States trade this year:

American exports, in decline for three years, will remain up at about last year's $56 billion level.

American imports will rise "significantly" above last year's $53 billion.

European unemployment will contribute to hover near 10.5 percent and will stunt growth of demand.

American machinery sales stand a chance of rising as Europe struggles to retool. Sales of paper, plastic materials, metal goods and textile products could show modest growth.

Demand for U.S. farm products will rise only slightly. Among the top sellers: wheat, coarse grains and soybean meal.

Thus, healthy trade relations with the EC possess important benefits for the United States on both sides of the Atlantic Ocean.

providing yet another strong incentive to preserve healthy United States-E.C. trade relations. Debate over the 10 billion dollar forgiveness—a clear windfall to previous DISC-users and probably an illegal subsidy under the GATT—may continue to plague the E.C.-GATT reception of the legislation.

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