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THE FOREIGN SALES CORPORATION LEGISLATION: A \$10 BILLION BOONDOGGLE

INTRODUCTION

The Foreign Sales Corporation (FSC) provisions of the Deficit Reduction Act of 1984¹ replace the Domestic International Sales Corporation (DISC) legislation² as the United States' primary tax incentive for exporters.³ The change follows more than a decade of controversy between the United States and its trading partners, who argued that DISC constituted an export subsidy violating the General Agreement on Tariffs and Trade (GATT).⁴ Although the United States never conceded that DISC contravened GATT's underlying policy, the Reagan Administration proposed the replacement of DISC with FSC⁵ to soothe other GATT signatories,⁶ most notably the European Economic Community.

The FSC legislation has not satisfied the European Economic Community. The European Economic Community contends that the FSC legislation's outright forgiveness of approximately \$10 billion in taxes deferred by United States exporters under DISC amounts to an export subsidy violating GATT.⁷

This Note explores the domestic and international implications of the new FSC program. First, this Note examines the GATT

¹ Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984) (codified in scattered sections of 26 U.S.C.). Division A of the Act is the Tax Reform Act of 1984; Division B is the Spending Reduction Act of 1984. Title VII of the Tax Reform Act of 1984 includes the FSC legislation. Pub. L. No. 98-369, §§ 801-805, 98 Stat. 985-1103 (1984) (codified at I.R.C. §§ 921-927 (Supp. III 1985)). An FSC is a foreign corporation formed by a United States exporter that remains subject to United States federal income tax. For a discussion of the FSC mechanism, see *infra* notes 67-78 and accompanying text.

² Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497, 53553 (1971) (codified as amended at I.R.C. §§ 991-997 (1982 & Supp. III 1985)). A DISC is a domestic "paper" corporation through which its American exporting parent channels export income. For a discussion of the DISC program, see *infra* notes 33-43 and accompanying text.

³ Congress has not repealed the DISC legislation. Small exporters may continue to use DISC. However, amendments by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 802, 98 Stat. 997-99 (1984) (codified at I.R.C. § 995 (1982 & Supp. III 1985)), require that small exporters pay interest on the taxes deferred.

⁴ 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].

⁵ This Note uses the acronyms "FSC" and "DISC" to refer both to the enabling legislation and to the entities which exporters form.

⁶ *New Reagan Proposal on Tax Aid for Exports*, N.Y. Times, Mar. 10, 1983, at D5, col. 1.

⁷ *Europeans Announce Plans to Force GATT Review of DISC and FSC*, 24 TAX NOTES 228 (1984).

ground rules concerning export tax incentives and argues that GATT unjustifiably discriminates against countries such as the United States that use a direct, rather than indirect, tax system.⁸ Second, this Note discusses the DISC program (Congress's attempt to counteract the GATT rules' discriminatory impact) and examines other GATT signatories' objections to the program.⁹ Third, it analyzes the FSC program, the congressional response to other trading nations' condemnation of DISC as a GATT-illegal export subsidy.¹⁰ This Note argues that although the FSC mechanism complies with the existing GATT rules, Congress's forgiveness of approximately \$10 billion in taxes deferred under DISC constitutes an export subsidy that violates GATT.¹¹ Thus, Congress deprived the United States Treasury of a source of substantial revenue without improving the United States' relations with its trading partners.¹² This Note argues that the United States should discard the discriminatory GATT framework and reformulate the GATT rules to more closely reflect modern economic theory concerning indirect and direct taxes.¹³

I

GATT'S ARTIFICIAL DISTINCTION BETWEEN DIRECT AND INDIRECT TAXES

Article XVI:4 of the General Agreement on Tariffs and Trade forbids a government's use of subsidies to bolster exports.¹⁴ Although this provision appears to promote free international trade, the rules promulgated to enforce it unjustifiably discriminate against countries like the United States that rely on direct, rather than indirect, taxation.¹⁵

Economists define direct taxes as those which a government imposes on a person or corporation.¹⁶ Income tax is a direct tax. Indirect taxes, on the other hand, are imposed on things.¹⁷ The value-

⁸ See *infra* notes 14-29 and accompanying text.

⁹ See *infra* notes 30-63 and accompanying text.

¹⁰ See *infra* notes 64-125 and accompanying text.

¹¹ See *infra* notes 79-116 and accompanying text.

¹² See *infra* notes 117-25 and accompanying text.

¹³ See *infra* notes 126-63 and accompanying text.

¹⁴ Article XVI:4 provides that contracting parties

shall cease to grant either directly or indirectly any form of subsidy on the export of any product . . . [which] 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.

³ GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS 31 (1958) (text of agreement in effect in 1958) [hereinafter cited as BISD].

¹⁵ See *infra* notes 25-29 and accompanying text.

¹⁶ See, e.g., R. LIPSEY, AN INTRODUCTION TO POSITIVE ECONOMICS 433 (5th ed. 1979).

¹⁷ See, e.g., *id.* at 433-34.

added tax (VAT) is an indirect tax. Under a VAT system, governments impose a tax based upon the value added to a product at each stage of production.¹⁸ The more value added by domestic producers, the greater the governments' total collection of tax.

The GATT rules do not prohibit a country from encouraging exports by exempting exporters from indirect tax or by remitting previously paid indirect tax.¹⁹ For example, when a company exports a product subject to VAT the government may exempt the exporting company from the tax on the value the exporter added to the product and may rebate the VAT that the exporter paid to its supplier.²⁰ The GATT theory assumes that an indirect tax has no impact on export prices because exporters shift the tax benefit forward to their foreign customers by reducing the export price.²¹ The GATT rules, however, prohibit governments from exempting exporters from direct tax or remitting to exporters previously paid di-

¹⁸ Smith, *Value-Added Tax: The Case For*, HARV. BUS. REV., Nov.-Dec. 1970, at 77, 78. A simple example may help explain VAT. Suppose that Acme Resources Company sells its product, widget material, to Beta Widget Manufacturing Company at a price of \$2. Beta manufactures and sells its product, widgets, to Delta Distribution Company for \$10. Delta packages and sells the finished product, widgets-in-a-can, to the ultimate consumer for \$20. The government would impose a VAT as follows:

<u>Stage of Production</u>	<u>Selling Price</u>	<u>Cost of Purchases</u>	<u>Value Added</u>
Acme Resources	\$ 2	\$ 0	\$ 2
Beta Manufacturing	\$10	\$ 2	\$ 8
Delta Distribution	\$20	\$10	\$10
		Total Value Added	\$20

If the government imposes a VAT rate of 10%, Acme, Beta, and Delta will pay \$0.20, \$0.80, and \$1.00, respectively, as VAT. Acme will bill Beta \$0.20 for the VAT, Beta will bill Delta \$1.00 (\$0.80 for which Beta is liable plus \$0.20 paid to Acme), and Delta will bill the ultimate consumer \$2.00 (\$1.00 for which Delta is liable plus \$1.00 paid to Beta). Each seller expressly indicates the amount of VAT; the tax is not hidden in the product's sales price. Surrey, *Value-Added Tax: The Case Against*, HARV. BUS. REV., Nov.-Dec. 1970, at 86, 87.

For a detailed discussion of other types of value-added tax, see R. LINDHOLM, *THE ECONOMICS OF VAT* (1980).

¹⁹ An interpretative note to article XVI provides:

The exemption of an exported product from duties or taxes *borne by the product* when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy.

3 BISD, *supra* note 14, at 71 (emphasis added). Thus, article XVI:4 permits only the remission or exemption of *indirect* tax. See K. DAM, *THE GATT LAW AND INTERNATIONAL ECONOMIC ORGANIZATION* 139 (1970).

²⁰ Surrey, *supra* note 18, at 91. The VAT rebate's effect may be illustrated by reconsidering the example presented *supra* in note 18. If Delta Distribution Company sells widgets to a foreign consumer, the government will exempt Delta from the VAT of \$1.00 for which Delta is liable and will also rebate \$1.00 (representing the amount of VAT Delta previously paid its suppliers).

²¹ Surrey, *supra* note 18, at 92. Similarly, the government may impose a border tax equal to the VAT on imports, thereby subjecting imports to the same level of tax as domestically produced goods. *Id.*

rect tax.²² Thus, a country using income tax may not use remissions or exemptions to provide an incentive to exporters.

The economic justification behind the distinction between direct and indirect taxes rests upon the assumption that producers shift indirect taxes, but not direct taxes, forward as a component of price.²³ The GATT theory characterizes price reductions due to tax benefits in direct tax jurisdictions as subsidies designed to compensate exporters for the differential in price between the domestic and foreign markets. Tax benefits in indirect tax jurisdictions, however, are deemed legitimate price components.²⁴

Modern economic theory establishes that the GATT distinction between direct and indirect taxes is artificial. Economists generally agree that exporters in indirect tax jurisdictions²⁵ do not fully shift tax savings forward to consumers.²⁶ Similarly, economists contend that exporters shift some direct tax benefits forward.²⁷

²² In 1970, a GATT working party examined article XVI:4 and issued an interpretive report which includes a list of practices the working party considered subsidies. Two of the condemned practices are remitting direct tax to exporters and exempting exporters from direct tax. *Subsidies: Report Adopted 19 November 1960*, GATT Doc. L/1381, reprinted in BISD, *supra* note 14, at 185-86 (9th Supp. 1961).

²³ K. DAM, *supra* note 19, at 214.

²⁴ To illustrate, if the United States exempts from the income tax all income American shoe manufacturers derive from selling shoes abroad, the price of American shoes in foreign markets will decrease and the volume of sales will increase. Why will the price decrease? The GATT theory presumes that the price drop derives from a subsidy: by eliminating the income tax, the United States in effect compensates American manufacturers for selling their products abroad at a lower price. The GATT theory rejects the proposition that prices decrease because American manufacturers pass their tax savings on to consumers.

According to Professor Kenneth Dam, GATT assumes that exporters shift indirect taxes (but not direct taxes) forward as a component of price. K. DAM, *supra* note 19, at 214. This Note's analysis of the policy behind the assumption that direct tax refunds represent subsidies for the price differential in domestic and foreign markets stems from Dam's explanation of the GATT theory on the forward shifting of direct and indirect taxes.

²⁵ This Note divides the world into indirect and direct tax jurisdictions for illustrative purposes. Most countries use both forms of tax to varying degrees. See K. DAM, *supra* note 19, at 219 n.19.

²⁶ *Id.* at 214-15. An exporter receiving an indirect tax refund reduces export price in part because the government compensates the exporter for the price differential between domestic and foreign markets. "[R]ecent, more sophisticated economic analysis . . . indicates that the shifting of tax burden does not depend so much on the type of tax as upon competitive market conditions." 3 *Export Policy, 1978: Hearing Before the Subcomm. on International Finance of the Senate Comm. on Banking, Housing and Urban Affairs*, 95th Cong., 2d Sess. 129 (1978) (prepared statement of Richard Hammer, Partner, Price Waterhouse & Co.) [hereinafter cited as *Export Policy Hearing*]; see also K. DAM, *supra* note 19, at 215 ("[F]ull refund of an indirect tax constitutes in fact a subsidy to exports and therefore has the same distorting effect on international trade that any other export subsidy would have.").

²⁷ Most economists agree that exporters shift direct tax savings forward. They disagree, however, as to the extent of such shifting. See, e.g., K. DAM, *supra* note 19, at 214-15.

Despite economists' suggestion that exporters behave similarly in both direct and indirect tax systems, GATT treats direct and indirect export tax incentive schemes in diametrically opposed ways.²⁸ Although some economists disagree as to the extent of the forward shifting that occurs under direct and indirect tax regimes, few support GATT's rigid distinction.²⁹

II

CRITICISM OF THE DISC PROGRAM UNDER GATT

The United States Congress enacted the Domestic International Sales Corporation legislation in 1971 to offset the discriminatory impact of GATT's distinction between direct and indirect taxes.³⁰ Congress accepted the modern view that no appreciable difference exists between the impact of direct and indirect taxes on prices.³¹ Congress designed the DISC legislation's benefits to equalize American exporters with foreign counterparts exporting from countries providing indirect tax refunds and exemptions.³²

A. How DISC Works

The DISC legislation permits an exporter to defer the payment of tax on income derived from exporting by establishing and channelling export income through a DISC.³³ A DISC need not perform

²⁸ The GATT distinction between indirect and direct taxes may be traced to 1957, when article XVI of the GATT was amended to exempt remissions of indirect taxes from the restrictions placed on other forms of subsidies. See *Export Policy Hearing, supra* note 26, at 230-32. The GATT drafters reasoned that GATT should not condemn refunds of indirect taxes because products should not be subject to both an exporting country's indirect taxes and an importing country's excise taxes. This argument presumes, however, that exporters shift indirect taxes forward to consumers. *Id.* at 229.

²⁹ See K. DAM, *supra* note 19, at 216 ("[I]t is hard to find authors who support without qualification the assumption behind the GATT rules.").

³⁰ See S. REP. NO. 437, 92d Cong., 1st Sess. 90 (1971) (purpose of DISC is to "remov[e] discrimination against those who export through U.S. corporations").

³¹ "[U]ltimately there is no difference [between direct and indirect taxation in terms of their effect on prices]. Ultimately, any company, however they are taxed, has to pass on . . . [t]hat tax as a cost of the item manufactured to the consumer." 1 *Foreign Trade, 1971: Hearings Before the Subcomm. on International Trade of the Sen. Comm. on Finance*, 92d Cong., 1st Sess. 45 (1971) (statement of John Connally, Secretary of Treasury) [hereinafter cited as *Foreign Trade Hearings*].

³² European nations began to harmonize their value-added tax systems in 1967. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 AM. J. INT'L L. 747, 750-51 (1978).

³³ A corporation must meet four requirements to qualify as a DISC: (1) an exporter must incorporate its DISC in any state, I.R.C. § 992(a)(1) (1982 & Supp. III 1985); (2) the DISC must derive at least 95% of its gross receipts from the sale or lease of goods outside the United States, *id.* § 992(a)(1)(A), 993 (f) (1982); (3) the DISC must invest at least 95% of the adjusted bases of its gross assets in exporter-related assets, *id.* § 992(a)(1)(B); and (4) the DISC's capital must equal or exceed \$2,500 and consist of only one class of common stock, *id.* § 992(a)(1)(C) (Supp. III 1985).

any functions apart from its parent, nor must it maintain office space, employees, or equipment.³⁴ The legislation exempts the DISC from federal taxation, but requires the parent to report and pay tax on a portion of the DISC's income by deeming that the DISC distributed that portion of its income to the parent.³⁵ Congress deferred taxation of the portion of DISC income not deemed distributed until the DISC actually distributes such income, or the DISC loses DISC status.³⁶

Because DISCs generally acquire inventory from a parent corporation, section 482 of the Internal Revenue Code attributes only a portion of the total income from an exporting transaction to a DISC.³⁷ Section 482 also requires that related taxpayers observe arm's length pricing principles in intercompany transactions.³⁸ In order to provide tax benefits to exporters, the DISC legislation allows a DISC to use liberal intercompany pricing rules to defer more income than section 482 normally allows.³⁹

Passage of the Foreign Sales Corporation legislation did not make DISC obsolete. DISC remains in effect to benefit small United States exporters which do not meet the foreign presence requirements of the FSC legislation.⁴⁰ The FSC legislation⁴¹ amends the

³⁴ See Bretz, *Current Developments on Domestic International Sales Corporations*, 9 N.C.J. INT'L L. & COMM. REG. 385, 387 (1984). The Treasury Regulations also require that a DISC have its own bank account, Treas. Reg. § 1.992-1(a)(6) (1982), and maintain its own set of books, Treas. Reg. § 1.992-1(a)(7) (1982).

³⁵ The DISC legislation deems that a DISC distributes 57.5% of its income to its parent. I.R.C. § 291(a)(4) (Supp. III 1985).

³⁶ *Id.* § 995 (1982 & Supp. III 1985).

³⁷ *Id.* § 482 (1982).

³⁸ I.R.C. § 482 provides:

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

Id. The regulations provide:

The purpose of Section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Treas. Reg. § 1.482-1(b)(1) (1982).

³⁹ The legislation allows a DISC to derive income from either the § 482 arm's length price or the greater of (1) four percent of qualified export receipts plus 10% of export promotion expenses, or (2) 50% of the combined taxable income of the DISC and its related supplier plus 10% of export promotion expenses. I.R.C. § 994(a) (1982).

⁴⁰ See *infra* notes 71-73 and accompanying text.

⁴¹ Deficit Reduction Act § 802 (codified at I.R.C. § 995 (1982 & Supp. III 1985)).

DISC provisions of the Internal Revenue Code by providing that DISC shareholders must pay interest on deferred DISC tax,⁴² and that any DISC taxable income in excess of \$10 million is deemed distributed to shareholders.⁴³

B. International Criticism of DISC

Canada and the European Economic Community (EEC) challenged DISC shortly after its 1971 enactment.⁴⁴ Within two years the EEC filed a formal complaint⁴⁵ alleging that DISC violated GATT article XVI:4.⁴⁶ The complainants argued that DISC constituted an illegal export subsidy because its tax deferral was equivalent to an "exemption" of direct tax.⁴⁷

The United States countered with formal complaints against Belgium, France, and the Netherlands, contending that DISC merely copied the hidden subsidy effects produced by European tax laws.⁴⁸ Belgium, France, and the Netherlands avoid the impact of international double taxation by using variations of the territorial method under which a nation exempts its residents' foreign source income from its own tax base.⁴⁹ The United States claimed that Belgian, French, and Dutch tax laws exempt substantial export income from domestic taxation, resulting in a "far greater subsidy"⁵⁰ than

⁴² I.R.C. § 995(f)(1) (Supp. III 1985).

⁴³ I.R.C. § 995(b)(1)(E) (Supp. III 1985).

⁴⁴ Jackson, *supra* note 32, at 760-61 & n.31 ("Canada and the European Economic Community expressed the opinion that DISC would amount to direct subsidization of exports inconsistent with GATT principles."). Other authors have reviewed the international dispute more extensively. See, e.g., Bretz, *supra* note 34, at 387-89; 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 (1983).

⁴⁵ The EEC utilized the dispute settlement procedures of GATT art. XXIII to initiate its complaint. Article XXIII can be summarized as follows:

If any contracting party believes a benefit it should get under GATT has been "nullified or impaired" as a result of another contracting party's breach or *other* measure, then it may seek consultation [with the alleged offender] and if that fails, the complainant may ask the plenary GATT body to authorize (by majority vote) suspension of GATT obligations (a sort of "retaliation") as a response.

Jackson, *supra* note 32, at 754 (emphasis in original).

⁴⁶ See *supra* note 14 and accompanying text.

⁴⁷ *Export Policy Hearing*, *supra* note 26, at 214-15 (prepared statement of Richard Hammer).

⁴⁸ Hudec, *GATT Dispute Settlement After the Tokyo Round: An Unfinished Business*, 13 CORNELL INT'L L.J. 145, 164 (1980).

⁴⁹ *Analysis of Proposals Relating to Comprehensive Tax Reform*, 25 TAX NOTES 161 (1984). The United States and most other major trading nations use the foreign tax credit method to avoid international double taxation. A country using this method includes its residents' worldwide income in the tax base and permits a credit for foreign taxes paid. *Id.*

⁵⁰ *Export Policy Hearing*, *supra* note 26, at 215 (prepared statement of Richard Hammer).

the tax benefits provided to United States exporters under DISC.⁵¹ The United States further argued that DISC, unlike the foreign tax laws, merely provided for deferral of direct tax.⁵²

Four panels established by the GATT Council to review each of the complaints issued their reports in 1976.⁵³ The panels concluded that DISC and the Belgian, French, and Dutch tax laws all constituted violations of GATT article XVI:4.⁵⁴ The GATT Council adopted the panel reports in 1981,⁵⁵ but qualified them⁵⁶ to provide that: (1) a country is not required to tax economic processes located

⁵¹ The United States filed its admittedly "unrealistic legal claim" in order to "dramatize its contention that the complaint by the EEC . . . was equally improper." Hudec, *supra* note 48, at 164.

⁵² See Note, *supra* note 44, at 479 (outlining Deputy United States Trade Representative David Macdonald's argument that "the effect of DISC is the *deferral* of tax on approximately 17% of the combined income attributable to DISC sales, and that this deferral percentage is lower than the percentage of income upon which *exemption* may be allowed under a territorial system." (emphasis added, footnotes omitted)).

⁵³ See *Report of the Panel, United States Tax Legislation (DISC)*, BIRD, *supra* note 14, at 98 (23d Supp. 1978); *Report of the Panel, Income Tax Practices Maintained by France*, BIRD, *supra* note 14, at 114 (23d Supp. 1978); *Report of the Panel, Income Tax Practices Maintained by Belgium*, BIRD, *supra* note 14, at 127 (23d Supp. 1978); *Report of the Panel, Income Tax Practices Maintained by the Netherlands*, BIRD, *supra* note 14, at 137 (23d Supp. 1978).

⁵⁴ *Report of the Panel, United States Tax Legislation (DISC)*, BIRD, *supra* note 14, at 113 (23d Supp. 1978); *Report of the Panel, Income Tax Practices Maintained by France*, BIRD, *supra* note 14, at 126 (23d Supp. 1978); *Report of the Panel, Income Tax Practices Maintained by Belgium*, BIRD, *supra* note 14, at 136 (23d Supp. 1978); *Report of the Panel, Income Tax Practices Maintained by the Netherlands*, BIRD, *supra* note 14, at 146 (23d Supp. 1978). The Panel considering United States tax legislation's conclusion that DISC was illegal under GATT art. XVI:4, rested on its finding that (1) DISC was an export subsidy, and (2) DISC created an export price lower than the price of like goods in the domestic market. See *supra* note 14 and accompanying text. The Panel concluded that DISC constituted a *prima facie* subsidy because it viewed the absence of an interest charge on the deferred tax as an "exemption" from direct tax. *Report of the Panel, United States Tax Legislation (DISC)*, BIRD, *supra* note 14, at 113 (23d Supp. 1978). The Panel utilized a presumption to find that DISC caused "bi-level pricing." *Id.* The Panels apparently agreed with the United States' contention that the European tax laws subsidized exports. Hudec, *supra* note 48, at 165 n.61 ("GATT obligations are contractual, and the words of a contractual obligation should never be read to arrive at results so clearly at odds with the parties' intentions.").

⁵⁵ *Reports Adopted: Tax Legislation*, BIRD, *supra* note 14, at 114 (28th Supp. 1982). The Tokyo Round of Multilateral Trade Negotiations in 1979 partly caused the five-year delay between the issuance of the Panel reports and adoption by the GATT Council. The Tokyo Round produced a "Subsidies Code," *Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade (Subsidies Code)*, GATT Doc. MTN/NTM/W236, reprinted in BIRD, *supra* note 14, at 56 (26th Supp. 1980), containing an illustrative list of export subsidies, including "(e) the full or partial exemption, remission or *deferral* specifically related to exports, of direct taxes . . . paid or payable by industrial or commercial enterprises." *Id.* at 81 (emphasis added). Although the inclusion of the word "deferral" clearly broadened the official definition of "export subsidy," see *supra* note 22 and accompanying text, and seemed to condemn DISC, a footnote to the illustrative list explained that the GATT Council did not intend the reference to deferral to prejudge the DISC case. The footnote also indicated that a deferral of direct tax may not constitute an export subsidy if the government collects an interest charge on the deferred tax. *Agreement on Interpretation and Application of Articles VI,*

outside its territory;⁵⁷ (2) a country must apply arm's length pricing principles between exporting companies and foreign buyers; and (3) a country may utilize measures to avoid double taxation of foreign source income. Arguing that because DISC provided a smaller tax benefit and thereby promoted exports to a lesser extent than the Belgian, French, and Dutch systems, the United States recommended that the GATT Council approve DISC under the qualifier.⁵⁸

The EEC became impatient with the slow resolution process and requested in 1982 that the United States pay the EEC over \$2 billion in compensatory damages arising from the subsidizing effects of DISC.⁵⁹ Although the GATT Council did not act on this request, the United States recognized that relations with its trading partners were deteriorating.⁶⁰

In 1983, the Reagan Administration proposed what Congress later enacted as the FSC legislation.⁶¹ The Administration believed that the FSC program would circumvent the EEC's retaliatory threats, eliminate the demand for compensatory damages,⁶² and bolster the United States' reputation in the international community.⁶³

XVI, and XXIII of the General Agreement on Tariffs and Trade, supra, reprinted in BIRD, supra note 14, at 82 n.2.

⁵⁶ *Reports Adopted: Tax Legislation*, BIRD, *supra* note 14, at 114 (28th Supp. 1982); see *GATT Acts on Export Tax Aid Panel Reports*, 13 TAX NOTES 1485 (1981).

⁵⁷ The first prong of the qualifier implicitly requires a country to tax economic processes located *inside* its territory. Note, *supra* note 44, at 475 n.24.

⁵⁸ For an analysis of the United States' position, see Note, *supra* note 44.

⁵⁹ *DISCs: GATT Postpones Action on EC Request for DISC Damages*, [July-Aug.] DAILY TAX REP. (BNA) No. 141, at LL-1 (July 22, 1982). The EEC relied on the Treasury Department's 1979 estimate that exports of \$10 billion were attributable to DISC in its computation. *Id.* at LL-2.

⁶⁰ Bretz, *supra* note 34, at 390 ("[T]he United States found itself increasingly isolated in the sixty-four member GATT body." (footnote omitted)).

⁶¹ See *New Reagan Proposal on Tax Aid for Exports*, *supra* note 6.

⁶² "The Administration believes that enactment of . . . [FSC] is essential if we are to avert a real threat of retaliation, and if we are ever to make progress toward resolving one of our longest, outstanding trade disputes [sic]." *Foreign Sales Corporation Act: Hearings on S. 1804 Before the Senate Comm. on Finance*, 98th Cong., 2d Sess. 61 (1984) (prepared statement of Robert E. Lightizer) [hereinafter cited as Lightizer's Statement].

⁶³ Maintenance of the DISC already has seriously impaired our effectiveness in challenging subsidies and other unfair trade practices of other nations that are damaging to our exports. Other governments are hesitant to enter agreements with us to discipline their subsidies because they believe we are maintaining an illegal subsidy under DISC. Likewise, our efforts to use and improve the dispute settlement procedure under GATT are undermined by the impression held by many nations that we are unwilling to abide by the GATT decision on DISC.

III FSC AS A DISC REPLACEMENT

Congress enacted FSC not only to eliminate the controversy over DISC, but also to provide an export tax incentive comparable to DISC in terms of benefit to exporters and cost to the Treasury.⁶⁴ Congress perceived that foreign tax laws disadvantage American exporters in the world marketplace.⁶⁵ Just as in its enactment of DISC in 1971, Congress designed the FSC legislation to shield American exporters from these disadvantages.⁶⁶

A. How FSC Works

The FSC legislation⁶⁷ permits an American company to gain tax benefits by forming a foreign corporation to engage in exporting. The foreign corporation remains subject to United States taxation; the FSC legislation, however, exempts a portion of the foreign corporation's income from federal tax.⁶⁸ The remaining portion remains taxable to the FSC.⁶⁹

To qualify for FSC status, an American exporter must meet two requirements. First, the exporter must incorporate its FSC in a foreign country with which the United States has entered into an exchange of information agreement, or in a United States possession other than Puerto Rico.⁷⁰ Second, the FSC must establish a "foreign presence" by maintaining an office outside the United States.⁷¹ The legislation allows an FSC to claim benefits on that portion of its income derived from the sale or lease of goods outside the United States⁷² only if the FSC meets additional "foreign management"

⁶⁴ *Id.* at 62 (DISC replacement "must (1) be GATT consistent; (2) be revenue neutral; (3) maintain the same level of benefit for U.S. exporters as existed under the DISC").

⁶⁵ See *supra* notes 30-32 and accompanying text.

⁶⁶ STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., REPORT ON DEFICIT REDUCTION ACT OF 1984, 634-35 (Comm. Print 1984).

⁶⁷ For a detailed discussion of the FSC mechanism, see Granwell & Rosensweig, *An Analysis of the Foreign Sales Corporation Provision and Rules*, 28 TAX NOTES 1265 (1985).

⁶⁸ If an FSC uses the § 482 rules to determine transfer price in a particular transaction, the legislation exempts 32% of the income attributable to such transaction from federal tax. I.R.C. § 923(a)(2) (Supp. III 1985). If an FSC uses the administrative pricing rules, 16/23 of the income attributable to the transaction is exempt. *Id.* § 923(a)(3).

⁶⁹ United States corporate shareholders of an FSC obtain a 100% dividends received deduction on dividends attributable to the exempt portion of an FSC's income. *Id.* § 245(c)(1)(2).

⁷⁰ *Id.* § 922(a)(1)(A). An FSC may not have more than 25 shareholders. An FSC may have more than one class of common stock, but it may not issue preferred stock. *Id.* § 922(a)(1)(C).

⁷¹ *Id.* § 922(a)(1)(D). The FSC must maintain a permanent set of records at the foreign office and certain other records at a United States location. *Id.* At least one director must not be a United States resident. *Id.* § 922(a)(1)(E).

⁷² *Id.* § 924(a). Specifically, an FSC computes the exempt portion of its income

and "foreign economic process" tests.⁷³

FSCs, like DISCs, generally acquire goods for sale or lease from related suppliers. Thus an FSC must fix the transfer price to determine its tax benefits. The legislation provides that an FSC may use either the arm's length provisions of section 482⁷⁴ or the administrative pricing rules to determine income.⁷⁵ If it uses the administrative pricing rules, the FSC must comply with standards of foreign contact more stringent than those under the foreign economic process test.⁷⁶

Finally, a crucial provision of the FSC legislation forgives taxes previously deferred under the DISC program.⁷⁷ The effect has been to forgive approximately \$10 billion in potential tax revenue.⁷⁸

from "foreign trading gross receipts" (FTGR). FTGR are receipts from the sale or lease of products manufactured in the United States and sold abroad. *Id.*

⁷³ I.R.C. § 924(b)-(d) (Supp. III 1985). The most significant requirement of the foreign management test mandates that an FSC must hold its shareholder and board meetings outside the United States. *Id.* § 924(c)(1). The FSC legislation also requires an FSC to maintain its principal bank account outside the United States and to disburse funds for dividends, fees, and salaries from foreign bank accounts. *Id.* § 924(c)(2)-(3).

The FSC legislation imposes the foreign economic process test on a transaction-by-transaction basis. A transaction will meet the foreign economic process test if (1) the FSC solicits, negotiates or makes the particular contract outside the United States, and (2) foreign direct costs incurred by the FSC equal or exceed 50% of the total direct costs attributable to the transaction. *Id.* § 924(d)(1). Foreign direct costs are expenses incurred by the FSC outside the United States which are attributable to (1) advertising, (2) order processing and arranging for delivery, (3) transportation, (4) "determination and transmittal of a final invoice or statement of account and the receipt of payment," and (5) the assumption of credit risk. *Id.* § 924(d)(3). An FSC meets the foreign economic process test's second prong if the foreign direct costs attributable to any two of the five activities listed above equal or exceed 85% of the total direct costs attributable to the transaction. *Id.* § 924(d)(2).

⁷⁴ See *supra* notes 37-38 and accompanying text.

⁷⁵ I.R.C. § 925(a)(1)-(3) (Supp. III 1985). The FSC administrative pricing rules permit an FSC to choose the greater of (1) 1.83% of foreign trading gross receipts, or (2) 23% of the combined taxable income of the FSC and its related supplier. *Id.* § 925(a)(1)-(2). If the FSC uses the second rule, only 46% of the combined taxable income of the FSC and its related supplier is available for tax benefits. *Id.* § 925(d).

⁷⁶ *Id.* § 925(c).

⁷⁷ Deficit Reduction Act § 805(b)(2)(A). Specifically, the legislation provides that a DISC which existed as of December 31, 1984, can distribute its accumulated income to shareholders tax-free. *Id.*

⁷⁸ Estimates of the tax forgiven under the FSC legislation range from \$9 billion to \$13.6 billion. See, e.g., Bernick, *Administration Seeks Assurances from Europe on DISC Replacement Proposal*, 22 TAX NOTES 270, 271 (1984) (\$9-\$10 billion); Kotran, *Of DISCs and FSCs*, 24 TAX NOTES 8 (1984) (\$10-\$13 billion); *A Tax Break for Exports that Hurts "The Small Guy in Kansas,"* BUS. WK., Jan. 16, 1984, at 86 (\$10 billion); *What the Deficit Reducing Bill Would Do*, WASH. POST, June 29, 1984, at A17, col. 3 (\$11 billion); Metzbaum, *"The Great Tax Grab,"* WASH. POST, July 19, 1984, at A20, col. 4 (\$13.6 billion); Fact Sheet No. 98-34, Democratic Study Group, at 14 (June 25, 1984) (on file at *Cornell Law Review*) (\$10-\$12 billion).

B. The Validity of FSC Under the GATT Qualifier

Apart from the forgiveness provision, the FSC mechanism complies with the GATT qualifier.⁷⁹ The FSC's foreign presence, management, and economic process requirements mandate enough foreign activity to qualify a particular transaction as a legitimate foreign process under the GATT qualifier's first prong.⁸⁰

The FSC mechanism also complies with the GATT qualifier's second prong, requiring arm's length pricing between related parties.⁸¹ Congress structured the FSC mechanism to avoid problems such as those DISC encountered. Under DISC, Congress adopted administrative pricing rules to ensure that substantial tax benefits would accrue to United States exporters that established DISCs.⁸² The EEC objected to the DISC administrative pricing rules on the grounds that those rules did not adequately reflect arm's length pricing.⁸³ Although FSC also provides administrative pricing rules,⁸⁴ the FSC rules allocate to an FSC only forty-seven percent of the amount that the old rules allocated to a DISC.⁸⁵ This reduction indicates Congress's intent to more accurately estimate arm's length pricing under FSC.⁸⁶ Moreover, when an FSC uses the administrative pricing rules, the FSC must perform substantially more activities abroad than if the FSC determined the transfer price under section 482.⁸⁷ The use of administrative pricing rules based on recognized arm's length principles and the imposition of additional

⁷⁹ See *supra* notes 56-57 and accompanying text.

⁸⁰ Accord Lightizer's Statement, *supra* note 62, at 62-63. One commentator argues that foreign incorporation alone satisfies the first prong of the GATT qualifier and therefore the "substantial foreign presence requirements are unnecessary to ensure that [FSC] . . . will not violate GATT." Note, *supra* note 44, at 499.

⁸¹ See *supra* text following note 57.

⁸² See *supra* notes 37-39 and accompanying text.

⁸³ The EEC argued that "the 4 per cent and 50 per cent rules of thumb were inconsistent with the arm's-length principle under which profits were allocated to different, even if closely related, entities by reference to conditions of fully effective competition." *Report of the Panel, United States Tax Legislation (DISC)*, BISD, *supra* note 14, at 105 (23d Supp. 1978).

⁸⁴ See *supra* notes 75-76 and accompanying text.

⁸⁵ The 47% figure is derived by comparing the administrative pricing rules under DISC and FSC. The 1.83% of foreign trading gross receipts option under FSC, see *supra* note 75, allocates approximately 47% of the income that the 4% of qualified export receipts option allocated under DISC. The 23% of combined taxable income option under FSC, see *id.*, also allocates approximately 47% of the income that the 50% of combined taxable income option allocated under DISC.

⁸⁶ See Goldberg, *GATT and Export Tax Incentives: The Proposed Foreign Sales Corporation*, 42 N.Y.U. INST. FED. TAX. 32-1, 32-27 n.82 (1984) ("It has been reported that the reduction to 46 percent of the current DISC allocation formulas was based upon an economic analysis of the relationship between the DISC allocation formulas and actual arm's-length pricing, with a view to achieving a transfer price mechanism for the FSC which would be acceptable under GATT.")

⁸⁷ See *supra* text accompanying note 76.

foreign presence requirements on FSCs using the administrative pricing rules satisfy the qualifier's second prong⁸⁸ and should quell EEC objections.⁸⁹

The third prong of the qualifier, which permits a nation to adopt measures to avoid international double taxation, allows the exclusion of a portion of an FSC's income from federal taxation.⁹⁰ FSC exempts some foreign trade income from federal tax, but such income remains taxable in the host country.⁹¹

C. Forgiving the DISC-Deferred Tax

The most troubling provision of the FSC legislation does not concern the FSC mechanism; rather, it involves the forgiveness of taxes deferred under the DISC program.⁹² Because it applies to approximately \$10 billion in taxes deferred under DISC,⁹³ FSC's forgiveness provision was the crucial issue during the congressional debates.⁹⁴

Congress's enactment of the forgiveness provision followed an intensive lobbying effort by American exporters.⁹⁵ The exporters argued that collection of the DISC-deferred tax would overburden industry and result in fewer American exports. For example, a group of trade associations urged Chairman Rostenkowski of the House Ways and Means Committee to support the forgiveness provision because the DISC-deferred tax had already been invested in capital assets:

[T]he deferred taxes do not exist in separate bank accounts but in many instances in the form of bricks and mortar and other illiquid assets. Therefore, a tax on DISC-deferred income would be nothing more than a tax on current U.S. production and employment in the United States and should be recognized as such. DISC-generated investments were made on the basis of assurances by successive Administrations that the DISC deferrals were intended to continue so long as invested in export assets To tax these deferrals retroactively would unjustifiably penalize U.S. exporters who in good faith have followed the requirements of the DISC

⁸⁸ *Accord* Lightizer's Statement, *supra* note 62, at 63.

⁸⁹ *But see* Goldberg, *supra* note 86, at 32-35 ("the allocation still may be subject to challenge").

⁹⁰ *See supra* text accompanying note 57.

⁹¹ I.R.C. § 921 (Supp. III 1985). Because an FSC may still perform some of its activities within the United States, some of its income may remain subject to United States tax. *See id.* § 924(d).

⁹² *See supra* notes 77-78 and accompanying text.

⁹³ *See supra* note 77 and accompanying text.

⁹⁴ Bernick, *Prospects Uncertain on Foreign Sales Corporation Provision*, 23 TAX NOTES 790 (1984).

⁹⁵ *Id.*

statute over the years.⁹⁶

Some proponents of the forgiveness provision argued also that the additional costs associated with the FSC foreign presence, management, and economic process requirements⁹⁷ offset any benefit resulting from the forgiveness.⁹⁸ Others argued that collecting a tax on deferred DISC income would have a devastating effect on exporters' balance sheets.⁹⁹ Many exporters did not carry the DISC-deferred tax on their financial statements as a deferred liability. Lobbyists argued that adjusting their balance sheets to reflect the deferred DISC tax liability would render exporters less competitive in the debt and equity markets.¹⁰⁰

1. *The Forgiveness Provision as an Export Subsidy Prohibited by GATT*

Before Congress enacted the FSC legislation, the Reagan Administration sought "some sort of private assurance . . . that the [EEC] will look favorably on the legislation."¹⁰¹ The EEC refused and later indicated that it would officially challenge the FSC legislation after President Reagan signed the bill into law.¹⁰² The EEC maintains that where DISC only permitted tax deferral, the FSC forgiveness provision, which provides "what a European ambassador described as 'a free gift to companies that benefitted from DISC,'"¹⁰³ is a GATT-prohibited direct subsidy.¹⁰⁴

⁹⁶ Letter of 18 Trade Associations to the Honorable Dan Rostenkowski, Chairman, Committee on Ways and Means, U.S. House of Representatives (May 8, 1984), reprinted in TAX NOTES MICROFICHE DATA BASE, Doc. 84-3692 (1984); see also *Tax Executives Institute Comments on Tax Bills*, 23 TAX NOTES 651, 653-54 (1984) (arguing that "subjecting accumulated DISC income to taxation at this time could have a disastrous effect on the financial viability of numerous U.S. exporters."); cf. Kotran, *supra* note 78, at 8 (DISC deferrals were really meant to be exemptions; exporters should not have to pay tax "simply because the government has decided to terminate the program"); Dole, "The Great Tax Grab": *Sen. Dole Replies*, Wash. Post, July 12, 1984, at A20, col. 4 (Chairman of the Senate Finance Committee arguing in support of forgiveness of DISC-deferred tax and stating that DISC legislative history makes clear that DISC deferral "could amount to a partial tax exemption").

⁹⁷ See *supra* notes 71-73 and accompanying text.

⁹⁸ See, e.g., *A Lobbying Victory Gives Exporters a Windfall*, BUS. WK., Aug. 27, 1984, at 77, 78 ("[Tax forgiveness] may prove to be 'a benefit given and taken away.'") (quoting David L. Prewitt, tax manager, Cincinnati Milacron, Inc.).

⁹⁹ See, e.g., *Prospects Uncertain on Foreign Sales Corporation Provision*, *supra* note 94, at 790-91. If Congress imposed a tax payable within a definite period on the deferred DISC income, most accountants would require their clients to show the full amount of the deferred tax on the balance sheet as a deferred liability. *Id.* at 791.

¹⁰⁰ *Id.*

¹⁰¹ Bernick, *supra* note 78, at 271.

¹⁰² *Europeans Announce Plans to Force GATT Review of DISC and FSC*, *supra* note 7, at 228.

¹⁰³ Metzbaum, *supra* note 78.

¹⁰⁴ *Id.*; see Kotran, *supra* note 78, at 8-9 (Europeans "are convinced that Congress'

Existing GATT rules support the EEC's position. The qualifier condemned DISC because DISC deferred direct tax on economic processes located inside the United States.¹⁰⁵ The forgiveness provision, enacted after GATT promulgated the qualifier, perpetuates the exemption of domestic economic processes that rendered DISC illegal. By forgiving tax on domestic economic processes, the United States has simply disregarded the qualifier.

In response, the United States argues that "forgiveness merely gives effect to the indefinite nature of the deferral when it was originally granted under DISC."¹⁰⁶ This argument is especially weak in light of the United States' reliance on the distinction between deferral and exemption while defending DISC.¹⁰⁷ The United States apparently believes that it can now argue that the DISC deferral was actually permanent because it has learned that the legality¹⁰⁸ of a direct tax incentive program under GATT is determined by the territoriality principle and not by the technical difference between deferral and exemption.¹⁰⁹

The United States has defended FSC primarily by capitalizing on defects in the GATT dispute resolution process rather than constructing substantive arguments. The United States contends that GATT should associate the forgiveness provision with DISC rather than FSC.¹¹⁰

Because the aim of the dispute settlement process in GATT is to seek discontinuance of GATT-illegal practices and not to provide compensation, we feel no obligation to tax the deferred earnings. Such taxation would be tantamount to paying the community for the past damages of the DISC, a practice totally unprecedented in GATT.¹¹¹

However, GATT article XXIII(2) technically authorizes the imposi-

forgiving the \$10 billion plus is simply concrete evidence that they have been correct in calling DISC an illegal export subsidy all along.").

¹⁰⁵ See *supra* note 22 and accompanying text.

¹⁰⁶ Lightizer's Statement, *supra* note 62, at 63.

¹⁰⁷ See *supra* note 52 and accompanying text.

¹⁰⁸ See *supra* note 57 and accompanying text.

¹⁰⁹ The [DISC] tax benefit was designed as a deferral for as long as a DISC remained in existence because it was considered then that deferral, rather than complete exemption, would be more likely to be considered compatible with the General Agreement on Trade and Tariffs [sic] (GATT) to which the United States is a party. We have since found that the deferral of tax, rather than exemption, is not considered determinate under GATT.

Dole, *supra* note 96.

¹¹⁰ Lightizer's Statement, *supra* note 62, at 63.

¹¹¹ *Id.* The Reagan administration's position is inconsistent with the administration's reliance on the EEC's retaliatory threats to support its proposal to replace DISC. See *supra* notes 62-63 and accompanying text.

tion of economic sanctions (although it has never been used).¹¹² According to one commentator, "The drafting history of [article XXIII(2)] . . . makes clear that the purpose of the remedy is purely compensatory."¹¹³

GATT dispute resolution procedures can span substantial lengths of time.¹¹⁴ Commentators have cited the inefficiency of the GATT process illustrated by the DISC controversy.¹¹⁵ However, as a GATT signatory and participant in litigation against other nations,¹¹⁶ the United States should promote efficient GATT dispute resolution procedures. Exploiting inefficient GATT procedures encourages similar abuse by trading partners and does nothing to justify the FSC legislation on its merits.

Although the FSC mechanism satisfies the GATT qualifier,¹¹⁷ the forgiveness provision, which exporters consider an integral part of the FSC package,¹¹⁸ is unacceptable to the EEC.¹¹⁹ The EEC's well-founded objections to the FSC forgiveness provision indicate that the FSC program does not meet its objective of thwarting EEC retaliation.¹²⁰ As one Senator warned, including the forgiveness

¹¹² Hudec, *supra* note 48, at 150. Article XXIII provides:

2. If no satisfactory adjustment is effected between the contracting parties concerned within a reasonable time, or if the difficulty is of the type described in paragraph I (c) of this Article, the matter may be referred to the CONTRACTING PARTIES. The CONTRACTING PARTIES shall promptly investigate any matter so referred to them and shall make appropriate recommendations to the contracting parties which they consider to be concerned, or give a ruling on the matter, as appropriate. . . .

If the CONTRACTING PARTIES consider that the circumstances are serious enough to justify such action, they may authorize a contracting party or parties to suspend the application to any other contracting party or parties of such concessions or other obligations under this Agreement as they determine to be appropriate in the circumstances. If the application to any contracting party of any concession or other obligation is in fact suspended, that contracting party shall then be free, not later than sixty days after such action is taken to give written notice to the Executive Secretary to the CONTRACTING PARTIES of its intention to withdraw from this Agreement and such withdrawal shall take effect upon the sixtieth day following the day on which such notice is received by him.

³ BISD, *supra* note 14, at 45-46.

¹¹³ Hudec, *supra* note 48, at 150 n.6.

¹¹⁴ See *supra* note 55 and accompanying text.

¹¹⁵ Discussing the controversy over the forgiveness provision, one writer noted that "given [GATT's] glacial pace, it could be another ten years before anything happens." *Trying It Their Way*, FORBES, Oct. 22, 1984, at 176, 177. This statement may prove to be accurate, for "[m]ost delegations to GATT . . . have adopted a 'wait and see' attitude" regarding FSC's forgiveness provision. Bernick, *supra* note 78, at 271.

¹¹⁶ Hudec, *supra* note 48, at 156.

¹¹⁷ See *supra* notes 79-91 and accompanying text.

¹¹⁸ See *supra* notes 95-96 and accompanying text.

¹¹⁹ See *supra* notes 101-05 and accompanying text.

¹²⁰ See *supra* notes 103-05 and accompanying text. Some large exporters which have benefited from FSC appreciate the importance of satisfying GATT, and have had "sec-

provision in the FSC legislation, Congress only "[substituted] one kind of trouble for another."¹²¹ Congress ought to avoid the EEC's threats of retaliation by enacting a substitute for the DISC program that complies with existing GATT rules.¹²²

2. *The Forgiveness Provision as an Unjustifiable Loss of Tax Revenue*

Congress sought with the FSC legislation to provide a tax incentive for exporters that is comparable to DISC in terms of benefit to exporters and cost to the Treasury.¹²³ However, the forgiveness provision deprives the Treasury of a substantial source of potential revenue.¹²⁴ Despite the substantial burden on United States export-

ond thoughts" about FSC. *A Tax Break for Exports that Hurts "The Small Guy in Kansas," supra* note 78, at 86-87.

¹²¹ *Administration Urges Passage of Foreign Sales Corporation Proposal*, 22 TAX NOTES 554, 555 (1984) (quoting Sen. John Heinz).

¹²² See *supra* note 64 and accompanying text.

¹²³ *Id.*

¹²⁴ Outright forgiveness of the \$10 billion in DISC-deferred tax drew sharp criticism from American commentators, see, e.g., *A Lobbying Victory Gives Exporters a Windfall, supra* note 98, at 77 (characterizing forgiveness provision as "fruit[] of a lobbying victory"); Rowen, *The Great Tax Grab*, Wash. Post, July 5, 1984, at A21, col. 5 (forgiveness provision as "great tax grab"), who argued that the forgiveness provision is fundamentally inconsistent with the purpose of the DISC legislation because Congress meant to defer taxation, not to exempt exporters from tax. See Metzenbaum, *supra* note 78 ("Each and every company that established a DISC since 1971 knew that the deferred taxes [under DISC] would ultimately have to be paid."). DISC's legislative history supports the contention that Congress designed the original DISC legislation as a tax deferral mechanism. See *The Revenue Act of 1971: Hearings Before the Senate Comm. on Finance*, 92d Cong., 1st Sess. 45 (1971) (memorandum supplied by Department of the Treasury: Summary Explanation of DISC and Foreign Country Practices) ("While deferral may be for a substantial period of time, it cannot be permanent."); *I Tax Proposals Contained in the President's New Economic Policy: Hearings Before the House Comm. on Ways and Means*, 92d Cong., 1st Sess. 169 (1971) (statement of John S. Nolan, chairman, Committee on Taxation, U.S. Council of the International Chamber of Commerce) ("DISC proposal only defers taxes on the profits of the DISC from selling products for export"); *International Aspects of the President's New Economic Policies: Hearings Before the Subcomm. on International Trade of the Senate Comm. on Finance*, 92d Cong., 1st Sess. 115 (1971) (statement of John Connally, Secretary of the Treasury) (DISC only provides deferral).

Notwithstanding DISC's legislative history, the loss of a potential source of substantial revenue also angered critics. See Bernick, *supra* note 78, at 271 ("[S]ome members [of the House Ways and Means Committee] have long felt that DISC deferrals are a ripe source of revenue."). They argued that the forgiveness provision was inappropriate in an era of concern over a soaring budget deficit:

There are a lot of American people, the elderly and middle-class people, who are going to pay \$7 billion more one way or another in medicare and medicaid It is interesting to note that with one sweep of the pen early Saturday morning, we gave \$12 billion to the major corporations in this country tax-free, as a gift Twenty-eight million people in this country are going to have \$8 or \$9 billion in cuts in benefits while we gave billions away to General Electric, TRW, Allied Chemical, Exxon, and the like.

Kotran, *supra* note 78, at 8 (quoting Rep. Fortney Stark).

ers and the serious balance of payments problem that a collection of deferred taxes would occasion, the loss of potential revenue is not justified if FSC fails to soothe the United States' trading partners.¹²⁵ Had Congress simply left DISC in place, the United States' trading partners would still be arguing that DISC violated GATT, but the United States Treasury would not have lost a vast source of potential revenue.

IV

ALTERNATIVES TO FSC AND THE FORGIVENESS PROVISION

Congress hoped to counteract the discriminatory impact of the GATT distinction between direct and indirect taxes by molding its export tax incentive program to the existing GATT rules. Both of Congress's attempts have failed to satisfy the current rules. DISC violated the GATT rules because it provided long term deferral of direct tax on income derived from economic processes located inside the United States.¹²⁶ Although the FSC mechanism complies with existing GATT rules by applying its direct tax benefits only to income derived from foreign economic processes,¹²⁷ the FSC legislation's forgiveness provision violates the GATT rules because it provides tax exemptions on the same domestic economic processes that condemned DISC.¹²⁸

Congress could satisfy the existing rules by either enacting an American VAT¹²⁹ or keeping the FSC mechanism but requiring payment of the DISC-deferred tax.¹³⁰ Both alternatives perpetuate GATT's fundamentally unsound distinction between direct and indirect tax. Furthermore, the United States should not reformulate basic tax policy to satisfy GATT rules that unjustifiably discriminate against countries that rely on direct taxes. Therefore, Congress

¹²⁵ This was essentially the position of the Executive Committee of the Democratic Study Group, summarized as follows in its chairman's letter to Chairman Rostenkowski of the House Ways and Means Committee:

[T]here are too many unanswered questions to act at this time—questions regarding FSC itself as well as whether the forgiveness provision represents an unwarranted tax giveaway or a necessary means of preventing imposition of an unfair, retroactive tax. With respect to FSC, we believe that any decision to continue export tax incentives should be carefully designed to assure that continued loss of tax revenues is justified by an increase in exports and is needed to offset foreign tax incentives which place U.S. exporters at a competitive disadvantage.

Letter from Hon. Matthew F. McHugh, Chairman, Democratic Study Group to Hon. Dan Rostenkowski, Chairman, Committee on Ways and Means, U.S. House of Representatives (June 13, 1984) (on file at *Cornell Law Review*).

¹²⁶ See *supra* notes 22 & 33 and accompanying text.

¹²⁷ See *supra* notes 79-91 and accompanying text.

¹²⁸ See *supra* note 105 and accompanying text.

¹²⁹ See *infra* notes 139-54 and accompanying text.

¹³⁰ See *infra* notes 132-36 and accompanying text.

should force other signatories to reconsider the economic theory upon which GATT is based by demanding renegotiation of GATT.¹³¹

A. Payment of DISC-Deferred Tax

Congress could resolve the international dispute over the forgiveness provision by repealing the provision and requiring the immediate and full payment of the DISC-deferred tax. Even though this payment would boost the United States Treasury receipts and satisfy trading partners, Congress is not likely to impose such a financial burden on exporters while the United States is in a weak balance of payments position.¹³²

A more practical alternative is for Congress to spread the payment of the DISC-deferred tax over time.¹³³ Congress used this type of payment system under DISC: if a DISC lost its DISC status, it had to pay previous years' DISC benefits over a period equal to two years for each year that the DISC was in existence, up to a maximum of ten years.¹³⁴ An extended payout period substantially reduced the effective tax on the deferred DISC income.¹³⁵ With this reduction in mind, American exporters might be less adverse to the payment of DISC-deferred tax over an extended period.¹³⁶ Although this alternative still results in a substantial loss of revenue, it would improve the United States' relations with its trading partners. Moreover, the FSC mechanism would still provide a tax incentive for American exporters.

Payment of the deferred tax leaves unchallenged GATT's distinction between direct and indirect taxes. Under the FSC mechanism, American exporters only receive direct tax benefits on transactions that "occur" outside the United States.¹³⁷ Foreign exporters in indirect tax jurisdictions gain tax benefits on income derived from both foreign and domestic economic processes.¹³⁸

¹³¹ See *infra* notes 156-61 and accompanying text.

¹³² The merchandise trade deficit was predicted to reach a record high of more than \$150 billion in 1985. *Reagan Proposes Export Subsidies to Gain Markets*, N.Y. Times, Sept. 24, 1985, at A1, col. 6.

¹³³ One European official has indicated that "some sort of 'partial recovery might solve the problem.'" Bernick, *supra* note 78, at 271.

¹³⁴ I.R.C. § 995(b)(2) (Supp. III 1985).

¹³⁵ Because of the time value of money, taxes due in the future are less costly than taxes due today.

¹³⁶ See *supra* note 120. One writer reports that United States exporters would have accepted a settlement of about \$4 billion to avoid the full deferred tax liability. Rowen, *supra* note 124.

¹³⁷ See *supra* notes 71-73 and accompanying text.

¹³⁸ See *supra* note 19 and accompanying text.

Furthermore, the GATT rules do not require such exporters to set up foreign sales corporations or to establish a foreign presence.

B. An American VAT

Congress could also resolve the dispute over export tax incentives by replacing the current income tax with a value-added tax.¹³⁹ An American VAT would comply with existing GATT rules and provide a simpler tax system. However, adoption of a VAT would involve a fundamental restructuring of the American tax system.

The FSC's foreign presence, management, and economic process requirements impose substantial burdens on United States exporters and may render the FSC program less cost effective than DISC.¹⁴⁰ Congress could alleviate these problems if it instituted a form of VAT as the nation's primary export tax incentive.¹⁴¹ Under existing GATT rules, a country may remit the VAT as a border tax adjustment even if an exporter's economic processes occur in its home country.¹⁴² Thus, if the United States used VAT, the FSC's foreign presence, management, and economic process requirements would be unnecessary.

Proponents argue that a VAT would not only provide an export tax incentive and permit the United States to avoid the impact of the GATT's discriminatory distinction between direct and indirect taxes,¹⁴³ but also it would provide a more rational basis for taxation.¹⁴⁴ Whereas income tax is based on potential consumption, VAT is based on actual consumption.¹⁴⁵ VAT supporters argue that "taxation should be based on the actual satisfaction derived from goods and services, rather than the ability to purchase them, and actual satisfaction may be more closely related to expenditures for

¹³⁹ This proposition has been the subject of lively debate for 15 years. See, e.g., R. LINDHOLM, *supra* note 18; Smith, *supra* note 18; Surrey, *supra* note 18.

¹⁴⁰ See *supra* notes 71-73 and accompanying text; see also JOINT COMMITTEE ON TAXATION, 98TH CONG., 1ST SESS., REPLACEMENT OF DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISCs), DESCRIPTION OF S. 1804 (FOREIGN SALES CORPORATION ACT) 46 (Joint Comm. Print 1983) ("for the same revenue loss, the FSC legislation may stimulate fewer additional exports than DISC since firms would only utilize a FSC if the tax savings cover the transaction costs of the offshore corporation").

¹⁴¹ There are essentially three types of VAT: "consumption," "gross product," and "national income." See Note, *Export Incentives: United States DISC Legislation as an Invalid Subsidy Under the GATT Provisions*, 20 WASHBURN L.J. 535, 551 n.134 (1981). The consumption type which the EEC uses has generally been considered appropriate for the United States by VAT advocates. Smith, *supra* note 18, at 79. For a simplified example of the consumption type VAT, see *supra* note 18.

¹⁴² See *supra* note 19 and accompanying text.

¹⁴³ Smith, *supra* note 18, at 82-83.

¹⁴⁴ *Analysis of Proposals Relating to Comprehensive Tax Reform*, *supra* note 49, at 174-75.

¹⁴⁵ *Id.*

goods and services than to income."¹⁴⁶

Congress may also favor VAT's reduced effect on business decisions and limited dependency on business profitability. A VAT is imposed on all businesses with sales, whether or not the business actually generates a profit.¹⁴⁷ Under the United States' current system, tax considerations permeate the entire corporate income statement.¹⁴⁸ Under a VAT, however, tax factors impact only the amount of sales a company derives, therefore "inherent advantages and relative efficiencies are allowed to operate in the market economy with minimum tax distortions."¹⁴⁹ A VAT simplifies the complex tax analysis that accompanies capital expenditures.

Although Treasury Secretary Regan reportedly noted that the "international competitiveness of the U.S. was a factor in Treasury's study of fundamental tax reform,"¹⁵⁰ the Reagan administration "abandoned any idea of proposing a value-added tax" in October 1984.¹⁵¹ Regan argued that the VAT is a regressive tax, and is therefore inconsistent with the American tax system's traditional progressive nature.¹⁵² The VAT makes the consumer the final payor of tax. Because low income consumers must spend a greater proportion of their incomes than high income consumers to meet their daily costs of living, low income consumers pay a greater percentage of their income in VAT than high income consumers.¹⁵³ Critics of the VAT charge that income, not consumption, is the valid measure of ability to pay tax because those with high incomes are better able to fund purchases of goods and services which satisfy public con-

¹⁴⁶ *Id.* at 162.

¹⁴⁷ See Smith, *supra* note 18, at 79 (VAT "minimizes any influence taxation might exert on decisions regarding the productive processes in industry").

¹⁴⁸ For instance, interest expense deductibility affects the decision to finance with debt or equity.

¹⁴⁹ Smith, *supra* note 18, at 79.

¹⁵⁰ *U.S. Competitiveness is a Factor in Treasury Tax Study, Says Regan*, 25 TAX NOTES 511 (Nov. 5, 1984) (paraphrasing Regan).

¹⁵¹ *VAT Held Unlikely by Regan*, N.Y. Times, Oct. 15, 1984, at D1, col. 6.

¹⁵² *Id.*

¹⁵³ Surrey, *supra* note 18, at 90. The progressive tax system can be justified in terms of equity: If people were faced with a choice between a progressive or a regressive tax

from the point of view of the very beginning of their lives, when they did not know their capabilities and resources and exactly where they would end up in the income distribution, they would be willing to agree to laws under which government would mitigate, to some extent, whatever inequalities emerged from a market economy. . . . [L]abor and property have value only because society establishes laws and regulations which allow each individual to engage in economic activity with relatively little interference from others Thus, because society establishes the framework which allows labor and property to be valuable resources, it can also establish a progressive tax system and other mechanisms to achieve a more equitable distribution of income.

sumption needs, that is, goods and services provided by the government.¹⁵⁴

C. Renegotiate GATT

Any discrepancy between the extent that exporters shift direct and indirect tax savings forward does not justify GATT's diametrically opposite treatment of direct and indirect tax incentive programs.¹⁵⁵ Exporters in indirect tax jurisdictions decrease export prices at least partly because the government, by remitting or exempting indirect tax, subsidizes its exporters for the price differential between foreign and domestic markets. If GATT permitted countries to remit to exporters, or exempt exporters from, direct tax, exporters could reduce export price in part.

Certainly the most direct (albeit most difficult) solution to the international controversy over export tax incentives involves renegotiation of GATT. The United States is at a competitive disadvantage because it relies on direct taxes to a more significant degree than its trading partners; thus, the United States has strong grounds to demand that GATT change the rules.¹⁵⁶

When Congress adopted GATT in 1948, world economic conditions differed substantially from conditions today. Export subsidies and the effects of different tax systems did not concern the United States, which "had emerged from World War II as the dominant economic force in the Free World and was running large trade surpluses."¹⁵⁷ One writer reports,

The record of the initial GATT deliberations . . . is devoid of any discussion of the effects of differing tax systems or differing types of taxes upon trade. Thirty years later, this failure to deal effectively with taxes as export subsidies has become a source of major inequity and serious distortions in the world trading system.¹⁵⁸

Beginning in the 1960's, the United States sought reformulation of the GATT ground rules.¹⁵⁹ The American effort failed because the

¹⁵⁴ See *Analysis of Proposals Relating to Comprehensive Tax Reform*, *supra* note 49, at 162.

¹⁵⁵ See *supra* notes 14-29 and accompanying text.

¹⁵⁶ Renegotiation of GATT is not a new proposition. Senator Bennett, after listening to Secretary of the Treasury Connally's discussion of the GATT position on direct taxes during a 1971 hearing, queried, "Don't you think, looking at the thing philosophically . . . we would all be better off if we renegotiated the basis of our international trade rather than continue to patch our own tax system to match the limitations in GATT?" *Foreign Trade Hearings*, *supra* note 31, at 45 (statement of Sen. Wallace Bennett).

¹⁵⁷ *Export Policy Hearing*, *supra* note 26, at 224 (prepared statement of Richard Hammer).

¹⁵⁸ *Id.* at 225 (prepared statement of Richard Hammer).

¹⁵⁹ The United States sought reformulation of GATT art. XVI:4. *see supra* note 14, under GATT art. XVI:5, which provides:

The CONTRACTING PARTIES shall review the operation of the provisions of

EEC and Japan "simply refused to entertain any possibility of meaningful compromise or revision of the rules which so favor their exporters."¹⁶⁰ The demise of DISC and the United States' attempt to satisfy the GATT qualifier with FSC indicate that it will be quite difficult for the United States to convince other GATT signatories to change the ground rules.

Even though "[w]ise diplomats do not like to deal with questions that have no good answers,"¹⁶¹ the United States should press the EEC and other GATT members to change GATT's position on direct and indirect taxes. Disputes and threats of retaliation will undoubtedly continue until the United States and its trading partners reconsider GATT's characterization of direct and indirect taxes, for therein lies the fundamental inequity at the heart of the DISC and FSC controversies.¹⁶²

If the United States succeeds in reformulating the ground rules, Congress could reenact a tax incentive program like DISC.¹⁶³ American exporters, like their counterparts in indirect tax jurisdictions, could reduce their export prices and gain tax benefits on income derived from domestic economic processes. Such a change in

this Article from time to time with a view to examining its effectiveness, in the light of actual experience, in promoting the objectives of this Agreement and avoiding subsidization seriously prejudicial to the trade or interest of contracting parties.

3 BISD, *supra* note 14, at 31. For a detailed account of the steps taken by the United States under this GATT provision, see *Export Policy Hearing, supra* note 26, at 236-41 (prepared statement of Richard Hammer).

¹⁶⁰ *Export Policy Hearing, supra* note 26, at 241 (prepared statement of Richard Hammer).

¹⁶¹ Hudec, *supra* note 48, at 167.

¹⁶² One writer suggests that GATT change the rules to permit review of indirect tax incentive schemes on a case-by-case basis. See K. DAM, *supra* note 19, at 216 ("[A] case-by-case approach . . . would give not only theoretically more correct results but also results more widely accepted as just and appropriate.").

¹⁶³ This Note presumes that DISC actually provided an incentive to American exporters. However, American commentators and politicians have criticized DISC on the grounds that the revenue cost to the Treasury outweighs the potential benefit of increased exports. They contend that an American company's decision to export depends on the existence of an attractive foreign market, not the availability of DISC benefits. See, e.g., President Carter's Message to Congress: Tax Reduction and Reform, PUB. PAPERS (BOOK 1) 158, 160 (Jan. 20, 1978) ("[T]here is no justification for the DISC export subsidy . . . to encourage our firms to do exactly what they would do anyway—export to profitable foreign markets."); *Corporate Tax Break on Exports is Likely to be Rescinded Soon*, Wall St. J., Jan. 5, 1977, at 1, col. 6 ("An airplane company doesn't sell a plane in Europe because it is getting a break from DISC. It sells the plane because it has found someone over there who wants to buy it.") (quoting Alan Benasuli, analyst, Drexel, Burnham & Co.). Discussion of the economic efficiency of an export tax incentive program like DISC is beyond the scope of this Note. For a concise discussion of the case against DISC, see Note, *Export Promotion Through Tax Incentives: The Future of DISC Under the GATT Subsidies Code*, 20 VA. J. INT'L L. 171, 190-98 (1979).

the rules would render the FSC's foreign presence, management, and economic process requirements unnecessary.

CONCLUSION

Although the FSC mechanism itself complies with the GATT qualifier, the forgiveness provision violates GATT rules and is vigorously rejected by the United States' trading partners. Because the FSC legislation fails to achieve its acknowledged goal of placating these trading partners, the loss of \$10 billion of potential revenue from DISC deferred taxes to the United States Treasury is unjustified.

The United States should not appease other GATT signatories by molding its export tax incentive program to comply with the discriminatory GATT rules. Rather, the United States should demand reformulation of GATT's outdated economic assumptions regarding direct and indirect taxes. Under reformed GATT rules American exporters could compete effectively and fairly with their foreign counterparts.

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