

# GENERAL AGREEMENT ON TARIFFS AND TRADE

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## UNITED STATES TAX LEGISLATION (DISC)

The following communication has been received from the Delegation of the United States.

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### SUMMARY OF STATEMENT OF THE UNITED STATES REPRESENTATIVE BEFORE THE GATT COUNCIL ON 29 JUNE 1982 REGARDING THE DISC LEGISLATION

The United States opposes the adoption of the recommendation proposed by the European Communities because the United States believes that the DISC programme operates in a manner which is consistent with the obligations of the United States under Article XVI:4 of the GATT.

The GATT Panel Report on the DISC, together with the panel reports on the examined tax practices of France, Belgium and the Netherlands, was adopted by the GATT Council on 8 December 1981 with the explicit understanding that Article XVI:4 does not require contracting parties to tax economic processes located outside the territorial limits of the exporting country. In the view of the United States, the 8 December understanding therefore reaffirms the consistency with Article XVI:4 of the principles embodied in a territorial system of taxation. The United States believes the DISC is fully consistent with its GATT obligations because, in its operation, the programme approximates the effective tax treatment of income from exports which would otherwise prevail under a purely territorial tax system.

The United States has an essentially global system of taxation. That is, the United States generally taxes the worldwide income of its citizens and corporations, whether that income is generated within or outside United States territory. By contrast, under a purely territorial system, a portion of export sales income that can be attributed to a foreign source is exempt from taxation in the home country. Virtually any export transaction will entail income from activities taking place both outside and within the exporting country, i.e., both foreign and domestic source income.

The use of a DISC for export sales diminishes the global U.S. tax burden by deferring from direct federal taxation a small portion of income attributable to export sales activities, and thus, similar to a territorial system, attributes a portion of U.S. export sales income as though it is foreign source income. Thus, the U.S. views DISC as an approximation of how U.S. income from exports would be taxed under the internationally accepted territorial system.

The creation of DISCs is provided for in Title V of the Revenue Act of 1971. Under Title V, income from an export sale may be attributed to a DISC under three methods: (a) four percent of receipts attributable to the sale of export property, plus ten percent of related export promotion expenses; (b) fifty percent of combined taxable income of the DISC and its related supplier attributable to the sale of export property, plus ten percent of related export promotion expenses; or (c) taxable income based on the price actually charged the DISC by its related supplier if that price is justifiable on an arm's-length basis.

Under the original DISC legislation, fifty percent of the income attributed to a DISC was deemed to be paid out as a dividend and subject to U.S. tax. Approximately twenty-five percent of the combined income attributable to DISC exports, therefore, could be retained tax deferred in a DISC, assuming the fifty percent assignment method was utilized.

Under amendments contained in the Tax Reform Act of 1976, the DISC legislation was further amended and its benefits limited to increases in exports over an amount attributable to its export sales over a four-year base period. Tax deferral through a DISC is currently limited to fifty percent of the income attributable to DISC exports over and above the base amount. Currently, U.S. manufacturers using DISCs are able to defer federal tax on income equal to approximately eighteen percent of the combined income of the DISC and its related supplier attributable to DISC export sales.

Under a territorial system, the foreign sales income related to an export transaction would be exempt from tax in the country using the territorial system. Total export income, in effect, is divided between domestic production income and foreign sales income. This is the same division that occurs in the operation of a DISC, and the amounts of income tax deferred are comparable, if not less, than the deferrals used by countries that have adopted a territorial system with internationally-acceptable safe haven rules. The net effect of the DISC is to place American exporters in the same comparable position as exporters operating under a territorial tax system.

The Panel which examined the DISC legislation found that the DISC had the effect of derogating from the global system of direct taxation, thereby increasing exports beyond those which would have existed under a purely global system. In effect, the Panel took the view that Article XVI:4 required that a country use a global system of taxation--in which taxes are collected not only on income generated within the territory of the taxing country (domestic source income) but also on income earned abroad by taxpayers (foreign source income).

To avoid double taxation, a global system grants a credit for foreign taxes paid on foreign source income. Still, in a pure global system, there is no tax incentive to export since the taxpayers' burden will be the same whether the income results from products sold domestically or in foreign markets.

The Panel cast doubt on the GATT legality of a territorial system of taxation, in which, theoretically, taxes are collected only on income generated within the territory of the taxing country. In a pure territorial system, there is a tax incentive for a business to export to the degree foreign source income is generated in a country assessing lower direct taxes than does the country from which the export transaction originates. Based on economic theory, the Panel took the approach that territorial tax legislation would constitute a subsidy prohibited by Article XVI:4, while the DISC was also found to operate as a subsidy, by virtue of its derogation from a purely global system.

Whatever the validity of the Panel's analysis as a matter of economic theory, it is evident in the understanding adopted by the Council on December 8, 1981, that this analysis was incorrect as a matter of the interpretation which should be given to Article XVI:4.

In its adoption of the understanding with respect to the four Panel Reports, the Council acknowledged the legitimacy for GATT purposes, of taxing income from exports in accordance with the principles of the territorial system of taxation, in which it is not necessary to tax foreign source income at all. The appropriate standard, therefore, with respect to which the DISC should be considered under GATT is whether the U.S. global system, as modified by the DISC, results in taxation of export income equivalent to that which would result under the principles of a territorial system. The DISC defers a small portion of taxes on export income in a manner comparable to the exemption of the foreign source component of export income under the principles of a territorial system.