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UNITED STATES TAX LEGISLATION (DISC)

Supplement

Attached is the full transcript of the United States representative's statement before the GATT Council regarding the DISC legislation. The summary of this statement has been circulated on 9 July 1982 in document C/W/389.

STATEMENT OF THE HONORABLE DAVID R. MACDONALD
FOR THE UNITED STATES
BEFORE THE GATT COUNCIL, ON JUNE 29, 1982
OPPOSING ADOPTION OF E.C. DRAFT DECISION

Mr. Chairman, I believe that the DISC is in conformity with the obligations of the United States under the GATT and we are prepared at this meeting to establish that fact. Preliminarily, however, in view of the ad hominem attack upon the motives of the United States, I do think it is worthwhile to go back over the circumstances that have surrounded the qualification followed by the adoption of the DISC report last December. The statement of the delegation from the European Community is simply wrong. We do not now believe and did not believe at any time when we were attempting to negotiate a solution to this matter with the European Community that the DISC was in violation of the GATT. I am sorry to find out now that our good faith attempts to negotiate a solution to this long standing problem are being held against us with the imputation that somehow the effort to settle is an admission of guilt. If that proposition ever becomes the rule of this organization, its death is near.

Before providing a detailed explanation of the DISC and why it is in conformity with the GATT, Mr. Chairman, I would also remind the delegation of the European Community that the qualification to the panel reports that was ultimately adopted by this Council was drafted jointly by the United States, the EC and the three concerned member states, and was discussed with several other Contracting Parties before its adoption. It was a qualification to all four panel reports -- not just three but all four panel reports. I personally stated in Room E (I think it is up next to the CG-18 meeting room) that the result of that qualification was to exonerate the DISC. No one at that time contested that statement. Again, when the qualifier was actually adopted by this Council and the reports were adopted, we once again elaborated upon what we believe to be the appropriate test for legality (the "level of taxation" text) of the direct taxation of exports. Nevertheless, any Contracting Party to Article XVI:4 is entitled to raise the issue of the DISC's legality again and we are happy to respond to their inquiries. We are not prepared, however, to accept a judgment against us, as proposed by the European Community, without the examination of the effect of the qualifier that was adopted by this Council on the DISC report, and this indeed is the gravamen of our presentation today. Nor do we ask that this Council condemn France, Belgium or the Netherlands, which were also found to be in violation of the GATT, without a similar examination.

I know that our presentation will be something of a burden to the Council. In all of the long history of DISC and the European tax practices, there has been relatively little discussion of the substance of this matter as opposed to the procedural issues that have regrettably taken so much of the Council's time. In retrospect, it may have been a mistake not to have delved more deeply before into the substance of this issue. Some delegations have fairly complained that the rather terse understanding adopted last December, that is to say the qualifier, was somewhat less than transparent in its meaning. Further, while we have alluded in general terms to the reasons we believe DISC conforms with our obligations, it is clear that misconceptions of the DISC and its operations still persist, at least among our friends in the Community and perhaps for others as well.

Mr. Chairman, the attacks on the DISC have been framed in rather simple terms, sometimes leading us to believe that the DISC is challenged simply because of its title. I hope that the full explanation that we are prepared to provide now will demonstrate that the DISC cannot be condemned without looking at the effect that the qualifier adopted by this Council has, and when that effect is explained, the DISC will be found to conform with GATT standards.

The first point I would like to raise is the enactment of the DISC and the purposes behind it. And the conclusion that I propose is that the enactment of the DISC alleviated disadvantageous United States federal income tax treatment of income from export sales, and its effect (which is the relevant test under all four panel decisions) is not more favorable to exports than a territorial system of taxation.

A. Background to Adoption of DISC

The United States taxes the worldwide income of its citizens and corporations. Since income earned outside the United States (i.e. foreign source income) normally involves the payment of an income tax to the foreign country where the income is earned, the result can be a dual payment of tax on the same income, once to the foreign country and then to the United States.

The United States has adopted the credit method, as opposed to the exemption method, discussed below, to alleviate the problem of international double taxation. Under this method the United States recognizes that the source country has the primary right to tax income earned within its borders, but the United States retains residual taxing jurisdiction. Thus, a taxpayer is allowed a credit against its U.S. tax equal to the foreign tax paid, subject to the limitation that the credit is only allowed to the extent of U.S. tax which would have been paid, under U.S. tax rules and absent the foreign tax credit, on the foreign source income. For U.S. income tax purposes, the maximum amount of foreign tax which can be credited against U.S. income tax is the lower of the actual foreign tax paid or the effective rate of U.S. tax (pre-credit) imposed on the foreign source income.*

Under the U.S. system, foreign source income (and this is a crucial concept for the purpose of understanding this discussion) is taxed by the United States at different times depending upon how and by whom the income is earned. Foreign source income earned by a foreign branch of a U.S. corporation is included in the income of the corporation when such income is earned under U.S. tax accounting rules, regardless of when repatriated from such branch. The United States grants a foreign tax credit for the amount of foreign taxes paid in connection with that income, subject to the foreign tax credit limitation. With respect to income earned through a foreign subsidiary of a U.S. corporation, the United States respects the separate entity status of a subsidiary corporation and, except as provided under the rules of subpart F of the Code,** described below (and which, among other things, causes exports

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* To the extent foreign taxes are imposed at a rate in excess of the U.S. rate, the excess foreign taxes can be carried back two years and carried forward five.

** The U.S. Internal Revenue Code. A similar exception to deferral also applies to foreign personal holding companies, generally with respect to passive income.

to be taxed on a global basis), does not subject to U.S. taxation foreign source income until it is repatriated. This is generally referred to as "deferral." To avoid double taxation upon repatriation, the United States permits a U.S. corporation to credit the taxes paid by the foreign subsidiary on or with respect to the earnings from which the dividend is paid, as well as any foreign taxes imposed on the dividend recipient upon repatriation, subject to the foreign tax credit limitation.

Other nations have found different solutions to the problem of potential international double taxation. The legislation of many European countries, including Belgium, France, and the Netherlands, purports to operate under a system known as the exemption or territorial system. Under this system, the territory or country where the income is earned has the primary right to tax that income while the resident country cedes or reduces its right to tax. This concept applies to both branches and subsidiaries. Thus, if a corporation which is a resident of a jurisdiction applying such a system earns income through a branch located in a foreign jurisdiction, which is subject to taxation in that foreign jurisdiction, the resident jurisdiction does not tax the income earned nor take into account the losses incurred in the foreign jurisdiction. (The resident jurisdiction could, however, tax income earned within its borders.) To avoid international double taxation in the case of income earned in another jurisdiction through a subsidiary, the legislation of the resident jurisdiction purports to allow the foreign source income to be repatriated either at reduced rates of tax or tax free. The application of this "territorial" system of taxation, however, varies widely from country to country. In none of the countries, France, Belgium and the Netherlands, for example, did the panel reports find that these countries actually applied the territorial system, and, in one of the three countries, the panel found that it had not applied the territorial system. (See: France Panel report at para. 54; Belgium Panel report at para. 45; Netherlands Panel report at para. 41.)

Prior to the enactment of its "subpart F" rules in 1962, the United States taxed foreign source income earned by a foreign subsidiary (other than a subsidiary classified as a foreign personal holding company) in a manner similar to that under an exemption or territorial system, that is, the income of the foreign subsidiary was not subject to U.S. tax unless and until the income was repatriated. A favored pre-1962 tax planning technique for a U.S. corporation with foreign sales was to establish a foreign subsidiary in a jurisdiction which imposed little or no income tax on income earned in that jurisdiction. International sales activities were channeled through the foreign subsidiary. As long as the income from those sales was not repatriated to the U.S. parent corporation, U.S. tax was deferred on such income. This was in effect similar to an exemption system. So long as the income was not repatriated, the overall effective rate of tax on the so-called "deferred" foreign source sales income was equal to the rate of tax imposed by the foreign jurisdiction. In these circumstances, it would not matter whether the ultimate shareholder was subject to a credit or an exemption system. (This system is noted in para. 7 of the DISC Panel report.)

In 1962 the United States enacted the subpart F legislation, which, generally, treats earnings of a foreign subsidiary in a manner comparable

to earnings of a foreign branch with respect to sales (and certain other) income, if the subsidiary is, in effect, only a conduit for the sale of products produced and sold for use outside the country in which the foreign subsidiary was incorporated. Comparable to income earned by a foreign branch of a U.S. corporation, the United States eliminated deferral with respect to subpart F income and taxed it on a current basis, subject to a deemed foreign tax credit with respect to foreign taxes imposed on the subpart F earnings of the foreign subsidiary. To a significant extent, subpart F prevented U.S. taxpayers from obtaining a rate of taxation on foreign source income from export sales which approximated that under an exemption system, especially to the extent that the effective U.S. tax rate on that income exceeded the effective rate of tax in the country of source. (The operation of subpart F is briefly described in para. 8 of the GATT Panel report on DISC.)

The dramatic deterioration in the U.S. international trade balance during the late 1960s created the incentive to correct the global taxation of foreign source income subsequent to 1962 by bringing U.S. tax treatment of foreign source sales income into approximate congruence with the tax treatment available under an exemption tax system. Thus, DISC was enacted in 1971. As the foregoing discussion shows, its primary purpose was to alleviate the relative disadvantage that U.S. exporters operated under as a result of the U.S. taxation of foreign source sales income. In that regard, as the credit and exemption systems each are internationally-accepted methods for avoiding double taxation of income, the United States should not be required to tax its exports in a more disadvantageous manner than would be required under an exemption system merely because the United States uses the credit, rather than the exemption system.

B. Enactment of DISC and 1976 Amendments

Legislation enacted in 1971 allowed a U.S. corporation engaging in export sales to establish a domestic corporation which would serve as the conduit for such sales, i.e., a DISC. The objective of this legislation was to allow U.S. corporations to structure foreign sales activities in a comparable manner to that which existed prior to enactment of subpart F in 1962. The difference was one of form, rather than substance.

Under the 1971 legislation, a U.S. exporter could allocate a certain portion of the income attributable to the export sales of qualifying goods and services to a DISC. The portion allocable to the DISC could be determined (at the discretion of the taxpayer) in one of three ways:

-- 50 percent of the combined net income of the related manufacturer and the DISC from export sales, plus 10 percent of qualified export promotion expenses. (This is the most common election by far.);

-- 4 percent of gross receipts resulting from the export sale, plus 10 percent of qualified export promotion expenses; or

-- the amount which would be allocable to the DISC under the otherwise applicable arm's-length intercompany pricing rules.

The DISC is not subject to U.S. taxation. Under the 1971 legislation, 50 percent of the income attributable to the DISC was deemed to be paid out as a dividend and, thus, was taxable at the shareholder level. For those who elect the first alternative approximately 75% of the income was subject to U.S. taxation (50% of the combined taxable income from the export sale attributable to the DISC related supplier plus 50% of the (remaining) income attributable to the DISC which is treated as a dividend to the DISC corporate shareholder and subject to tax at the regular corporate rate). (This is pointed out in para. 14 of the DISC Panel report). Thus, under the 1971 legislation, approximately 25 percent of the combined taxable income attributable to DISC sales could be tax-deferred through utilizing a DISC. The amount subject to tax deferral was further reduced by the Tax Reform Act of 1976. Under that legislation, a DISC was deemed to distribute an additional amount so that the tax deferral was limited to 50 percent of the income attributable to exports over and above a base amount of 67 percent of export sales for a four year moving base period. Based on statistics for the most recent year available, it is estimated that DISCs defer Federal tax on only approximately 17% (rather than 25%) of the combined income attributable to DISC sales. Thus, the DISC provisions merely assist in neutralizing the adverse relative effect of the U.S. tax system on export sales described above. As we are willing to demonstrate, this 17% deferral is lower than the percent of income for which exemption may be allowable under a reasonable safe haven system in a territorial system of taxation.

The second broad point we would like to make is that the DISC is consistent with Article XVI:4 of the GATT as interpreted by the GATT Council Resolution of December 8, 1981, adopting the DISC, Belgium, France and the Netherlands Panel reports.

The Panel reports on DISC and on the examined tax practices of Belgium, France, and the Netherlands concluded that the tax practices of all four countries had, in some cases, effects which were not in conformity with Article XVI:4. The four reports were adopted subject to an important qualifier, which provides as follows:

> The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the price which would be charged between independent enterprises acting at arm's-length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.

This understanding of the interpretation of Article XVI:4 is fundamentally different in import from the interpretation of Article XVI:4 upon which the panels examined the tax practices of the four countries and reached its conclusion. The premise underlying the panelists' reasoning, as evidenced by the conclusion of each panel report, was that the failure to tax the complete cycle of economic activity related to an export transaction constituted a subsidy on exports. Thus, the DISC and all systems purporting to be territorial systems of taxation were found by the panels to run afoul of the GATT.

The economic reasoning of the panel reports was properly viewed by the four countries involved as placing in doubt the conformity with Article XVI:4 of systems of taxation which do not assess direct taxes on all of the foreign source income from the sale of goods through a foreign sales affiliate to an unrelated party. The understanding adopted by the Council interpreting the four panel reports was intended to legitimize under Article XVI:4 the use of direct tax systems which exempt from direct taxation a portion of the profit earned on export sales, subject to the caveat that transactions between related parties must be on an arm's-length basis.

Both the U.S. system of direct taxation (worldwide as modified by DISC) and exemption systems employed by Belgium, France, and the Netherlands, among others, extend similar treatment to their exporters. Under all systems, the portion of the profit on an export sale which is attributable to export activities is exempt (or deferred) from direct taxation.

In its adoption of the understanding with respect to the four panel reports, the Council acknowledged the legitimacy, for GATT purposes, of a country taxing its exports at a level equal to an exemption tax system. In doing so, it accepted that the level of direct taxation imposed on exports under exemption systems is consistent with GATT rules.

As stated above, the understanding adopted by the Council provides that "economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement." In other words, a system of taxation which has the effect of a deferral, or even an exemption, of tax with respect to foreign source income from an export sale is not a violation of GATT. Thus, DISC is in its operation entirely consistent with this qualification.

The DISC provisions are a method to cause export sales to be subject to tax in a manner that approximates that of an exemption system, given reasonable safe-haven rules. More specifically, the DISC provisions effectively permit deferral of tax with respect to an amount of taxable income which, in operation, would not exceed the foreign source income element of an export sale, determined under generally applicable U.S. source of income rules.

Under U.S. source of income rules, income derived from the purchase of personal property within the United States and its sale in a foreign country is considered foreign source income. This is entirely consistent with the

qualification to the panel decisions adopted by this Council. In this circumstance, the place of sale is generally determined by where title to the goods passes to the purchaser. Thus, it is possible to cause all of the income from a sale of goods which have been purchased in the United States to be foreign source income by causing title to the goods to pass to a foreign purchaser at the foreign destination of the sale. A different source rule applies, however, where property is produced in the United States and sold in a foreign country. In this circumstance, the income from the sale must be allocated and apportioned between the United States (where production occurs) and the foreign jurisdiction (where the sale occurs). This source rule, found in section 863(b) of the Internal Revenue Code of 1954, as amended (the "Code"), would apply if an export sale was made by a producer to a foreign customer directly, passing title abroad, with or without the interposition of a DISC.

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

The section 863(b) source rule is an economically realistic and appropriate measure of the relative amounts of domestic and foreign economic activity conducted with respect to an export sale. The rule recognizes that the production or factory element of the taxable income from the sale should be attributed to the United States and the sales element of the taxable income to the foreign country. The rule first looks to a comparable arm's length transfer price and, if such a price is not available, only then to an allocation and apportionment based on the relative values of property and gross sales in the respective countries.

The section 863(b) source of income rule is generally applicable under U.S. tax rules to determine the source of income from sales of property produced in the U.S. and sold in a foreign country. The source rule determines the income attributable to the economic activities conducted in the United States and the foreign country. In most cases, the foreign source portion of the taxable income from an export sale, determined under the section 863(b) rules, would equal or exceed the portion of the combined taxable income of a parent corporation and its DISC on an export sale which

would be subject to a deferral of tax under the present DISC rules. The understanding of this Council explicitly permits exemption from taxation of economic processes, including sales activities, that occur outside the territorial limits of the exporting country. Accordingly, the DISC deferral is not in violation of Article XVI:4, as interpreted in the GATT Council resolution of December 8, 1981.

Now, therefore, going to specific provisions of the DISC Panel reports: First, all four panels found that it is the effect of the tax system and not its intent that determines its legality. This is found in the U.S. Panel report, paragraph 67; in the Belgian Panel report, paragraph 34; in the French Panel report, paragraph 47; and in the Netherlands Panel report, paragraph 34.

The Panels then found that the DISC had the effect of derogating from a global system, and increasing exports beyond those which would exist under a global system. But, when the Panel report is modified, as it has been by this Council, to revert to a territorial system, this comparison is no longer valid. Thus, because of the qualifier adopted by this Council, the thoughts found by the Panel report, in paragraphs 17 through 21, are no longer relevant, and the conclusions drawn by the Panel report, in paragraphs 67 through 71, are simply no longer material. All of those findings compare the DISC system of taxation with a global system of taxation. With the adoption of the qualifier, of course, this comparison has become irrelevant. Now, therefore, as a result, all other conclusions of the Panel, including paragraph 74, which was quoted by the EC delegation, are dependent upon these conclusions. So all of the conclusions of the Panel are also immaterial. This is why we have said that the DISC does not have the effect -- and here again we are only following the rules put forth by the Panel decisions as adopted by this council -- of taxing export income at a tax rate less than that of a true territorial system. The comparison made by the U.S. Panel report of U.S. taxes deferred was a comparison with the taxes which would have been collected under a pure global system of taxation.

Now, instead, the uncontested U.S. statement during the Panel's consideration of the issue that it collects more taxes under its global system as modified by DISC than would be collected under a territorial system becomes crucial to this Council's deliberation. This statement was uncontested and found in the Netherland's Panel report, paragraph 27; the French Panel report, paragraph 33; and the Belgian Panel report, paragraph 28. This Panel did not comment on this factual assertion believing it to be irrelevant; but with the adoption of the qualifier, it becomes crucial. Now the EC Delegation would like to overlook this kind of factual analysis and rush to judgment. In the United States, we call that drumhead justice. We would suggest, therefore, the convening of some type of forum in which our tax practices, as well as those of other countries, can be tested against this new understanding that this Council has now adopted. We realize that the tax practices of other countries are not now before the Council. Nevertheless, we are sure that this Council believes that what is sauce for the goose, must be sauce of the gander.

In considering the U.S. tax practices, the tax practices of our trading partners leave many questions unanswered. The Panel which examined the French practice (at paragraph 54 - 55) found that the deduction of losses incurred by a foreign branch of a French corporation operated as an additional exemption from tax violating the territorial system. The French representative admitted that the French law allowed such an exemption (at paragraph 36). Apparently, so does the tax law of the Netherlands (at paragraph 8 of the Netherlands Panel report). As the Council can readily see, a country cannot legitimately adopt a territorial or exemption system for export profit, but then adopt a global system of taxation for export losses. Yet we can find no place where France or the Netherlands have alleged that their tax practices have been corrected in this regard. Our question is: Do France or the Netherlands expect to be relieved of the Panel's findings of violation without establishing that their systems have been cured of these defects, while the United States should be condemned without any proof?

As for Belgium, the Panel found that the tax administration of Belgium "is given latitude in the Administration of its tax system" (at paragraph 13). We would like to ask whether this latitude has been used by Belgium to arrange safe-haven levels of taxes on exports similar to the DISC.

The facts in the law surrounding the taxation of exports are unquestionably complex. These facts, which the delegations assembled here have never considered before, authorize the exoneration of the DISC. At the same time, however, we have never argued that any party should be bound by our conclusion, and we invite any contracting party to Article XVI:4 to raise the issue before any appropriate forum to examine the actual operation of the DISC against the background of the qualifier that this Council has adopted.