

TAX INCENTIVES TO EXPORTATION: ALTERNATIVES TO DISC

I. INTRODUCTION

In 1978, the balance of payments deficit of the United States reached a new high of more than \$34 billion.¹ This amount represents nearly a 10% increase over the previous record of \$31 billion set in 1977.² Although the adverse economic consequences of this trend are well recognized, the question of how most effectively to curb this deficit remains. One author suggests that the greatest opportunity for improvement lies in reducing foreign payments by stemming the rise in imports, capital outflows, and overseas military expenditures.³ While United States tax policy at one time attempted to effect the outflow side of the balance,⁴ more recently programs have been aimed at increasing receipts by encouragement of export sales. This approach is designed to narrow the gap between payments abroad for imported goods and receipts by U.S. firms for their exports. Additionally, it is thought that the stimulus approach may result in a number of beneficial effects on the domestic economy, such as increased employment, greater plant utilization and an incentive to reinvest profits in the United States.

II. POLICY OF EXPORT TAX INCENTIVES

Tax incentives are internationally recognized as a method for stimulating exportation. Many countries have comprehensive tax incentive programs allowing, for example, total income tax exemption for foreign source income, specific export income exemptions, favorable accelerated depreciation on export assets, special deductions and credits, and special reserves for market development costs and export bad debt losses.⁵ The United States program con-

¹ Wall St. J., Feb. 2, 1979, at 6 col. 2. This figure was determined by using a balance of payments basis that excludes federal military trade and reflects certain adjustments. According to the census basis, the American deficit was \$28.45 billion.

² *Id.*

³ Considine, *The DISC Legislation: An Evaluation*, 7 N.Y.U. J. INT'L L. & POL. 217, 222 (1974).

⁴ An example of this was the Interest Equalization Tax which was discontinued in 1974; see I.R.C. §§ 4911-4931 (repealed). This tax was designed to discourage outflows by taxing the issuance of foreign securities on U.S. markets at rates as high as 15%.

⁵ *Trade Amendments to the Social Security Amendments of 1970: Hearings on Amendments 925 and 1009 to H.R. 17550 Before the Senate Comm. on Finance* [hereinafter cited

sists of one incentive to exporting, the Domestic International Sales Corporation (DISC),⁶ and two indirect incentives, accelerated depreciation and the investment tax credit.⁷

This Note will consider the effectiveness of United States tax incentives as a stimulus to exporting. First, the policies underlying incentives will be reviewed. Then, from a brief outline of the provisions of the present tax incentive device known as DISC and consideration of problems with the DISC program in implementing national policy and meeting international legal obligations, a proposal for a more efficient tax stimulus will be developed.

Tax incentives to exports have two objectives: first, to increase receipts from export sales in order to reduce the current balance of payments deficit; and second, to expand overseas markets for United States goods in order to improve the prospects for growth in the domestic economy. From these objectives, two policy issues arise. Upon whom should a tax incentive be focused, and how much of an incentive should be given?

The issue with regard to the first policy question is basically whether the encouragement provided by tax incentives should be focused on present exporters in order to foster expansion of existing presence in overseas markets, or whether incentives should be directed at firms presently selling only in the domestic market but who might be convinced to enter world markets. The author concurs with those who assert that incentives should operate to expand the exporter base by focusing on small and medium companies that have remained substantially outside the export market.⁸ In all probability, corporations which are already export-

as *Trade Amendments*], 91st Cong., 2d Sess., 21 (1970) (statement of Edwin S. Cohen). For an in-depth analysis of the tax practices of various foreign countries see *Export Policy: Hearings on U.S. Programs and Facilities Designed to Support Exports Before the Subcomm. on International Finance of the Senate Comm. on Banking, Housing and Urban Affairs*, [hereinafter cited as *Export Policy*] pt. 3, 95th Cong., 2d Sess., 102 (1978) (statement of Richard M. Hammer); *Causes and Consequences of the U.S. Trade Deficit and Developing Problems in U.S. Exports: Hearings Before the Subcomm. on Trade of the House Comm. on Ways and Means* [hereinafter cited as *Causes and Consequences*] 95th Cong., 1st Sess. 295 (statement of the Special Committee for U.S. Exports); [1972] 168 INT'L TRADE REPORTER'S U.S. WEEKLY (BNA) 0-1; *Tax Reform Act of 1975: Hearings on H.R. 10612 Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 1026 (1976); *Tax Reform: Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means* [hereinafter cited as *Tax Reform*], 94th Cong., 1st Sess. 1935, 1945 (1975) (statement of Stanford G. Ross).

⁶ The DISC incentive is that tax on a portion of export income may be deferred. The basic provisions are contained in I.R.C. §§ 991-997.

⁷ *Causes and Consequences*, *supra* note 5, at 355.

⁸ See generally, *Export Policy*, pt. 6, *supra* note 5, at 92 (statement of Richard C.

ing will continue to do so.⁹ It is clear that incentives calculated upon present levels of exports, rather than on increases in export sales, will result in a windfall to corporations exporting at present.¹⁰ In contrast, incentives focused on companies that have never exported before will initially expand manufacturing output, benefit the current United States trade position, and may establish a base for future sales through the acquisition of export experience by new exporters.

In considering the second policy question—how much of a tax break should be given—it would appear that any stimulus to the new exporter must eliminate or be sufficient to overcome the obstacles presented by inexperience with foreign markets and government regulation of exports. In testimony before a Senate Subcommittee, Richard Fenton of the Special Committee for United States Exports (SCUSE) outlined five major impediments facing the small exporter:¹¹ (1) a negative attitude on the part of small or medium companies which view exporting as risky and complicated; (2) a general lack of knowledge concerning how to do business under complicated trade regulations; (3) higher costs associated with exporting and the lack of foreign marketing experience; (4) foreign buyer resistance; and (5) foreign competitive factors. This last category includes programs to assist foreign exporters in overseas markets, such as marketing research assistance,¹² a vast array of foreign tax incentives,¹³ and foreign principles of taxation unfavorable to United States exporters in particular.¹⁴ Fenton and others have called for a coordinated national

Fenton); *Trade Amendments*, *supra* note 5, at 9 (statement of Paul A. Volcker) and at 12 (statement of Edwin S. Cohen).

⁹ *Tax Reform*, *supra* note 5, at 1945 (statement of Stanford G. Ross); *see also Id.* at 2319 (statement of Michael J. McIntyre); *Trade Amendments*, *supra* note 5, at 62 (statement of Nathaniel Goldfinger).

¹⁰ *Tax Reform*, *supra* note 5, at 1945 (statement of Stanford G. Ross); *Trade Amendments*, *supra* note 5, at 39 (statement of Stanley Surrey) and at 65 (statement of Nathaniel Goldfinger).

¹¹ *Export Policy*, pt. 6, *supra* note 5, at 98.

¹² One example of such a program is the Japanese External Trade Organization (JETRO). This organization provides information to Japanese firms on activities and opportunities in other countries. It aids in market research and centralizes the information process which enables Japanese firms to move efficiently into foreign markets. *Export Policy*, pt. 3, *supra* note 5, at 43 (statement of Robert D. Hormats).

¹³ *See supra* note 5.

¹⁴ The United States and countries of the European Common Market use different methods of taxation to raise a major portion of revenues. The United States relies heavily on direct taxes levied on legal or natural persons, typically in the form of income or profits taxes. As a result, there is no basis consistent with this general principle of taxation for

export policy to eliminate excessive obstacles to reaching foreign markets.¹⁵ While this improvement would eliminate significant impediments to smaller exporters, such coordination cannot alone balance other advantages which foreign exporters enjoy in overseas markets. At a minimum, then, any tax incentive given should be sufficient to counter the tax advantage enjoyed by foreign exporters, thus equalizing the competitive position of U.S. exporters in foreign markets. Equalization was a major objective of the DISC, the initial United States foray into the export tax incentive area. The effectiveness of the DISC will be considered in the following three sections.

III. POLICY OF THE DISC LEGISLATION

DISC provisions of the Internal Revenue Code were enacted as part of the Revenue Act of 1971, after a compromise between the House and Senate versions of the bill.¹⁶ In order to improve the balance of payments position of the United States, the DISC was proposed with the objective of increasing exports. The DISC was designed to minimize the burden of U.S. taxes on exports to counter the competitive effects of remission of certain taxes for exported goods under the tax systems of a number of foreign countries. In addition, the DISC was to serve other functions.

distinguishing between profits on exported goods and profits on goods consumed in the United States. EEC countries on the average derive more than half of their total revenue from indirect taxes levied on goods and services. Remission of taxes on exports is easily calculated. Statistics on the character of foreign taxes is available in FIFTH ANNUAL REPORT ON DISC, *infra* note 50, at M-11.

The unfavorable impact on U.S. exports of the difference in these systems of taxation results from the recognition in international practice, confirmed in the General Agreement on Tariffs and Trade, of each nation's right to exempt exports from indirect taxation and to subject imported goods to local indirect taxation. See Rosendahl, *Border Tax Adjustments: Problems and Proposals*, 2 LAW & POL. INT'L BUS. 85 (1970). In effect, U.S. exports are burdened by direct taxes on the manufacturer at their origin and then by indirect taxes at their destination. Exports from countries which remit indirect taxes, in contrast, are subject to taxation primarily in the country of destination.

¹⁵ *Export Policy*, pt. 6, *supra* note 5, at 97. Richard C. Fenton states:

[I]t is imperative that the U.S. government give priority to and assume an active role in stimulating exports, particularly among smaller companies. In doing so, however, all branches of government must develop a clear, comprehensive, consistent, and positive export policy underscoring a serious commitment to exports.

See also *Tariff and Trade Proposals: Hearings on Tariff and Trade Proposals Before the House Comm. on Ways and Means* [hereinafter cited as *Tariff and Trade Proposals*], 91st Cong., 2d Sess. 499 (1970) (statement of David M. Kennedy).

¹⁶ Revenue Act of 1971, Pub. L. No. 92-178, § 501, § 85 Stat. 497 (1971).

DISC originated as part of the government response to a general recession in the American economy in 1971.¹⁷ It was anticipated that DISC would strengthen the economy in several ways. First, DISC was supposed to increase foreign demand for goods produced in the United States. The DISC legislation provided a tax break on profits from exported goods which allowed exporters to sell abroad at a more competitive price. These tax savings improved the profits and cash flow from exporting, but were limited in ways designed to promote the financial and marketing resources necessary to overcome non-tax export impediments.¹⁸ Also, DISC was intended to increase employment in the United States. In order to benefit from these provisions, exported goods are required to be produced in the United States.¹⁹ The increased foreign demand for American goods would therefore require increased production in the United States, resulting in new jobs. These new jobs would then stimulate domestic consumption which would further encourage manufacturing in the United States. To the extent that DISC was successful, the requirement that goods be produced in the United States would influence businesses to build new plants in this country rather than abroad.²⁰ Finally, it was believed that DISC would give the private sector a clear indication that exports were a national priority.²¹ This would focus the attention of American industry on opportunities in foreign markets.²²

Congress recognized that export incentives could raise problems under the General Agreement on Tariffs and Trade (GATT). Article XVI of the GATT prohibits subsidies to exports.²³ Thus

¹⁷ Note, 5 SYRACUSE J. INT'L & COMP. L. 93, 94 (1977).

¹⁸ *Export Policy*, pt. 6, *supra* note 5, at 81 (statement of John R. Babson).

¹⁹ I.R.C. § 993(c)(1)(A). Subsection (C) requires also that not more than 50% of the fair market value can be attributable to articles imported into the United States.

²⁰ "By stimulating exports, the DISC should not only lead to fuller utilization of presently unutilized capacity; it should also, over time, affect managerial decisions on the location of new plants in a direction favorable to the U.S." *Trade Amendments*, *supra* note 5, at 53 (response of the U.S. Dep't of Treasury); *see also id.* at 10 (statement of Paul A. Volcker).

²¹ *Supra* note 15.

²² *Trade Amendments*, *supra* note 5, at 9 (statement of Paul A. Volcker).

²³ General Agreement of Tariffs and Trade, Oct. 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 194 [hereinafter cited as GATT].

GATT is an international agreement to which the United States is a party. The primary purpose of the GATT is the gradual reduction of tariff barriers. GATT Article XVI, concerning export subsidies, reads in pertinent part as follows:

Subsidies

Section A—Subsidies in General

1. If any contracting party grants or maintains any subsidy, including any

Congress chose a deferral concept, rather than an exemption, in the hope of avoiding characterization of the DISC program as an export subsidy prohibited by the GATT.²⁴

IV. DISC PROVISIONS²⁵

The DISC provisions operate as an export tax incentive by permitting export manufacturers to defer taxation on a part of their income derived from export sales. In accordance with applicable DISC provisions, a manufacturer establishes a separate corporation to serve as a conduit for its export sales. This subsidiary, the DISC, is usually little more than a "paper" entity, the activities of which are confined to exporting. The DISC itself pays no income tax.²⁶ Instead, shareholders of the DISC (usually only the parent

form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory, it shall notify the CONTRACTING PARTIES in writing In any case in which it is determined that serious prejudice to the interests of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the CONTRACTING PARTIES, the possibility of limiting the subsidization.

Section B—Additional Provisions on Export Subsidies

4. Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. Until 31 December 1957 no contracting party shall extend the scope of any such subsidization beyond that existing on 1 January 1955

Section A is the original Article XVI as enacted in 1949. Section B was added at the Ninth Session of the Contracting Parties in 1955. Article XVI imposes on a subsidizing nation the duty to notify and consult with effected parties. In addition, Article XXIII permits parties to initiate consultation with the subsidizing party, and to submit the issue to the Contracting Parties as a whole. The Contracting Parties may authorize suspension of concessions to the subsidizing nation as they consider appropriate. Also, unilateral emergency suspension of concessions is provided for in Article XIX.

For an extensive discussion of GATT and the issue of export subsidies, see K. DAM, *THE GATT—LAW AND INTERNATIONAL ECONOMIC ORGANIZATION* (1970); Anninger, *DISC and GATT: International Trade Aspects of Bringing Deferral Home*, 13 HARV. INT'L L.J. 391 (1972); Comment, 41 MO. L. REV. 180 (1978); Note, 5 CASE W. RES. J. INT'L L. 87 (1972).

²⁴ Considine, *supra* note 3, at 225.

²⁵ For a more complete discussion, see R. FEINSCHREIBER, *DOMESTIC INTERNATIONAL SALES CORPORATIONS* (1978); R. RHOADES & E. STEINBERG, *INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS*, §§ 4.41-4.60 (1978); Note, 11 GA. L. REV. 902 (1977), *reprinted in* 7 GA. J. INT'L & COMP. L. 629 (1977); Note, 5 SYRACUSE J. INT'L L. & COM. 93 (1977); Note, 56 MINN. L. REV. 407 (1972).

²⁶ I.R.C. § 991.

manufacturer) are taxed on the basis of distributions, both constructive and actual. Only part of the DISC's income must be recognized by the parent; the balance is deferred. Moreover, the period of deferral can be indefinite if the DISC continually expands exports.²⁷ This is equivalent to an interest free loan of taxes to the exporter.²⁸

In order to qualify as a DISC, the export corporation must meet six requirements: 1) it must be a domestic corporation;²⁹ 2) it can have only one class of stock;³⁰ 3) the capital account must be at least \$2,500;³¹ 4) 95% or more of gross receipts must consist of "qualified export receipts";³² 5) 95% or more of assets must be "qualified export assets";³³ and 6) it must elect to be treated as a DISC.³⁴ In addition, Treasury regulations require that the DISC maintain a separate bank account³⁵ and separate books and records.³⁶ These requirements are designed to limit substantially all of the DISC's transactions and assets to export-related activities. Frequently the DISC is a separate entity only in a technical sense, possessing a simple organizational structure and relying upon a related manufacturer to supply export products.³⁷

Because a DISC is usually controlled by a related producer, a major determinant of the amount of tax incentive is the amount of total profits from an export sale which may be deferred through the DISC. In order to link the incentive to the added burdens of export activity without providing a general subsidy to the manufacture of export goods, the parent company is entitled to deferral on the sales profits but not on the manufacturing profit made on a given export item.³⁸ This distinction requires the determination of an appropriate transfer price on sales to the DISC from the

²⁷ *Tariff and Trade Proposals*, *supra* note 15, at 528 (statement of John S. Nolan).

²⁸ R. FEINSCHREIBER, *supra* note 25, at 1.

²⁹ I.R.C. § 992(a)(1).

³⁰ I.R.C. § 992(a)(1)(C).

³¹ *Id.*

³² I.R.C. § 992(a)(1)(A). The definitions of qualified export receipts, I.R.C. § 993(a)(1), and of qualified export assets, I.R.C. § 993(b), are extensive. Comprehensive definitions are required in order to assure that the DISC incentive accrues only with respect to export activities of the DISC.

³³ I.R.C. § 992(a)(1)(B).

³⁴ I.R.C. § 992(a)(1)(D).

³⁵ Treas. Reg. § 1.992-1(a)(6), T.D. 7273, 1974-2 C.B. 229.

³⁶ Treas. Reg. § 1.992-1(a)(7), T.D. 7273, 1974-2 C.B. 229.

³⁷ Note, 11 GA. L. REV. 902, 906 (1977), *reprinted in* 7 GA. J. INT'L & COMP. L. 629, 633 (1977).

³⁸ R. FEINSCHREIBER, *supra* note 25, at 5.

parent company or other related manufacturer. The DISC provisions establish special intercompany pricing rules which allow objective, "safe haven" bases of profit allocation as alternatives to the general provisions of Section 482 of the Internal Revenue Code.³⁹

Under the special provisions of Section 994 of the Code, an exporter can maximize the sales component of profit, i.e. tax-deferred DISC profit, under three different pricing methods. These provisions apply only to sales of export property to a DISC from a seller which controls the DISC. Under the first method, the taxable income of the DISC is 4% of the "qualified export receipts" of the sale plus 10% of the "export promotion expenses" related to such sale.⁴⁰ The second method sets the taxable income of the DISC at 50% of the combined taxable income from exports of the DISC and the related seller, plus 10% of the related export promotion expenses.⁴¹ Under this second method, taxable income from exports can be calculated using a marginal costing approach. This allows the parent to allocate production costs on the basis of products or product lines between export sales through a DISC and parent company sales of the same item.⁴² The third method determines profit on the basis of the price actually charged, but this price is subject to challenge as artificial under Section 482 of the Code.⁴³ Use of one of the first two methods will often result in a transfer price below the arm's length bargain price. By reducing the price and profits of the seller a greater proportion of profit is attributed to the DISC when the goods are resold abroad, result-

³⁹ *Export Policy*, pt. 6, *supra* note 5, at 108 (statement of Richard C. Fenton). I.R.C. § 482 employs an arm's length bargaining test which considers the amount which was charged or would have been charged in independent transactions with unrelated parties under the same or similar circumstances. Treas. Reg. §§ 1.482-1(d)(3) and 1.482-2(b), T.D. 6952, 1968-1 C.B. 221 and 224. This section empowers the Secretary of the Treasury to reallocate the tax consequences of a transaction and therefore it is not considered a "safe-haven," objective allocation test.

⁴⁰ I.R.C. § 994(a)(1). Under this method, a DISC with \$500,000 in qualified export receipts would have allocated to itself \$20,000 of the combined export income of the DISC and parent, plus 10% of the export promotion expenses.

⁴¹ I.R.C. § 994(a)(2). Under this method, if the combined taxable income of the DISC and its parent is \$500,000, \$250,000 plus 10% of the export promotion expenses would be allocated to the DISC.

⁴² Note, 11 GA. L. REV. 902, 907 (1977), *reprinted in* 7 GA. J. INT'L & COMP. L. 629, 634 (1977). See also Kauder, *Marginal Costing for DISCs: An Explanation and Analysis of Treasury's Proposed Regs*, 38 J. OF TAX; 304 (1973); R. FEINSCHREIBER, *supra* note 25, at 275; R. RHOADES & E. STEINBERG *supra* note 25, at § 4.46(6)(b)(iii).

⁴³ I.R.C. § 994(a)(3). See *supra* note 39.

ing in greater tax deferral on the sale.⁴⁴ The first two methods also provide a "safe haven" from reallocation by the IRS under Section 482.

As originally enacted, DISC legislation provided that one half of the DISC's income from export sales would be deemed distributed to DISC shareholders.⁴⁵ Tax on the remaining half of the income was deferred unless an actual distribution exceeded the assumed 50% distribution.

The DISC scheme was subjected to much criticism for inefficiency, because its benefits applied to exporters whether or not their exports were increasing. In response, Congress, as part of the Tax Reform Act of 1976, amended the DISC provisions by instituting an incremental approach to calculating tax-deferred income.⁴⁶ These calculations add considerable complexity to the DISC. A complete explanation of them is outside the scope of this paper.⁴⁷ The general effect of the provisions is to increase the amount of export income which is taxable to DISC stockholders to

⁴⁴ Note, 56 MINN. L. REV. 407, 482 (1972).

⁴⁵ A "deemed distribution" is the statutory term for DISC income which is currently taxable to the shareholders even though not actually distributed. *Id.* at 430.

⁴⁶ Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976). See H.R. REP. NO. 638, 94th Cong., 2d Sess. 263, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 2897, 3159.

⁴⁷ For an example of the computations involved see R. RHOADES & E. STEINBERG *supra* note 25, at § 4.43(2)(e). In summary form the total combined base period and 50% income distributions may be expressed as follows:

ti = taxable income

ti_{pp} = taxable income attributable to base period activity

egr = current year export gross receipts

bp = base period export gross receipts level

dd = total deemed distribution attributable to the base period rule and the 50% of DISC income rule

$$dd = ti_{bp} + \frac{1}{2} (ti - ti_{bp})$$

$$\text{where } ti_{bp} = ti \times \frac{bp}{egr}$$

$$\text{then } dd = \left(\frac{1}{2} ti \times \frac{bp}{egr} \right) + \frac{1}{2} ti$$

$$\text{and } dd = \frac{1}{2} ti \times \left(\frac{bp}{egr} + 1 \right)$$

Thus, where bp = 0 the distribution is 50% of the DISC's taxable income. Conversely, where bp = egr, the deemed distribution would be the total amount of DISC income. Therefore, no DISC income would be subject to tax deferral benefits. Note, *supra* note 37, at 916 n. 78.

Base period is defined as follows: for years beginning before 1980 the base period shall be the taxable years beginning in 1972, 1973, 1974, and 1975, and for years beginning after 1979, the base period shall be the taxable years beginning in the fourth, fifth, sixth, and seventh calendar years preceding such calendar year. I.R.C. § 995(e)(5).

the extent that current DISC receipts are not significantly greater than average receipts during a four year base period. Therefore, unless the DISC continues to increase its export sales, the benefits of deferral will diminish. This creates an incentive to increase export sales. Small DISCs—those with adjusted taxable income of \$100,000 or less—are exempted from these incremental deferral provisions.⁴⁸

V. EFFECTIVENESS OF DISC LEGISLATION

As noted, the objectives of DISC legislation were to increase exports, to equalize the burdensome effects of the United States tax system in relation to foreign tax systems, and to increase domestic production and employment. Throughout its relatively brief history, DISC legislation has been criticized in the United States and abroad. Within the United States, an initial criticism of the DISC was that it would result in unjustified profits to existing exporters on goods which would be exported even without incentives being offered. The 1976 amendments withdrew this aberration, but the added complexity of incremental deferral added force to another early concern that the small or new exporter would avoid the DISC because of the extensive legal and accounting expertise required to reap the benefits of a DISC. Present criticism of the DISC is centered on the issue of whether the revenue lost by the DISC incentive is justified by the degree to which exports have increased under the program. As will be seen in the discussion that follows, consideration of this issue is impaired by the many variables affecting export development.

Whether or not the DISC has been effective at increasing exports, another issue to be considered is the complaint by several nations that the DISC concept violates United States obligations under the General Agreement on Tariffs and Trade (GATT). Members of the European Economic Community and Canada have asserted that the DISC incentive constitutes an export subsidy which threatens to imbalance reciprocal trading concessions under the GATT.

A. *Increase in Exports*

Several factors have resulted in the dramatic growth of Ameri-

⁴⁸ I.R.C. § 995(f)(1).

can exports since the inception of the DISC program.⁴⁹ Independent of the rapid growth of DISCs, three other developments have influenced export figures, thereby impeding a definitive assessment of the increase in exports attributable to DISCs. First, adoption by the United States of the floating exchange rate in 1971 allowed the dollar to be devalued with respect to foreign currencies. This may have caused the price of American exports to become more attractive to foreign buyers.⁵⁰ Second, inflationary price increases for many products⁵¹ distort aggregate export figures as well as the value of receipts earned by individual DISCs. Because the incremental deferral concept of the 1976 amendments to the DISC is keyed to receipts unadjusted for inflation, a margin of deferral may be attributable to inflation. Finally, this period has seen a continuing increase in world trade volume, accompanied by comparatively strong economic expansion overseas which has resulted in increased demand for U.S. exports.⁵² The interplay of these three broad influences on U.S. exports and DISCs has made it difficult to accurately measure whether the DISC has been a cost efficient incentive to exports. The result has been conflicting conclusions by government and private sources on this issue.

Reports by the government have generally been critical of the DISC as an effective stimulus to exportation. The House Budget Committee, in a 1975 report, estimated that less than 1% of the total increase in exports during the period from 1971-1975 was at-

⁴⁹ See generally U.S. DEPT OF TREASURY, THE PRESIDENT'S 1978 TAX PROGRAM: DETAILED DESCRIPTION AND SUPPORTING ANALYSIS OF THE PROPOSALS, HOUSE COMMITTEE OF WAYS AND MEANS COMM. PRINT NO. 65, 95th Cong., 2d Sess. 51, 521 (1978) [hereinafter cited as PRESIDENT'S 1978 TAX PROGRAM, reprinted in [1978] 193 INT'L TRADE REPORTER'S U.S. WEEKLY (BNA) M-1.

Exports for the period 1970-1977 are as follows:

(in billions)	
1970—43.224	1974— 98.507
1971—44.130	1975—107.592
1972—49.778	1976—114.992
1973—71.339	1977—120.163

U.S. DEPT OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF 1978 874 (1978).

⁵⁰ PRESIDENT'S 1978 TAX PROGRAM, *supra* note 49, at 321; U.S. DEPT OF TREASURY, FIFTH ANNUAL REPORT ON THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION (1978), reprinted in [1978] 203 INT'L TRADE REPORTER'S U.S. WEEKLY (BNA) M-1 [hereinafter cited as the FIFTH ANNUAL REPORT ON DISC].

⁵¹ PRESIDENT'S 1978 TAX PROGRAM, *supra* note 49, at 321; FIFTH ANNUAL REPORT ON DISC, *supra* note 50, at M-1.

⁵² *Id.*

tributable to the DISC program.⁵³ The Treasury Department, in its most recent report to Congress concerning the DISC, estimates that the program increased exports by \$2.9 billion at a cost in a lost tax revenue of \$1.146 billion for fiscal year 1976.⁵⁴ This report includes the estimate that in 1976 less than 3% of the annual growth in total U.S. exports was attributable to DISC.⁵⁵ Although this demonstrates an increase over the Budget Committee estimates for the earlier 1971-1975 period, a Treasury report concerning President Carter's tax proposals concluded that "DISC is . . . an anachronism in a world of flexible exchange rates, and a costly and wasteful anachronism at that."⁵⁶

A major element of the Treasury's criticism of the DISC is the impact of general export incentives on the value of the dollar under floating exchange rates. Their view is that to the extent DISC stimulates exports, increased export demand will cause the dollar to appreciate in relation to foreign currencies. Appreciation of the dollar acts as a stimulus to import purchases in the United States, offsetting the effect of DISC on the overall balance of trade.⁵⁷ The Treasury report recommends that the DISC program be gradually phased out, as outlined by President Carter in his 1978 message to Congress concerning tax proposals. The report further suggests that increased loans and loan guarantees through the Ex-Im Bank would permit more flexibility in export policy to avoid unintended stimulus to imports.⁵⁸

Reports from the Special Committee for United States Exports (SCUSE), a lobbying group which advocates the retention of the DISC, conflict with government reports. In testimony before the House Ways and Means Committee, David Garfield of SCUSE estimated that DISC added \$7-9 billion in exports, and, taking into account the multiplier effect, the DISC program contributed an

⁵³ STAFF OF HOUSE COMM. ON THE BUDGET, 94th CONG., 1st SESS., AN ANALYSIS OF DOMESTIC INTERNATIONAL SALE CORPORATIONS (DISC) 6 (Comm. Print 1975). See also Note, *supra* note 37, at 909.

⁵⁴ FIFTH ANNUAL REPORT ON DISC, *supra* note 50, at M-1.

⁵⁵ *Id.* at M-3.

⁵⁶ PRESIDENT'S 1978 TAX PROGRAM, *supra* note 49, at 319.

⁵⁷ FIFTH ANNUAL REPORT ON DISC, *supra* note 50, at M-3;

If we artificially stimulate exports, at the very same time and by the very same technique with floating exchange rates, we are going to stimulate imports.

Tax Reform, *supra* note 5, at 2321 (statement of Michael J. McIntyre).

⁵⁸ PRESIDENT'S 1978 TAX PROGRAM, *supra* note 49, at 318. See also *Message from the President: Proposals for Tax Reductions and Reform*, H. Doc. No. 283, 95th Cong., 2d Sess. 15 (1978).

additional \$21-27 billion to the U.S. Gross National Product.⁶⁰ As this contrast suggests, there is variance among the figures for DISC effectiveness. Uncertainty on this issue clearly still exists.

B. *Equalizing Tax Systems and Incentives of Foreign Nations*

Many foreign systems of taxation have inherent export incentives built on principles of taxation which exempt a large portion of export revenues.⁶⁰ For example, France, unlike the United States, does not tax subsidiaries having their situs outside France, and, unless otherwise provided by treaty, 95% of the dividends of a subsidiary are exempt from tax to the parent.⁶¹ This is in recognition of the territoriality principle of taxation dating back to the beginning of the century in the French system. Under this system only income arising in France is taxed. As another example, Ireland totally exempts from corporate taxation profits attributable to exported goods produced in Ireland.⁶² Other tax incentives of foreign countries include favorable accelerated depreciation on export related assets,⁶³ rebates or the allowance of special reserves for export market development expenses,⁶⁴ and remission of value-added taxes on exported goods.⁶⁵

DISC was enacted by Congress as a means of equalizing the competitive position of American producers who are taxed on

⁶⁰ *Tax Reform, supra* note 5, at 2281 (statement of David Garfield).

⁶¹ *See supra* notes 5 and 14.

⁶² *Trade Amendments, supra* note 5, at 24.

⁶³ *Id.* at 26.

⁶⁴ *Id.* at 22. For example, Spain allows companies which export more than 50% of their production to take accelerated depreciation of up to 40%. SPECIAL COMMITTEE FOR U.S. EXPORTS. INCREASED IMPORTANCE OF DISC AS AN ELEMENT OF U.S. POLICY IN INTERNATIONAL TRADE (1977) reprinted in [1977] 168 INT'L TRADE REPORTER'S U.S. WEEKLY (BNA) 0-1, 0-6 [hereinafter cited as SCUSE].

⁶⁵ *Trade Amendments, supra* note 5, at 22. Australian law provided a tax rebate (credit) of 42.5% of an expenditure incurred for export market development and also permits full deduction of the expenditure incurred. *Id.* This credit was applicable between the period July 1, 1968 and June 30, 1974. 5 BOARD OF INLAND REVIEW, INCOME TAXES OUTSIDE THE UNITED KINGDOM, Group 13 Australia 15 (1977). Spain allows corporations engaged in exporting to establish special reserves equal to 50% of their net profits from export operations for (1) future acquisitions of assets to be used in the export business and (2) future expenditures for overseas advertising and marketing. SCUSE, *supra* note 63, at 0-6.

⁶⁶ The Value-added tax (VAT) is a form of national sales tax which is the primary source of general revenues in many European tax systems. As a so-called "indirect tax," it is levied on consumption rather than on income and savings. Wall St. J., Feb. 2, 1979, at 1, col. 1. As its name implies, a value-added tax will generate most of its revenues at stages of production where materials are converted into finished goods. The effect of a remission can, therefore, be quite substantial even if the exported goods become subject to value-added taxes in the country of their destination.

their worldwide income, in relation to foreign exporters, who are often exempt from tax on exported goods. Although Canada and members of the European Economic Community have made a formal complaint that DISC violates GATT as a direct subsidy to exportation, critics of the DISC at home continue to question the effectiveness of the DISC as an equalizer to the export incentives of foreign tax systems.⁶⁶

In a study conducted by SCUSE, DISC failed miserably as a tax equalizer. SCUSE simulated the sale of merchandise under the tax systems of various foreign nations and through a DISC.⁶⁷ The increase in after-tax profit of the American exporter using DISC was found to be insignificant in comparison to the increase in after-tax profit resulting under the foreign tax systems considered.⁶⁸

Although little information concerning the effectiveness of DISC was available following its enactment, the European Community and Canada filed a complaint in 1972 with the Contracting Parties of GATT alleging that DISC amounted to a subsidy prohibited by Article XVI of the Agreement. The United States filed a counter complaint claiming that the territoriality based tax systems of France, Belgium, and the Netherlands constituted a tax subsidy for exporters of those countries. Four panels of experts were appointed by GATT to study the complaints and in 1976 the results of their study were announced. The tax systems of France, Belgium, and the Netherlands, as well as DISC were found to be export subsidies.⁶⁹ The GATT Council discussed the

⁶⁶ At present there appears to be a general consensus that our major trading competitors offer greater assistance and better incentives to their exporters than we do to our own . . . Tax incentives are another area in which we do not appear to be competitive. A study conducted by the Special Committee for U.S. Exports reveals that other nations tax practices significantly improve the price competitiveness and profitability of their exports. Our major tax incentive, the DISC program, did not compare favorably.

Export Policy, pt. 3, *supra* note 5, at 2 (opening statement of Sen. H. John Heinz III); *see also* *Id.* at 102 (statement of Richard M. Hammer.)

⁶⁷ *Causes and Consequences*, *supra* note 11, at 345.

⁶⁸ *Id.* The increase in after tax profit on a \$10,000 sale attributable to export tax incentives were as follows:

Belgium	\$	300	Brazil	\$	200
France		280	Spain		65
The Netherlands		290	Ireland		1000
			U.S. Insignificant		

SCUSE, *supra* note 63, at 0-3.

⁶⁹ It was found that these practices by all countries constituted *prima facie* cases of nullification or impairment of benefits under GATT. *United States Tax Legislation (DISC)*;

panel's findings in 1977, but has not yet adopted them. If findings are adopted, the GATT Council could make recommendations to the parties concerning an appropriate settlement.⁷⁰

Recognizing the ineffectiveness of the DISC at tax equalization, SCUSE issued a report in 1977 urging that the DISC nonetheless be retained because, as the only general export tax incentive of the United States, the DISC program could provide leverage in negotiating equitable international standards for export tax incentives.⁷¹ This "bargaining chip" justification for retaining the DISC was rejected by the Treasury in its analysis of the President's tax proposals. The Treasury asserts that if DISC is repealed the United States would have the right to expect other countries to comply with GATT in their tax practices. If other countries do not conform to GATT, goods benefitting from subsidies could be subjected to countervailing duties.⁷² Regardless of the pros or cons of this "bargaining chip" argument, there seems to be some agreement that DISC cannot compete favorably with foreign tax incentives.

C. *Increase in Employment*

The third main objective of DISC legislation is to increase employment in the United States. According to SCUSE, DISC has been successful on this point. Testifying before the House Ways and Means Committee, David Garfield of SCUSE stated that between 280,000-300,000 new jobs may be attributed to DISC during its first few years of operation.⁷³ Garfield added that the unit cost of jobs created as a result of DISC was less than that of public service jobs created under other federal programs.⁷⁴ Employment figures of FMC Corporation showing that it added 3,197 export related jobs between 1971 and 1974 as a result of the DISC legisla-

Income Tax Practices Maintained by France; Belgium; and the Netherlands, Reports of the Working Panels, GATT DOCS. L/4422-4425 (Nov. 2, 1976). See also GATT, GATT ACTIVITIES IN 1976-77 (1977); 18 HARV. INT'L L.J. 706 (1977).

⁷⁰ PRESIDENT'S 1978 TAX PROGRAM, *supra* note 49, at 324.

⁷¹ SCUSE, *supra* note 62.

⁷² PRESIDENT'S 1978 TAX PROGRAM, *supra* note 49, at 325.

⁷³ *Tax Reform*, *supra* note 5, at 2281 (statement of David Garfield).

⁷⁴ The Senate recently voted unanimously to approve a \$1.6 billion program to create 310,000 public service jobs—at an average cost per job of over \$5000. The demonstrated job-creating benefits of DISC show a cost per each job created or preserved of less than \$4000 . . .

Id. at 2282.

tion were given to the Committee as an example of the positive impact of the DISC incentive.⁷⁵

Although such evidence would support a positive view of the DISC by organized labor, the AFL-CIO has been critical of DISC legislation from its inception. This early opposition was based on the view that DISC creates a tax loophole benefiting primarily large corporations and that DISC provided no incentive to increase exports.⁷⁶ More recently, the Department of Labor has joined in advocating elimination of the DISC.⁷⁷

In summary, the DISC does not seem to be meeting the objectives for which it was enacted. Although it is evident that export revenues have increased since the enactment of DISC, a substantial amount of this increase might have occurred in any event. More significant is the view expressed by the Treasury that in a world of floating currency exchange rates, an export incentive which reduces the price of United States exports will tend to be neutralized by increased imports due to appreciation of the dollar. DISC has failed to compete favorably with tax incentives for foreign nations, and there is considerable uncertainty as to the impact of DISC on domestic employment. Even so, the DISC has been found to violate United States obligations under the GATT. At home, elimination of the DISC has been supported by the Departments of State, Commerce, Labor, and Treasury⁷⁸ and the program receives increasing scrutiny by the Congress. For these reasons, a fresh look at tax incentives to export is needed. The remaining portions of this Note will analyze one existing proposal to achieve more effectively the goals of the DISC, and then an alternative to the DISC will be developed and proposed.

⁷⁵ *Id.* at 2245 (statement of Robert H. Malott). FMC Corp. is a diversified producer of machinery and chemicals with headquarters in Chicago, Illinois.

⁷⁶ *Trade Amendments*, *supra* note 5, at 64 (statement of Nathaniel Goldfinger).

⁷⁷ U.S. DEPT OF TREASURY, TAX REFORM OPTION PAPER NO. VIII (1977) *reprinted in* [1977] 177 INT'L TRADE REPORTER'S U.S. EXPORT WEEKLY (BNA) M-1, M-2.

This aversion of DISC could be explained in the following way. According to a House Budget Committee staff study using Bureau of Labor statistics, the \$400 million increase in exports created 15,950 jobs in 1974. However, the billion in revenues lost under DISC would have generated 112,500 jobs in defense, 120,000 jobs in health, 150,000 in education, or 240,000 public service jobs. Another thing to consider is that to the extent that increased exports cause the dollar to rise in relation to foreign currencies, this would make imports seem cheaper. Because U.S. imports tend to consist of labor intensive products, the result is that DISC may easily displace more jobs than it creates. *Tax Reform*, *supra* note 5, at 256 (statement of Robert M. Brandon).

⁷⁸ TAX REFORM OPTION PAPER NO. VIII, *supra* note 77.

VI. FRAMEWORK FOR ANALYSIS

A tax incentive to exportation which would alleviate the major problems exposed in the DISC approach may be gauged by several criteria: 1) maximization of exports at an acceptable cost in lost tax revenue, and without incidentally stimulating imports; 2) consistency with United States obligations concerning subsidies under GATT; and 3) simplicity in operation to encourage use without undue dependence on professional assistance.

A. *Maximization of Exports—Minimization of Revenue Loss*

A tax incentive designed to maximize exportation must be cost effective in terms of lost tax revenue resulting from allowances, exemptions, or deferrals. The cost in lost tax revenue under DISC was reduced by the incremental deferral approach adopted by the 1976 amendments, yet the cost of DISC is projected to be \$1 billion in 1978.⁷⁹ Therefore, an alternative to DISC will have to achieve greater leverage by continuing to reward only increases in exports and, further, by directing incentives against the most burdensome costs of entering the export market. To minimize neutralization by increased imports in a world of floating exchange rates, an export incentive should offset only the added costs of developing and reaching export markets, in comparison to the costs of developing domestic markets. Incentives should not lower the foreign price of exports below the comparable price of such goods on the domestic market. Rather, incentives should offset only the incremental costs of reaching the foreign market.

B. *Violation of GATT*

An alternative tax incentive should not constitute a subsidy under the terms of GATT.⁸⁰ The tax deferral concept of the DISC has been found to be such a subsidy in violation of GATT Article

⁷⁹ FIFTH ANNUAL REPORT ON DISC, *supra* note 50, at M-6. Revenue cost estimates and projections from 1972-1983 are as follows in millions:

1972	\$	350	1978	\$	1,000
1973		730	1979		1,190
1974		1,130	1980		1,320
1975		1,170	1981		1,360
1976		1,430	1982		1,460
1977		880	1983		1,590

Id.

⁸⁰ See *supra* note 23.

XVI.⁸¹ GATT Art. XVI gives no detailed definition of "subsidy." However, a GATT working party issued a list of eight practices which will be considered subsidies. Proscribed practices pertinent to tax incentives analysis include:

* * *

(b) The provision by governments of direct subsidies to exporters;

(c) The remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises;

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

* * *

(g) The grant by governments (or special institutions controlled by governments) of export credits at rates below those which they have to pay in order to obtain the funds so employed;

(h) The government bearing all or part of the costs incurred by exporters in obtaining credit.⁸²

The GATT panel examining DISC made extensive reference to this list in comparing the effect of the DISC with the activities proscribed by the working party. Therefore, until further harmonization of the export impact of tax systems of other nations is achieved, an export tax incentive proposal should be assessed in light of the activities proscribed by the working party.⁸³

⁸¹ See text accompanying note 69 *supra*.

⁸² 9 GENERAL AGREEMENT ON TARIFFS AND TRADE, BASIC INSTRUMENTS AND SELECTED DOCUMENTS 185, 186-187 (1961).

⁸³ As part of the Tokyo Round negotiations, delegations of major industrialized nations and certain developing countries had agreed in principle on a Code on Subsidies and Countervailing Measures as of December 27, 1978. One of the Code's major provisions is that signatories will seek to avoid causing injury or serious prejudice to the domestic industry of another signatory, or nullification of GATT benefits accruing to the signatory caused by export subsidies. Annex A to the Code presents an illustrative list of export subsidies. The list presents two alternative provisions pertinent to the legitimacy of the DISC and future export tax incentives:

Version 1(d). The full or partial exemption, remission or deferral, specifically calculated in relation to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.

C. *Tax Simplification*

The 1978 tax program of President Carter characterized the DISC as one of the "most complex" areas of the Code⁸⁴ and proposed elimination of the program to aid the goal of tax simplification. Experts have acknowledged that the costs of legal and accounting expertise needed to apply the complex DISC provisions are a substantial export barrier facing small manufacturers.⁸⁵ Therefore, in order to be attractive to United States traders, incentive provisions must be conceived and drawn in light of an observation contained in the tax program that "it is essential to our system of self-assessment . . . that the law be understandable to the people to whom it applies."⁸⁶ An alternative tax incentive should be understandable to businessmen without dependence upon lawyers and accountants.

VII. TWO PROPOSALS TO THE PROBLEM OF FINDING AN ALTERNATIVE TAX INCENTIVE

A. *World Trade Credit*

1. *Outline and Policy of the Credit*

In June of 1978, the Presidential Task Force on Export Policy, headed by Secretary of Commerce Juanita Kreps, proposed a new tax incentive plan developed around the concept of a "World Trade Credit."⁸⁷ Recognizing some of the shortcomings of DISC, the plan is intended to be an incentive primarily to small and

Version 2 [In lieu of paragraph (d) . . . , the following paragraph would be added at the beginning or the end of the text:

The relationship of direct tax practices to export trade and pricing, and to Article XVI of the General Agreement, has been a subject of concern to many signatories to this Arrangement. It is agreed that the Contracting Parties should examine practices and GATT findings in this area with a view to supplementing this list and formulating comprehensive recommendations for adoption and implementation by signatories].

See Graham, *Results of the Tokyo Round*, at 153 *supra*. Mr. Graham stated that he believed Version 2 would be the one finally agreed upon. Conversation with Thomas R. Graham, Senior Associate of the Carnegie Endowment for International Peace, formerly Deputy General Counsel for the Office of the Special Representative for Trade Negotiations, May 25, 1979.

⁸⁴ PRESIDENT'S 1978 TAX PROGRAM, *supra* note 49, at 71.

⁸⁵ *Export Policy*, pt. 6, *supra* note 5, at 111 (statement of Richard C. Fenton).

⁸⁶ PRESIDENT'S 1978 TAX PROGRAM, *supra* note 49, at 68.

⁸⁷ TAX RECOMMENDATION OF PRESIDENT CARTER'S TASK FORCE ON EXPORT POLICY, PROPOSAL FOR WORLD TRADE CREDIT AND DISC MODIFICATION (1978) [hereinafter cited as TASK FORCE PROPOSAL]; reprinted in [1978] 211 INT'L TRADE REPORTER'S U.S. EXPORT WEEKLY (BNA) N-1.

medium exporters. It would also be expected to reduce revenue loss in comparison to DISC. The plan has three basic elements: 1) retention, with modification, of DISC; 2) establishment of a World Trade Credit which would allow exporters a tax credit equal to 50% of their incremental export market development costs; and 3) establishment of an export development trust fund to be administered by the Commerce Department.⁸⁸ The plan is designed to reduce the cost of DISC by eliminating excessive profit margin on DISC sales and to channel most of these savings to smaller businesses.

The first element of the plan proposes a modification of the DISC intercompany pricing provisions.⁸⁹ Under the proposal, the 50% profit allocation rule and the arm's length pricing option would both be eliminated, in favor of the remaining "safe haven" rule allocating 4% of export receipts plus 10% of export promotion expenditures to the DISC.⁹⁰ This reduction in DISC revenue loss would be used to finance a new tax credit. The Task Force proposal does not advocate phasing out the DISC; rather, it presents an alternative which is directed to new exporters.

The heart of the Task Force's proposal is the establishment of what would be called a "World Trade Credit." This Credit would be equal to 50% of incremental export development expenditures. As with the DISC, the incremental approach rewards only increases in marketing efforts. Unlike the DISC, which bases its incentive primarily on actual sales of exports, the Credit rewards marketing efforts alone. The Credit goes another step further by allowing expenses of reaching markets in countries to which an exporter has not previously exported to be credited even if total development expenditures do not increase. Creditable export development expenses are defined as "ordinary and necessary business expenses incurred by the taxpayer, either directly or by contract, whose principle purpose is to advance the sale, lease, or other distribution of its own export property outside the United States."⁹¹ The Credit could be applied against the total U.S. tax

⁸⁸ *Id.*

⁸⁹ Over 60 percent of DISC benefits are received by parent companies having more than \$250 million in assets. The average profit margin on DISC sales, under the present alternative pricing provisions, was 14.0 percent in 1976. The average margin on sales to the domestic market was 6.5 percent in the same period. FIFTH ANNUAL REPORT ON DISC, *supra* note 50, at M-6 and M-11.

⁹⁰ TASK FORCE PROPOSAL, *supra* note 87. See also *supra* note 41.

⁹¹ *Id.* at N-2. Among the types of expenditures classified as export development expenses are the direct and incidental costs of:

liability of a firm, in comparison to the DISC, which ties its advantages to export profits.

The Credit would be limited to \$100,000 per year, and not to exceed \$300,000 over the five year period from 1979-1984.⁹² By limiting the Credit, the task force proposal is aimed at reducing the tax cost of the incentive and making the Credit attractive primarily to small and medium exporters.⁹³ By allowing a tax credit against all income, but limiting its amount, the World Trade Credit is designed to overcome the start-up costs and uncertainty facing the new exporter. Further, the costs and complexity of a separate export corporation are avoided.

The third element of the proposal would establish an export development trust fund to be administered by the Department of Commerce. This fund would finance the promotion and expansion of American exports through "trade mission, export educational efforts, tailored export expansion programs, and other types of overseas promotion and domestic stimulation efforts."⁹⁴ In order to maintain the fund, the proposal would earmark 10% of the taxes paid on DISC income for investment in the fund.⁹⁵

-
- a. Market research and the marshalling of market information.
 - b. Preparation and distribution of samples and technical data.
 - c. Advertising preparation and media, and other dissemination.
 - d. Participation in Public and Private trade fairs, missions, and exhibits.
 - e. Maintaining sales, market development, instructional service, and technical representatives abroad.
 - f. Preparing and submitting bids for commodities, goods, equipment, and construction, technical or engineering projects.
 - g. Packaging and package design and labelling.
 - h. Opening or maintaining warehousing, sales and service establishments abroad.
 - i. Post sale instruction and warranty servicing.
 - j. Foreign patent, trademark and copyright registrations.

Id. cf. "exporting promotion expenses" under the DISC; I.R.C. § 994(c). These expenses could include a portion of shipping costs in computing the DISC income allowed deferral.

⁹² *Id.* at N-1.

⁹³ *Id.* The Task Force's estimation of the cost of the credit is as follows:

Maximum Annual Credit of	5-year Revenue Loss	Average Annual Revenue Loss
\$ 50,000 (total 150,000)	\$1.5 billion	\$300 million
\$100,000 (total 300,000)	\$2 billion	\$400 million
\$150,000 (total 750,000)	\$3.5 billion	\$700 million

Id. at N-2.

⁹⁴ *Id.*

⁹⁵ *Id.* If DISC were modified in 1976 according to this proposal, taxes paid on DISC income would have been about \$500 million per year and the trust fund would have received about \$50 million that year.

2. *Analysis of the Task Force's Proposal*

The first step of the analysis is to determine the effectiveness of the World Trade Credit proposal in maximizing exports and minimizing revenue loss. The proposal includes a modification of the DISC legislation which will reduce tax revenue loss arising from DISC. At the same time the proposal calls for a maximum credit for incremental export development expenditures of \$100,000 per year, not to exceed a total of \$300,000 for five years. At this level, the Task Force estimates that the revenue lost from the World Trade Credit will be \$400 million per year for a total of \$2 billion over five years.⁹⁶ Considering that the proposal expects to reduce the cost of DISC by 50 percent,⁹⁷ but including the revenue loss from the World Trade Credit, the overall tax cost of the proposal may be expected to increase annually but at a lower level than the present DISC program alone. Based on Treasury Department projections, this would mean a revenue loss in 1980 of approximately \$1.06 billion, in comparison to over \$1.3 billion under DISC.⁹⁸ The question remains then whether the increase in exports will justify the large revenue loss.

The Task Force's proposal fails to project the increase in exports which may be expected from the World Trade Credit, and such a computation is well beyond the scope of this paper.⁹⁹ Even so, the Task Force feels that there will be an increase in exports due to the Credit. The Credit is specifically designed to encourage new exporters to enter foreign markets and to encourage smaller existing exporters to enter additional foreign markets. Also, the proposal may be more effective because executives of smaller exporters may more readily evaluate a \$100,000 credit against total tax liability, in comparison to the cumbersome deferral concept of DISC. This proposal therefore may be expected to expand the export base, as well as exports, by encouraging initial sales by new and smaller exporters.

The cost of the proposal in lost revenue remains high; it would exceed one billion dollars by 1980. This reduction from the \$1.3 billion estimated cost of DISC alone is a proper direction of change. However, the proposed World Trade Credit is not based

⁹⁶ *Supra* note 93.

⁹⁷ *Id.*

⁹⁸ *See supra* note 79.

⁹⁹ For the computations used in projecting DISC impact on exports *see* FIFTH ANNUAL REPORT ON DISC, *supra* note 50, at M-19.

upon sales, but rather on the expenses of export marketing efforts. To the extent these marketing efforts fail, resources are wasted. If marketing efforts result in sales, crediting the costs of promotion will enable exporters either to reduce export prices, which would raise the problem of an unintended stimulus to imports, or to receive excessive profits based on reduced costs. In the latter case, as excessive profits are eliminated by the ceilings on the Credit, exporters formerly eligible for the Credit might be induced to move into the modified DISC. If this occurs, the cost of the DISC will increase. So long as the DISC is continued, an increasing number of exporters may become dependent on incentives to remain in overseas markets. In view of the tax cost of the proposal and the unexplored assumption that the costs of the Credit and the DISC are independent, the proposal cannot be endorsed as a long-range approach to making U.S. exports competitive.

The second point of analysis concerns whether the proposal violates GATT. As noted before, Article XVI of GATT prohibits subsidization of exports,¹⁰⁰ but does not define what constitutes a "subsidy." Therefore, the World Trade Credit must be evaluated with respect to the list of practices considered export subsidies under an interpretation of Article XVI(4) by a GATT working party.¹⁰¹

The remission of direct taxes "calculated in relation to exports" is one practice proscribed by the working party¹⁰² which is relevant to the validity of the World Trade Credit. Technically, direct taxes have not been remitted by the Credit, but at least one author suggests that "remission" could mean either the exemption or abatement of a tax otherwise due or the refund of all or part of a tax already assessed or paid.¹⁰³ Another proscribed practice is exemption from taxes, "in respect of exported goods."¹⁰⁴ The World Trade Credit is arguably an abatement of a tax otherwise due, or an exemption. Moreover, the effect of the Credit is perhaps even more favorable than a remission because no payments in anticipation of liability are made. It is less clear that the Credit is "calculated in relation to exports." As noted above, the

¹⁰⁰ See *supra* note 23.

¹⁰¹ See text accompanying *supra* note 82.

¹⁰² *Id.* at item (c).

¹⁰³ Anninger, *supra* note 23, at 403.

¹⁰⁴ See text accompanying note 82, item (d) *supra*.

credit is based on export marketing expenses without regard to whether or to what extent goods are actually exported. This absence of relation to actual exports, however, results in the Credit appearing more like a "direct subsid[y] to exporters," another proscribed practice.¹⁰⁵ Interpretation of the scope of this provision becomes circular by reference to the word "subsidy." It is submitted that, consistent with the present view of DISC under the GATT, a "direct subsidy" may include forgiveness of direct taxes as well as payments. Therefore, on several grounds the World Trade Credit would be a violation of the GATT. Also the DISC, which has been found to violate the GATT, would be retained under the Task Force Proposal.

The final question is whether the World Trade Credit proposal is consistent with the policy of tax simplification. By proposing modification of DISC rather than its elimination, the proposal runs contrary to the position of major government agencies that DISC is so complex that it must be eliminated.¹⁰⁶ The modification is a substantial move towards tax simplification by reducing three alternative profit allocation methods to one well defined method. Although many complexities remain in the DISC, a major advantage of the proposal is that exporters discouraged by DISC have a more simple alternative in the World Trade Credit.

The World Trade Credit by itself does satisfy the goal of tax simplification. Since the Credit is intended to be independent of DISC, companies can take advantage of the credit without forming a separate export corporation. In this way the added costs and complexity of the DISC can be avoided by the small exporter. In comparison to DISC, the complexity of computing incremental development expenses remains, but provisions limiting the use of income generated by the incentive are avoided by allowing the Credit against all other income.¹⁰⁷ The tax simplification aspect of the World Trade Credit is one of the strong points of the proposal.

In conclusion, the World Trade Credit is a step in the right direction. It is aimed at small and new exporters, it is fairly simple to apply, and it should result in an increase in exports and expansion of the exporter base. The special export development fund has the potential for coordination of export efforts and efficient

¹⁰⁵ *Id.* at item (b).

¹⁰⁶ PRESIDENT'S 1978 TAX PROGRAM, *supra* note 49, at 71.

¹⁰⁷ *Compare*: qualification as a DISC requires, *inter alia*, that 95% of the gross assets of the DISC be "qualified export assets." I.R.C. § 992(a)(1)(b).

development of foreign markets. Resources of the fund could also be devoted to assisting exporters with domestic regulations to affirm the high priority of exports in trade policy. The proposal may be criticized for its cost in terms of revenue loss and because it would probably be found to violate the GATT. Further, the proposal would be strengthened by including gradual elimination of the DISC.

B. *Elimination of DISC: Continuation of Deferral Concept*

1. *General Provisions of the Proposal*

It has been noted that DISC is considered by many experts to be expensive, complicated, and of uncertain effectiveness. Any new tax incentive should eliminate the DISC. Considering the problems of DISC and the deficiencies in the World Trade Credit proposal, an improved tax incentive would replace the DISC with a more effective deferral concept. In addition, primary emphasis should be placed on negotiations to balance direct and incidental foreign tax incentives on exports. A proposal embodying these elements will be developed in the remainder of this Note. An outline of the key provisions of this proposal is as follows:

- Repeal of the DISC legislation
- A new 100% deferral of incremental export income for a period of three years
- Maximum deferral of \$200,000 per year
- Repayment of deferred taxes after 3 years, with interest.
- Election to deduct or to capitalize and amortize export development expenses
- Assertion of a claim under GATT against foreign tax incentives in order to emphasize negotiations

a. *Elimination of the DISC*

In light of the large revenue loss and the uncertainty of benefits, the DISC has been shown to be ineffective at implementing national policy. DISC was enacted to achieve a number of noble goals: to increase exports, to equalize the effect of foreign tax systems in export markets, and to increase employment in the United States. Although the DISC should be commended for making U.S. manufacturers aware that exporting is a national priority, it has largely failed to attain more specific objectives. The following proposal will build upon some of the groundwork laid by

DISC, but DISC should be eliminated in order to reduce lost revenues and refocus export policy.

b. Deferral of Incremental Export Income

The heart of the present proposal is enactment of legislation which would allow an election by U.S. manufacturers to defer 100% of incremental export income. This differs from the DISC because the proposal allows deferral directly to the manufacturer; no intermediate export corporation is required.

Under the plan, net income from export sales for the tax year will be compared to the average export income of the preceding three years. Current export income which exceeds this base period average will reflect increased sales and some component of inflation. The tax on this excess, referred to as the incremental export income, will be computed at the applicable tax rate but will be totally deferred for three years. For example, assume that the plan would become effective in 1980 and that a manufacturer's net export income is as follows: \$3,000 (1977), \$5,000 (1978), \$7,000 (1979), \$15,000 (1980). As of 1980 the base period average export income would equal:

$$\frac{\$5,000 (1978) + \$7,000 (1979) + \$15,000 (1980)}{3} = \$9,000 \text{ (base period average)}$$

$$\$20,000 \text{ (export income for 1981)} - \$9,000 \text{ (base period average)} =$$

$$\$11,000 \text{ entitled to deferral}^{108}$$

The moving average computation and calculation of the amount of income entitled to deferral would work the same way in 1982. The moving average concept tends to smooth out extraordinary export fluctuations in years prior to enactment of the plan. Even so, provision must be made to discourage corporations that are already exporting from reincorporating or forming new subsidiaries to get

¹⁰⁸ A formula for this proposal would be as follows:

- N_1 = previous year's export income
- N_2 = Export income from 2 yrs. before
- N_3 = Export income from 3 yrs. before
- N = Current year's export income
- ABPI = Average base period income
- D = Amount deferred from taxation

$$\frac{(N_1 + N_2 + N_3)}{3} = \text{ABPI}$$

$$N - \text{ABPI} = D$$

a base period average export income figure of zero. This loophole could result if income attribution rules are not considered with respect to incremental export income.

Losses should be allowed currently. Losses would also be allowed in computing the base period average export income in order to give the exporter the benefit of other parts of the Internal Revenue Code in addition to benefits under the proposal.

c. Deferral Limited to \$200,000

The incremental export income on which tax could be deferred would be limited to a maximum of \$200,000 over the life of the proposal. This ceiling on the deferral is similar to the credit ceiling imposed by the World Trade Credit proposal. The purpose of the ceiling in both proposals is to direct tax relief to the smaller or newer exporter and to avoid a windfall to large manufacturers which are already exporting. The deferral is in effect a loan to the exporter to enable him to overcome barriers to initial or increased exportation.¹⁰⁹ It is believed that the relative benefits of, and need for, the proposal are greater for smaller firms with fewer resources and limited credit. Only \$200,000 can be deferred, and the balance of export income will be taxed at normal rates even if this ceiling is reached in less than three years.

d. Payment of Tax Liability After Deferral

The tax on incremental export income is deferred for three years. The exporter must begin to repay the deferred tax liability three years following the year in which the tax was computed. The deferred tax liability will be determined in the year that export income is received or accrued at rates based on earnings in that year. After three years this amount of tax will be added to the tax due in that later year.

By deferring 100% of incremental export income the proposal is designed to "lure" small to medium sized firms into exporting in order to expand our exporter base as well as exports. The benefit of total deferral is tempered by the limited, three year term of this deferral. Because the deferral reduces the total tax liability of the manufacturer, without regard to future export earnings, the small exporter may conceive of the deferral as a loan to help offset added marketing start-up and penetration costs. This differs from

¹⁰⁹ See text accompanying note 11 *supra*.

the World Trade Credit proposal which would confer a permanent grant through the credit. It is hoped that the temporary deferral will stimulate long-range export marketing efforts. Once experienced in the market, smaller exporters will have overcome structural barriers to exporting and may be expected to continue to export to otherwise profitable markets after expiration of the deferral period.

Repayment would be in a lump sum or in installments for up to ten years, with interest for the period of deferral, and on the installments, if chosen. In order to make the plan attractive to the exporter other than as an alternative source of credit, the interest rate on installments should be set below the average market rate to smaller manufacturers. This reduced rate can be justified as a reflection of the reduced risk of default on amounts due as taxes, especially where the deferral is allowed only to the extent export sales are increasing.

Charging interest on payments for deferred tax serves two purposes. First, this avoids the argument that the United States is granting export assistance at a rate below the market, in view of the risk involved, which could be a violation of various parts of Article XVI of GATT. Second, interest payments will reduce the amount of revenue lost as a result of this proposal.

e. *Elective Tax Treatment of Export Development Expenditures*

Export development expenses are those sustained primarily to advance export sales.¹¹⁰ These will be treated under this proposal in the same manner as research and development expenditures under the present Internal Revenue Code.¹¹¹ Section 174 of the Code allows research and development expenditures to be deducted as expenses in the year which they are incurred,¹¹² or as deferred expenses chargeable to a capital account and later amortized.¹¹³

Export development expenditures are analogous to research and development expenses because, although they are incurred in

¹¹⁰ This proposal utilizes the same definition of export development expenditures as the World Trade Credit Proposal. For a more in-depth look at what constitutes export development expenditures, see *supra* note 91.

¹¹¹ I.R.C. § 174.

¹¹² I.R.C. § 174(a).

¹¹³ I.R.C. § 174(b)(1).

one year, they benefit following years as well, if new overseas markets are established. The initial cost of reaching an export market and developing product acceptance may generate sales in future years which can support gradual amortization. If, however, the product is not accepted overseas, development expenses may be advantageously deducted immediately. It is therefore believed that the exporter should have the option of deducting export development expenditures in the year incurred or capitalizing and amortizing these expenses over future years.

f. Program Limited to Five Years—“Sunset Provision”

This proposal includes a “sunset provision” which would terminate the plan after a five year period if it has not been renewed by Congress. Therefore, an exporter must begin to defer income within the five year period, inclusive of the year enacted. Upon expiration of a consecutive three year period following the first year of election, no additional income could be deferred. If this proposal were enacted in 1980 and a company did not elect deferral in that year, it could begin its three consecutive years of eligibility for deferrals in 1981, 1982, 1983, or 1984. Export income in years in which deferral was not elected would be included in the three year base period described earlier.

If the proposal was not renewed after 1984, the program would terminate. In five years, a reasonably sound assessment of the plan's effectiveness can be obtained to determine whether the plan should be continued. Interim evaluations should be developed by the Treasury Department and reported to Congress, as is presently done to analyze the effectiveness of DISC. If the reports by the Treasury are unfavorable, the plan would automatically terminate in 1984 unless extended in order to allow time for the development of modifications. The “sunset provision” of the proposal is designed to force a decisive review of policy and program effectiveness at a reasonable time in the future. Moreover, assessment and termination or modification of the proposal in five years may act as a stimulus upon the executive branch and foreign nations to engage in productive negotiations for the harmonization of world tax systems with respect to exports.

g. Emphasis on Negotiations for Removal of Foreign Tax Incentives

To combat the vast array of tax incentives granted by foreign

countries, this country must continue to recognize GATT obligations and press its claim that some foreign tax systems, especially those utilizing the territoriality principle, are violative of Article XVI(4) of GATT. This proposal would include a mandate to the Executive to enter tax harmonization negotiations. This constructive approach could develop a long-range means of achieving global trade on fair terms in the spirit of the GATT, as compared to the present situation where findings of tax imbalance by a GATT Working Party go formally unrecognized.

2. *Analysis of the Continued Deferral Proposal*

A statistical estimate of the cost of this proposal and its potential to increase exports is beyond the scope of this paper, but some general comparisons are possible. This proposal will involve some loss in tax revenues. The revenue loss, however, will be considerably less than the \$1 billion for DISC and \$400 million for the World Trade Credit. The cost will equal the present value differential between the current cost of money to the Treasury and the reduced interest rate levied on the payment of the deferred tax liability. Under this proposal, the deferred taxes will definitely be repaid, unlike the DISC, where deferral can be indefinite, or the World Trade Credit, where the credit permanently excludes an amount of export income from taxation. It seems clear even at this point, therefore, that the amount of revenue loss will be reduced.

On the other side of the balance — maximization of exports — this proposal is directed specifically at newer or smaller companies. This increase may be less than the increase originally attributable to DISC, but the cost of the increase, in terms of revenue loss, will be much smaller than under the DISC. Of at least equal significance is the potential of this proposal to stimulate the exporter base of smaller firms at less cost than the World Trade Credit.

The proposal is dangerously close to being a violation of GATT Article XVI. It would eliminate the DISC and with it the argument that DISC, in effect, grants a permanent deferral which amounts to a tax exemption specifically proscribed by the GATT Working Panel.¹¹⁴ The present proposal permits deferral for the definite term of three years, then the exporter must begin to repay the deferred taxes. Also, interest accrues on the deferred

¹¹⁴ See *supra* note 82.

taxes, which diminishes the objection that deferral amounts to an interest-free loan.

There is a remaining argument that the exporter receives some economic benefit calculated with respect to exports through the present value differential during deferral. This suggests an abatement or partial exemption proscribed by GATT. A GATT Panel could find that this proposal exceeds the line of legality under the GATT. Yet this proposal is probably more defensible than either DISC or the World Trade Credit. For this reason, the proposal represents a superior position from which to bargain for a new subsidies code or consider countervailing measures.

The final concern is tax simplification. Although more simple than DISC, this proposal is more difficult than the World Trade Credit. The deferral concept central to the DISC legislation is utilized in the proposal, but exporters get the deferral without having to form a separate corporation. The proposal will reduce the exporter's paperwork and legal costs. Unlike DISC, exporters would not have to continue to invest in qualified export assets¹¹⁵ in order to retain export incentives. Because the deferral is calculated using net export income from sales, the exporter computes net income from export sales using the regular costs of production.

The World Trade Credit is simpler than the continued deferral concept. This results from the ease with which any credit can be computed in comparison to deferral which may involve a number of years with varying total income. It may be easier for businesses to readily appreciate the immediate benefits of a credit. The continued deferral proposal requires computation of moving average base period export income, and determination of deferral repayments using installment payback if elected. Both the World Trade Credit and the proposal present the common factual difficulty of segregating indirect export development costs. On the whole, it seems that the World Trade Credit would be more simple to use than the continued deferral proposal.

VIII. CONCLUSION

As the United States' trade deficit continues to grow and the value of the dollar declines in relation to foreign currencies, the world will closely observe this country's efforts at corrective mea-

¹¹⁵ *Supra* note 33.

asures. There are a number of proposed remedies. Some advocate focusing attention on increasing exports; while others suggest that this country should strive to alleviate the problem of rapidly increasing imports.

With the enactment of the DISC, the Congress determined that our tax policy would be to increase exports by utilizing an export incentive as a partial solution to the trade imbalance. The uncertain effectiveness of DISC and the incumbent loss of revenue from the program have created a situation where an alternative tax incentive now appears necessary.

Any tax incentive to exportation must be efficient as a matter of domestic policy, and fair as a matter of foreign policy. This Note has examined the present export incentive—the DISC, and a new proposal, the World Trade Credit—with these two objectives in mind. From this examination a proposal has been developed which better meets these objectives. The proposal would reduce the revenue loss of incentives and refocus incentives to increase the exporter base of the United States by encouraging smaller firms to attempt exporting. It is hoped that the analysis and proposal of this Note will generate additional thought concerning the role of tax incentives in the master objective of a coordinated national export policy.

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